Session 3
FDI Policy, Advantages and Points at Issue

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FDI in Hungary: Past Patterns and Future Challanges

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1. Introduction

Hungary used to be called a success story of FDI among transition economies. This country attracted the most capital for years, and foreign penetration of the economy was among the highest in international comparisons. Modernization of the Hungarian economy after 1989 was largely attributed to the activity of foreign investment enterprises (FIEs).

However, the share of Hungary in inward FDI has declined during the past few years. High penetration ratios raised questions of economic security since FDI is heavily concentrated on a few businesses, and even to some degree on a handsome of multinational enterprises. The expected beneficial spillover effects of FDI on the non-FIE controlled part of the economy did not surpass an initial stage until recently. Also,some disadvantageous (or at least unexpected) macroeconomic effects occurred that required special attention. Massive transfers of income both direct and hidden produced a negative net in the current account in 1998.

Thus, both positive and negative impacts of FDI could be observed in Hungary. Though observers and most policy-makers continuously expect a strong positive overall balance of the different effects of FDI, it is time to think about how positive effects can be increased and negative side-effects neutralized.

This paper first highlights some basic features of the FDI process in Hungary, and compares with some other transition economies. Then we concentrate on three topical issues that call for special attention: FDI promotion in the light of the approaching joining the European Union, FDI and regional development and capital flows' effects on the current account.

2. Patterns of FDI in Hungary

During the first half of the 1990s Hungary attracted the most foreign investments in Central and Eastern Europe (CEE). Yearly inflows of capital varied between USD 2-4,5 bn, and the total stock reached USD 20 bn. (with reinvested profits not included). Changes in inflows and stock are illustrated by Table 1.

FDI in Hungary (capital transfers through the banking sector)

	1995	1996	1997	1998	1999
Inflow	4453	2275	2173	2037	1944
Stock	12829	14961	16086	18517	19276

Table 1

Source: National Bank of Hungary

As it is seen from Table 1. FDI has a slightly decreasing trend. This tendency has its known reasons. First, this is because privatization was principally finished in Hungary. Hungarian privatization policy favored foreign investors mainly because of their quick cash transfers to the state budget, but also because of the expected modernization activity launched by foreigners in the acquired facilities. There is plenty of evidence for strong modernization efforts including substantial additional investments (another source of FDI inflows). Privatization and immediate modernization efforts were successfully finished, therefore the two most important sources of inward FDI dried up. The still continuing flow of FDI has to be attributed to greenfield investments and the expansion of already existing FIEs. Both are signs of continuing investor confidence. We may also risk the statement, that this is also a sign of growing international integration of the Hungarian economy.

With somewhat declining share in inward FDI in CEE Hungary still leads the list of the relative importance of FDI. Per capita FDI is still highest in the region, the Czech Republic, Estonia and Latvia are very close. These countries also provided good opportunities for FDI in the first or second tire of their privatization process. Poland also attracted huge amounts of mainly greenfield investments (a stock twice as high as Hungary), but this country is four times bigger. Slovenian sock of FDI also contains privatized firms, but even more greenfield investments (joint ventures). These figures are introduced on Chart 1.

Per capita FDI stock (USD)

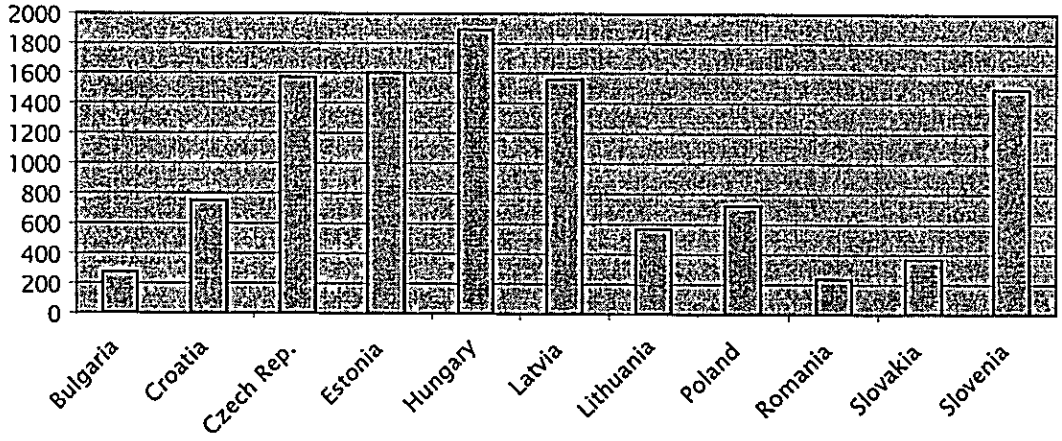


Chart 1

Source: www.bcemag.com/statsdb

FIEs took very important positions in the Hungarian economy. Chart 2. illustrates how widespread foreign penetration was in 1997 (more details for manufacturing are attached in the Annex). The higher added value and lower employment figures reflect both higher efficiency of FIEs and their concentration in more efficient branches (higher labor productivity). FIE penetration in Hungary is the highest in CEE. The high level of penetration certainly calls for measurable positive effects. A series of studies (partly empirical) indicated that the beneficial modernization effects were spotted in the companies in foreign ownership.

FIEs played a decisive role in structural changes of the economy, especially in the recovery of engineering industry and electronics. Both of these branches underwent heavy shrinking. For example Hungarian electronics industry's output was hardly measurable in the industrial statistics in 1992-4 and became the third strongest industrial branch by 1998. The development of automotive industry was even more spectacular. From almost nil in 1989 it became the strongest manufacturing branch in ten years time.

% share of FIEs in Hungarian economy, 1997

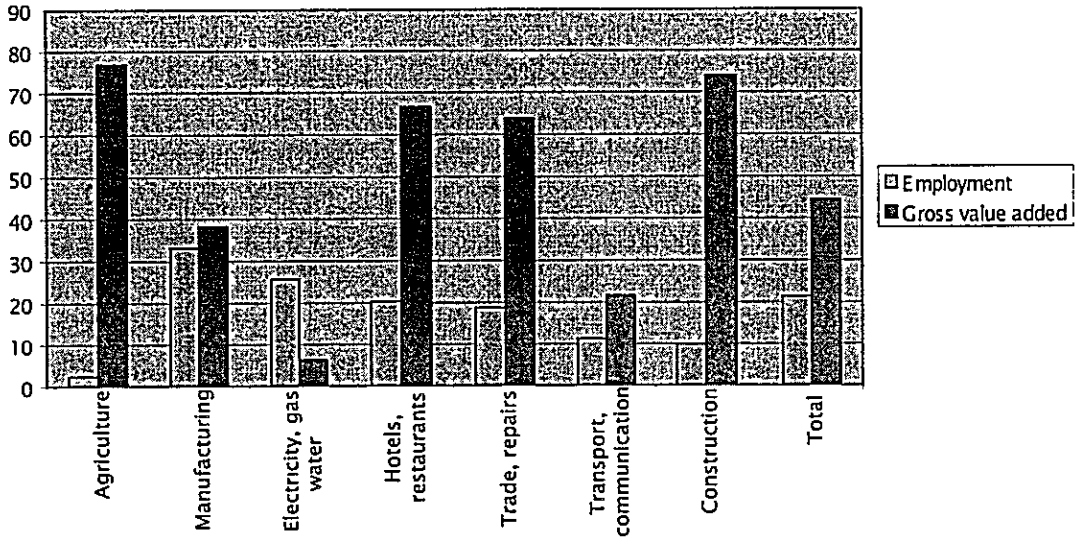


Chart 2

Source: CSO

3. FDI-related future policy challenges

3.1. FDI promotion – the role of customs-free areas

The first issue to be discussed here derives straight from the above observation of slightly declining yearly inward FDI in Hungary. An FDI-based modernization policy must continuously maintain favorable investment climate that attracts FDI. The accumulated during the past ten years experience with FDI indicates that the most important incentives of any kind of investments are economic and political stability. Transition economies that can not provide stability, as well as a minimum level of institutional changes are not competitive in the attraction of FDI. As soon as these conditions are fulfilled more targeted incentives may play a role.

Among targeted incentives currently in use in Hungary the most important ones promote investments with considerable export potential, investments in high tech branches and the ones deployed in crisis areas with substantial job-creating effect. R and D facilities and activities are also supported. There is a relatively high threshold level for qualification, thus it is mainly the large multinational enterprise that can make use of them.

There is a different small business promotion system too. Besides the publicly announced competitive incentive schemes custom-tailored supports are not very rare either. Local communities and investment promotion agencies provide further substantial support usually in the form of local infrastructure development.

Meanwhile the use of the above incentive tools is usual internationally, there is another important measure that is not so common in other countries. Hungarian regulation of industrial free trade zones is rather unique, and provides a rather important impetus for investments[1]. Almost unique in the world is that in Hungary each company may establish its own customs-free zone anywhere (there are no geographically separated locations), if it meets the requirements of foundation The creation of customs-free zone is allowed by the Customs and Excise Office. A customs-free zone is a separated part of the customs zone, and is qualified as foreign territory as far as customs-, foreign exchange and foreign trade regulations are concerned. The border of customs-free zone is considered to be the border of customs as for customs control, i.e. goods may be moved in or out from the customs-free zone only with the knowledge of customs office and only if customs control can be carried out. Products with the exception of building material subject to duty otherwise are duty-free here.

According to legal regulations customs-free zones were allowed to be founded by foreign and domestic investors in Hungary from 1982. The Hungarian Government aimed primarily the attraction of FDI at that time already. The number of customs-free zones and their economic importance started to grow from the end of the eighties. In 1989 70, in 1990 118, in 1991 144, in 1992 about 200 customs-free zones were registered. From 1995, as the new customs law came into force the number of customs-free zones declined, the customs-free zone licence was withdrawn from those not meeting the requirements. From the second half of the nineties the number of customs-free zones began to increase again, mainly the suppliers of multinational companies operating already in Hungary invested in this form. In 1997 89, in 1998 109 in 1999 116 industrial customs-free zones had licence. The number of really productive customs-free zones was 101. The customs-free zones were operated by about 70 companies, as a company -like Philips, Videoton, Flextronics Group - may posses of more customs-free zones.

The activity of customs-free zones is strongly concentrated from more points of view as well. About 70 percent of them were engaged with production of parts, components and finished goods of telecommunication, electronics, informatics and car industry and engineering goods. 15 percent produced textile, clothing and shoes articles, so these 4 areas of activity covered 85 percent of customs-free zones similarly to customs-free and special zones all over the world. In the last years share of telecommunication, electronic, informatics and car industrial goods has increased unambiguously, textile and clothing industry have stagnated, while the number of customs-free zones carrying out other activities has fallen.

The number of employees by customs-free zone companies increased by 2.5 times between 1996 and 1999, and totaled 53.8 thousand people at the end of last year. This is about 6 percent of employees in manufacturing industry, while 28.2 percent of gross production value added of manufacturing industry_was produced by customs-free zone companies. Also their role in employment was greater than registered in the statistics if connecting services (transfer, maintenance, real estate utilization) and suppliers are taken into consideration as well. The role of customs-free zones played in our economy can be described by foreign trade figures the best: the share of customs-free zones in Hungarian export increased from 18 to 43 percent between 1996 and 1999 in import from 14 to 30 percent.

[1] The section about industrial free trade zones was prepared with the use of the paper of Katalin Antalóczy. FDI policy and incentives in Hungary at the end of the nineties. mimeo.

In the last five years the circle of companies operating in this form made our export and import dynamic, had a decisive impact on the transition of commodity structure of foreign trade - for the illustration of this the share of machinery goods increased from 36 to 57 percent - and influenced the regional structure of our export and import significantly. Customs-free zone companies have improved the foreign trade balance continuously and to a growing extent: in 1996 by USD 318 million, in 1998 by 1.8 bn, in 1999 by 2 bn already. Of course export is concentrated significantly as well. In 1999 35 percent of export was exported by the first ten Hungarian exporters, the first six of which are customs-free zone companies and from the ten only two operate as domestic companies. Customs-free zone companies - mainly subsidiaries of multinational companies - contributed to the microintegration of the Hungarian economy to the European Union (93 percent of customs-free zone export aims at developed countries, within that mainly at European Union), in broader sense to its connection to globalization and to its integration to the world economy.

The share of industrial free trade zones in Hungarian foreign trade (%)

	1996	1997	1998	1999	2000. I-III.
Export	18,1	26,2	36,0	43,0	43,7
Import	13,9	19,8	25,2	30,6	27,7

Table 2

Source: Ministry of Economic Affairs

The system of FDI incentives in the narrow sense currently applied in Hungary corresponds with the requirements of international organizations and fits by and large the legal system of the European Union as well. Therefore no major change in the promotion system is expected: without doubt the application system remains in place, within which - according to the practice of the European Union - regional elements will gain importance. Among FDI incentives of Hungary it was only the possibilities of investing in customs-free zones that was declared as non EU-conform by the Union. In fact the customs-free zones' regulation is largely identical and only to a smaller extent different from EU norms.

Identical rules in the EU and in Hungary:

- Customs free area is part of the customs area that can be declared as separated from this by a licence issued by the entitled authority. Declaration to customs free area can be applied by anyone under the effect of customs regulations. Besides the declaration for customs-free area also the activity carried out on the customs-free zone is to be licensed (production, storing, trade, services).
- Customs-free area enjoys a special status and is regarded as abroad from the point of view of customs- foreign exchange and trade regulations. Products delivered to customs-free areas (in the EU non EU products)are free of customs if they are stored or are processed directly in the area. Customs levy has to be paid both in Hungary and in the EU for building materials and maintenance, as well as for products consumed out of processing.
- Both regulations require the physical separation of customs area and customs-free area in order to secure customs control. The entry of the customs-free area functions as customs border and is controlled by the customs office. Processing and storing can be carried out on customs -free areas. Customs-free area production for exports (mainly from non EU inputs) can be licensed.

Differing regulations of the European Union and Hungary

- The location of customs-free zones in Hungary is spatially not concentrated, since according to the regulation as many customs-free zones can be created as it is applied for by companies and permitted by authorities. In the EU in turn it is the national governments who centrally locate customs-free zones for which several economic agents may apply for activity licence. Hungarian customs-free areas correspond rather to EU's customs-free warehouses.
- Production equipment can be delivered to the customs free area customs free in Hungary which is in principle not the case with EU regulation. This is the single important, broad exemption in Hungarian regulation compared to the EU's.
- Owners of customs-free areas in Hungary must deposit customs guarantee that is to strengthen the security of customs control. This piece of regulation is more rigorous, than in the European Union. Different - and more rigorous than in the EU- is the registration and documentation requirement of product movements in Hungary. In the EU it is only the shipping bill or any other shipment document that should be registered and no customs declaration is to be made when entering the customs-free area. It is the stock list of the company running the customs-free area or warehouse that provides data for customs control. In Hungary every move of products in and out of the customs-free area must be registered in customs documents (or in/out storing document) that are to be given the customs office. The up-to-date control is secured this way.
- Hungarian customs regulation does not consider production on customs-free areas as business purpose customs procedure (though according to EU practice customs office may consider cases based on economic conditions involving the corresponding ministries). Thus, the terms of active processing and production with customs supervision as well as their permission are absent from the Hungarian regulation. But the more rigorous than in the European Union registration requirements of product movements in customs-free areas provides an up-to date control of the Customs Authority.

Share of industrial free trade zones in Hungarian foreign trade

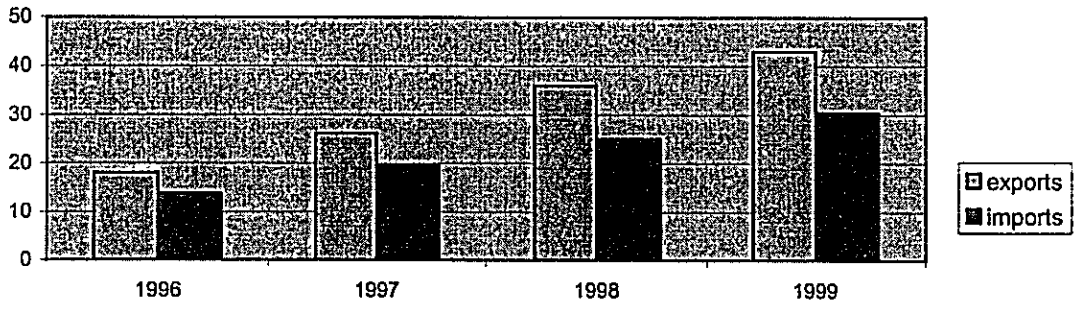


Chart 3

Source: Ministry of Economic Affairs

- Summing up one may declare that it is only the customs-free delivery of production equipment that differs fundamentally in Hungarian and in EU customs-free regulations.Other differences are partly ostensible (The Hungarian category of customs-free area corresponds to EU's customs-free warehouse), partly Hungarian regulation is more rigorous. The Hungarian government declared that before becoming a member of the European Union no change of the current regulation is foreseen and investors qualifying for the requirements continuously receive licenses of customs-free areas. Benefits enjoyed until now (production equipment's customs- and VAT exemption) will not be paid back afterwards.

3.2. Impacts of FDI on national accounts

Capital flows have a crucial role in shaping the national accounts. This became more evident with the 1998 Mexican and Russian monetary crises, that also affected Hungarian balances. In 1998 Hungary's current account deficit deteriorated by USD 1,3 bn and amounted to USD 2,3 bn or almost 5 % of the GDP. In 1999 the deficit was up again with USD 2,1 bn. The deterioration of the current account was rather unexpected, since after the successful 1995 stabilization program GDP continuously grew, exports almost doubled, and economic conditions improved. In the shadow of the international monetary crisis serious concerns raised as for the reasons of the deficit. Populist voices blamed foreign capital that withdrew from Hungary and also repatriated substantial profits.

Some new features of the current account supported this view. There was a huge increase in repatriated incomes of FIEs. According to the general opinion expenditures on business and other services also served as a hidden tool of profit repatriation, and the net of this type of transfers was also negative. Net outflow of incomes open and covert amounted to USD 1,5 bn. This was only partially compensated by net inflow of FDI that covered only 42 % of the current account deficit. Inward FDI shrank substantially, meanwhile outward FDI increased. Net inflow of FDI suddenly ceased to cover deficits of the trade balance and income balance. This was rather unusual in 1998 in Hungary, since economic policy during the transition years always gave this balancing role to FDI: this was one of the main reasons of preferring foreign investors in the privatization process.

The first neutral explanations of the new phenomenon stressed the changing behavior pattern of FIEs. These, after a not very long period of establishment and reorganization (in the case of privatization deals) started full scale production, reduced opening large scale investments and started to generate profits. It was, of course, a crucial task of investment promotion to stimulate reinvesting of profits. This proved to be, however, much more difficult than to sell state assets or to ignite first investment decisions. With inward FDI stagnating, outward FDI growing and increasing profit transfers the pattern of Hungarian FDI entered a new phase of established business. This meant, that new patterns of capital and income flows were to be expected on the longer run too. The current account balancing role of net FDI inflow could not be maintained any more.

In order to better understand what happened we calculated the cumulative role of FDI related capital and income flows. This is introduced on Chart 4. Obviously enough, there was no fundamental change of patterns in 1998. Inward FDI was still around USD 2 bn (same amount for 4 subsequent years) business and technical services also amounted roughly USD 2 bn[2].

[2] We did not calculate the net FDI inflow and net expenditures, since this net amalgamates actions taken by Hungarian capital owners abroad, and foreigners' in Hungary. What we tried all over this study was a clear separation of foreign capital owners' actions from nettings. Thus, incomes from services conducted by Hungarians abroad are not deducted from the services account.

This amount should contain among others hidden profit transfers. What is important for us here is that there was no sudden increase in services payments towards abroad, regardless of the real content of these payments (e.i. if and how much profit was transferred through this way). The only change was in the increase of FDI-related income transfers, though compared to the volume of the other two elements of the capital flows this change was not dramatic either[3]

Capital flows associated with FDI in Hungary (mn USD)

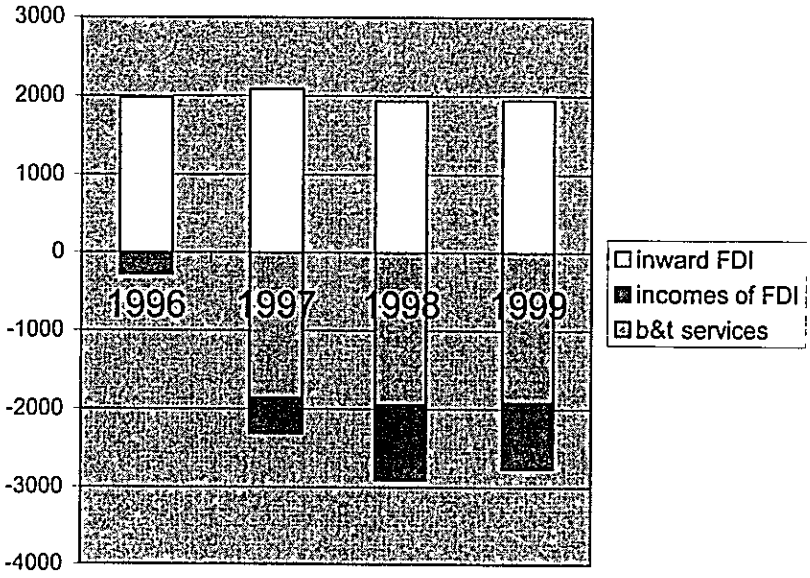


Chart 4

Source: National Bank of Hungary, own calculations

This stress on this feature should, of course, not query the importance of growing profit transfers and the role of these in passivating the current account. What is argued here is that the negative net of FDI-related capital and income flows in 1998 was not a sudden and exceptional case. Moreover we would like to emphasize that macroeconomic balances of modern, integrated in the world economy economies usually rely on an interplay of capital and income flows of domestic and foreign capital owners. Hungarian capital owners' income flows from abroad may have an important balancing effect. The 1998 deterioration of the current account was at least as much a consequence of Hungarian capital owners' practices as of foreign ones.

Still, growing volumes of inward and outward capital and income transfers pose a potential threat for macroeconomic stability. Higher risks may require more advanced tools of monetary policy. This means not only an appropriate FDI promotion system, but also an adequate use of conventional monetary policy tools.

[3] For 1996 no separated business and technical services account was available, therefore Chart 4 Does not contain this data. We may assume, however, that this amount was also in line with the trends, and must have amounted to USD 1,7-1,8 bn.

In order to demonstrate the relative importance of the three types of capital investments and the related flows, we separated from the net figures the volumes of foreign capital owners' transactions.

Thus, we calculated capital flows that could be attributed to foreigners' direct investments, portfolio investments and bank deposits. We calculated the nets of the capital and income flows of inward FDI, already introduced in Chart 4. We calculated the net of the change of the stock of foreign held portfolio investments (net in- or outflow) and transfers of incomes generated by foreign held portfolio. Similarly, we introduced the net of foreign held bank deposits and their income transfers. The three nets are cumulated in Chart 5.

Chart 5. shows most interesting changes in the patterns of foreign investments in Hungary. There was a clear improving trend between 1996 and 1999. The large negative contribution of changes in foreign held assets in 1996 improved very significantly in the subsequent years and turned to positive in 1999. Biggest changes were observed in the net portfolio and net bank deposit situation. Outflows of deposits and income transfers in 1996 generated a negative balance of USD 2,6 bn. It was the decline of the portfolio stock and continuous portfolio profit transfers that took the lead in the 1997 accumulation of negative impacts. The outflow of bank deposits slowed down in that year. The behavior of portfolio investors and bank depositors changed in 1999 when the net of both of these investment types was positive.

We do not want to go into detailed analysis of the reasons why the short-term investment climate improved so much. Traditional policy tools like interest rate policy may have had a role here, as well as economic growth and good business perspectives. What is important from our point of view is the fact, that changes in the behavior of short-term investors determined the current account and the capital account to a much larger degree, than foreign direct investments.

Capital flows associated with different types of investment in Hungary (mn USD)

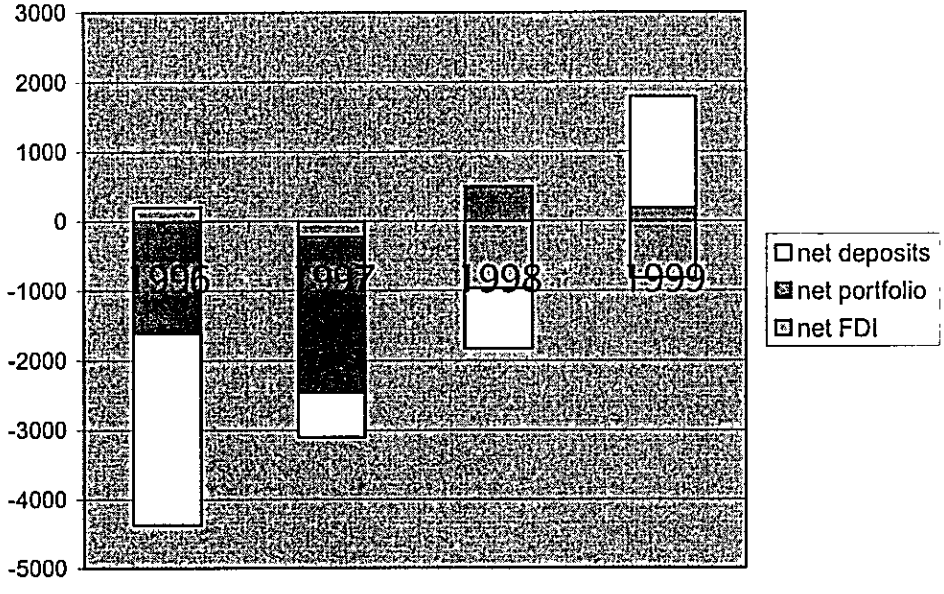


Chart 5

Source: National Bank of Hungary, own calculations

Changing patterns of FDI's role can be seen from Chart 5 as well. Yet, the relative importance of these changes was much smaller, than in the case of the other two types of investments. Moreover, the impact of FDI-related capital flows showed more clear trends and proved to be less volatile posing less difficulties in macroeconomic calculations and prognoses.

Summing up FDI increases vulnerability of the macroeconomic balances much less, than other capital outlays. Though, there is a clear change in the behavior of FIEs that started the realization of their profits. Investment promotion should therefore increase efforts at stimulating profit reinvestment. There is also an urgent need of reconsideration FDI's role as a main tool of improving the current account position.

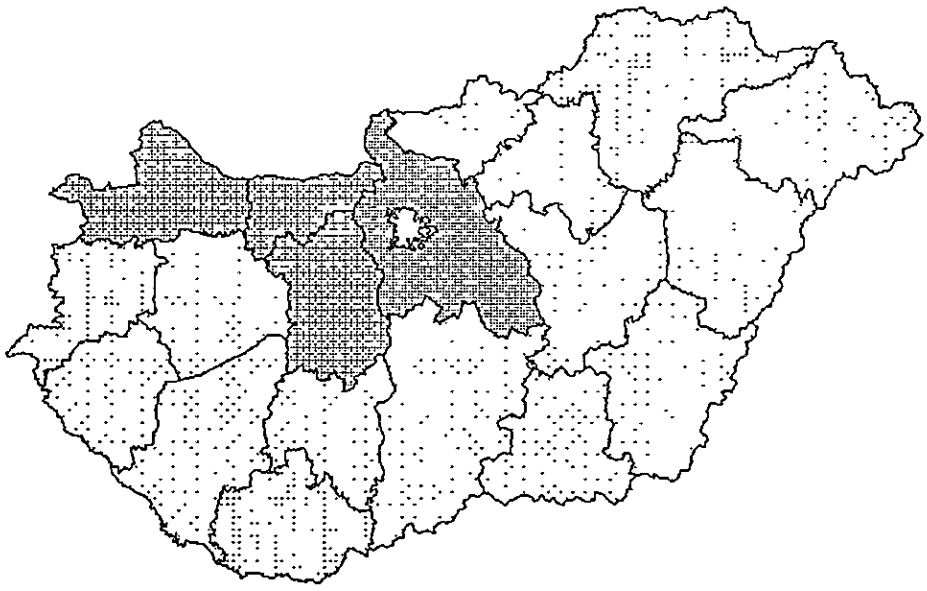
3.3. Regional development and FDI

The third issue that we discuss in this paper relates to the modernization role of FDI. As it was argued FIEs contributed to a large extent to the structural changes and microeconomic modernization of the Hungarian economy. However, this role was rather concentrated. As far as the above mentioned structural changes in manufacturing are concerned, electronics and automotive business is largely concentrated on the activity of 3-6 large multinational enterprises and their traditional suppliers, who also settled in Hungary. In the spatial choice of these large investors agglomeration effect played a crucial role. They usually relied on the valuable sources inherited from the previous economic system. Most important role was played by the trained and experienced labor force, that was concentrated in large socialist enterprises. The spatially concentrated stock of high quality and relatively inexpensive labor largely determined premise selection choices.

Agglomeration effects were strengthened by the fact that socialist industrialization projects also established training and education facilities, sometimes even research background for the large enterprises. These are now also very valuable sources of competitive strength, and are concentrated likewise. The problem of the spatial limits of modernization impacts emerges here. The settlement of FIE's showed a very clear geographical concentration mainly in Budapest, the capital city, and on the north-western part of Hungary. Since the above mentioned inherited valuable human resources were not strongly concentrated in these areas earlier analyses of spatial distribution of FDI stressed rather the advantages of close geographical location to the parent company's other premises. Relative closeness provided a good opportunity of integrating Hungarian facilities into close international co-operation networks (e.g. just-in-time production systems). The most important condition for such co-operation was adequate travel-, transport-, and communications infrastructure. These facilities were to a large degree already established in the mentioned region already by the early 1990's. As a result of the combined effect of these factors rather strong geographical concentration of FDI was observed in 1994 (see Map 1.).

Infrastructure networks were quickly developed during the 1990's in Hungary. Among the nation-wide networks it was the mobile phone system that developed most quickly, but the wired telephone system was also vastly improved. Relatively less development was achieved in the transport system, although the achieved limited advance might have influenced FDI flows to some extent. Few hundred km new motorway was built towards the Southern and Eastern part of the country, and an important section of the Budapest surrounding motorway was also opened. Local infrastructure systems were also largely improved, especially drainage and water supply and the electric supply. Local governments' important tool of luring FDI to localities was the free establishment of full infrastructure networks for industrial premises.

Hungary 1994



Map 1

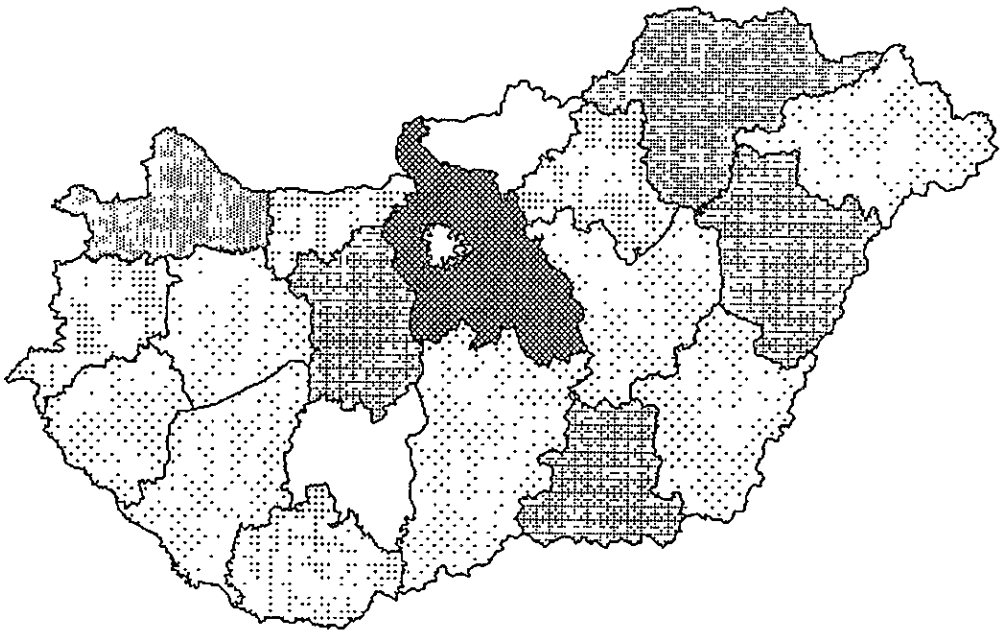
Source: CSO

Infrastructure developments made accessible geographically further lying premises with their valuable production inputs (labor, R & D facilities, higher education centers). Another important change was the relative saturation of the traditional locations with FIE's. In certain areas there was a shortage of qualified labor, that induced labor migration within Hungary, but also from Slovakia. Better access to the East and South-East of Budapest increased the utilization of these areas by FIEs by 1998. Map 2. Does not show a dramatic shift towards these directions, but the earlier strong concentration was eased. Table 4. In the Appendix contains more data on this topic.

It is perhaps too early to make a strong statement, but with some reservation we may say that the settlement of FDI is most likely in areas where there is an important factor of production that matters in increasing investors' competitive strength (labor, educational background), which can be reliably reached. It is most likely besides the capital city the biggest and most important towns, with sizeable educational and R & D background that provides a big enough pool of labor force both qualitatively and quantitatively. Not all candidate towns showed remarkable improvements between 1994 and 1998. Investments in the South-Western part of Hungary did not develop quickly. In our view this was mainly due to the lack of a motorway here. Other locations, even in the once so popular North-Eastern part of Hungary, lost importance, mainly because of the lack or relative distance from the labor and educational hot-spots.

This view of the likely future development pattern of FDI would mean a repeat of the earlier, pre-transition patterns of regional development. There is some evidence that this already happens. This would then also mean that some of the same regional problems typical for socialism remain or reemerge. We are rather skeptic if FDI can be used as a tool of regional development policy. But if nothing more than a restoration of the relative development levels would happen with the help of FIEs, this would already mean an improvement compared to the current situation. We see a chance of easing the current disproportion but only in the development hot-spots.

Hungary 1994



Map 2

Source: CSO

4. Appendix

Share of foreign investment enterprises (1998, in percentages)

	Sector	no.of organi-sations	no.of emplo-yees	value-added	invest-ments	Net sales revenue	export sales
15	Food and beverages	12.93	40.26	57.11	60.46	55.71	66.98
16	Tobacco	62.50	87.87	96.24	96.88	95.71	100.0
17	Textiles	15.44	38.32	60.24	73.58	55.93	72.06
18	Wearing apparel, dressing	11.51	32.88	46.55	66.22	47.20	60.23
19	Tanning and dressing of leather	20.39	47.77	57.83	75.68	57.28	77.12
20	Wood	9.74	23 04	46.33	50.00	45.50	69.38
21	Paper and paper products	13.67	55.81	79.79	92.86	77.58	85.84
22	Publishing, printing	6.90	21.14	36.18	47.50	40.53	31.11
23	Coke and petroleum	25.00	99.91	100.00	100.00	99.97	100.0
24	Chemicals	21.94	72.32	88.93	93.33	83.62	92.38
25	Rubber and plastic	15.16	40.96	55.14	51.59	51.68	64.92
26	Other non-metallic minerals	15.28	50.49	71.44	78.29	70.18	81.26
27	Basic metals	15.87	36.64	45.19	68.32	47.66	59.40
28	Fabricated metals	10.55	30.84	40.93	54.66	39.06	62.52
29	Machinery and equipment n.e.c.	12.58	42.23	48.70	67.84	52.57	76.09
30	Office machinery	12.64	77.33	96.64	94.41	95.80	99.86
31	Electrical machinery and app.	13.01	66.81	80.71	92.33	79.91	92.74
32	Radio, TV sets	12.20	46.42	66.40	63.31	82.80	87.03
33	Medical, precision, opt. Instruments	11.10	35.06	44.29	68.00	40.60	57.14
34	Motor vehicles, trailers	28.90	79.13	95.09	98.36	96.85	99.12
35	Other transport equipment	13.36	35.99	38.06	64.71	48.62	79.06
36	Furniture, manufacturing n.e.c.	9.01	25.72	35.33	58.73	32.99	56.47
37	Recycling	12.18	29.72	22.22	16.67	31.63	85.53
D	Manufacturing	11.76	44.88	69.29	78.65	70.01	85.86

Table 3

Source: calculations based on Central Statistical Office data

Regional distribution of the stock of FDI by counties (% of total stock)

Name of the county	1994	1998	Direction of change
Baranya	1,6	1,8	-
Fejér	3,2	3,0	-
Győr-Moson-Sopron	3,3	5,7	++
Komárom-Esztergom	2,9	2,0	--
Somogy	0,9	0,8	-
Tolna	0,5	0,3	-
Vas	2,2	2,1	-
Veszprém	1,2	1,1	-
Zala	1,2	1,2	0
Bács-Kiskún	1,3	0,9	-
Békés	1,1	0,9	-
Csanád-Csongrád	0,8	2,7	++
Hajdú-Bihar	1,6	2,8	++
Jász-Nagykún-Szolnok	1,1	0,9	-
Pest	5,2	9,3	++
Szabolcs-Szatmár	1,0	0,6	--
Borsod-Abaúj-Zemplén	1,9	5,0	++
Heves	1,0	1,9	++
Nógrád	0,7	0,4	--
Budapest	67,4	56,5	--

Table 4

Source: CSO data, own calculations

The Most Important factors which encourage foreign investors to engage in usiness in Poland

Mr. Adam Pawlowicz, Poland
President
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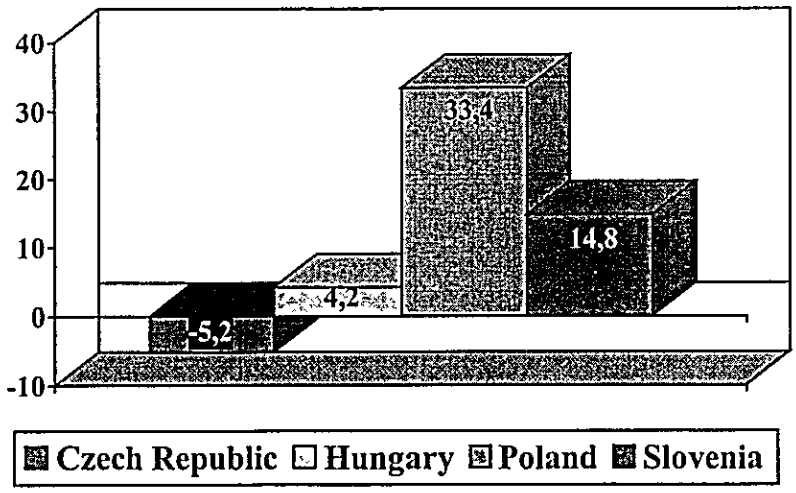
1. Preface

The most important factors which encourage foreign investors to engage in business in Poland include: successful economic transformation, stable economic policy and a high growth of GDP. Poland's membership in OECD, NATO, as well as a consequent approach to European Union and European Monetary Union (EMU) are factors of a great importance. The elements mentioned above contribute the market economy performance, which increases foreign investors' interest in Polish market.

Cumulative growth of GDP 1991-1999. Central Statistical Office



Graph 1

2. The state of direct foreign investments in Poland in June 2000

It follows from data compiled by PAIZ (Polish Agency for Foreign Investment) that USD 3.7 billion have been invested in Poland by foreign companies in the first half of 2000. Direct foreign investments exceeding one million USD each have reached the figure of USD 38.9 billion by June 2000. Investment inputs of below one million USD are estimated at USD 4.1 billion. Total foreign capital invested in Poland so far has exceeded the value of USD 43 billion.

Almost 90% of all direct foreign investments came to Poland from OECD countries (USD 34.6 billion). Investors from the European Union countries have so far invested USD 24.7 billion, that is 63.6% of all investments with the participation of foreign capital in this country. Investors from North America have invested USD 6.6 billion (17,1%), while USD 2 billion (5,7%) was invested by Asian countries.

3. The number of companies on the List of Major Foreign Investors in Poland

In the first half of 2000, the List of Major Foreign Investors in Poland covered 840 companies from 35 countries. 45 of the companies have been registered on the list for the first time. During the past seven years, the number of entities with the participation of foreign capital monitored by PAIZ has been growing rapidly. Suffice to say that the first List of Major Foreign Investors published by PAIZ back in 1993 registered 193 companies, which invested more than USD one million each. The number of such companies increased to 362 in 1995, 585 in 1997 and up to 799 in December 1999.

The largest group of investors (189 in all) has come from Germany, the second (128) from the United States, the third (70) from France, followed by Italy (67 companies) and the Netherlands (58).

3.1. The volume of direct foreign investments by country of origin

During the first half of this year Germany, the heretofore leader with respect to the volume of direct investment outlays in Poland, has lost its position to the Americans who have invested a total of USD 6.4 billion. That figure has pushed the Americans to the top in the ranking of major foreign investors by country of origin. German investments in Poland amount to 6.2 billion.

France occupies the third place in the ranking with total capital of USD 4.1 billion. The fourth place belongs to Dutch investors who have invested USD 3.7 billion by now. Italian investment outlays of USD 3.3 billion rank fifth. Direct foreign investments from Great Britain have reached the value of USD 2.6 billion. International corporations, which occupy the seventh place on the ranking list, have invested USD 2.6 billion in Poland so far. The eighth place on the list belongs to Korean investors (USD 1.6 billion), the ninth to Sweden (USD 1.3 billion). The last among the top ten is Russia (more then USD 1.2 billion). The position of other countries in the ranking is shown on the table below.

Foreign Direct Investment in Poland – country breakdown (at the first half of 2000)

NO.	Country of origin	Capital invested (millions of USD)	Planned investment (millions of USD)	Number of investors
1	USA	6396,5	2648,1	128
2	Germany	6234,4	2277,5	189
3	France	4091,1	1614	70
4	Netherlands	3714,7	692,8	58
5	Italy	3273,8	607,0	67
6	Great Britain	2646,1	259,0	36
7	International	2617,6	401,9	20
8	Korea	1617,4	658,5	5
9	Sweden	1302	610,8	48
10	Russia	1249,5	338,5	2
11	Ireland	813,7	100,0	3
12	Austria	770,4	214,5	34
13	Switzerland	709,8	317,1	16
14	Denmark	537,1	47,5	30
15	Belgium	469,8	299,1	23
16	Japan	361,6	137	12
17	Norway	350,3	148,2	15
18	Portugal	319,5	323,5	4
19	Spain	296,1	0	7
20	Finland	258	63,0	20
21	Canada	255,3	36,5	21
22	Croatia	173	16,0	2
23	Turkey	100,1	58,0	4
24	Israel	83,4	20,0	5
25	Australia	68	22,0	3
26	Czech Republic	51,2	0	4
27	China	45	45,0	2
28	Lichtenstein	29,5	12,0	3
29	RSA	25	40,0	1
30	Luxemburg	11,6	0	2
31	Malaysia	10,7	2,2	1
32	Cyprus	7,2	6,5	2
33	Slovenia	6	50,0	1
34	Taiwan	5,7	200,0	1
35	Greece	1,5	4,0	1
Total value of FDI over 1 mln USD		**38,902.5**	**12,270.2**	**840**
Estimated value of FDI below 1 mln USD		**4,1148**		
Total FDI in Poland		**43,017.3**		

Table 1

3.2. Direct foreign investments in Poland by national economy sectors

The analysis of the by-branch pattern of direct foreign investments in recent years reflects that foreign capital has now been present in many sectors and that this tendency to diversify is continuing. Most of the direct investments in Poland have been made in the traditional sectors of the national economy and primarily so in the manufacturing sector. The manufacturing sector has attracted the greatest interest of foreign investors and absorbed the highest investment outlays.

The development dynamics of the manufacturing sector has been stable, but it is significant that the share of that sector in the accumulated value of direct investments compared to previous years has been gradually declining. In 1997 the percentage share of that sector in overall investments amounted to 62.4%, in 1998 to 58.3 %, in 1999 49.2%, and in June 2000 to just 46.7%.

This has been a positive trend as it indicates a gradual shift in investment outlays in Poland in line with tendencies observed in highly developed countries. New investment projects carried out by foreign companies have increased capital involved in the services sector.

The largest investments outlays in the manufacturing sector have been registered in the production of food products, beverages and tobacco: the volume of the investments have reached USD 4.8 billion, that is 12,2% of all the investments in the sector. The second largest outlays have been spent in the transport equipment field and amounted in June 2000 to nearly USD 4,5 billion (11,5%). Products made of other non-metal raw materials have absorbed investment outlays worth USD 2.3 billion (5,8%). The electrical and optical equipment manufacturing sector with investment outlays of USD 1.7 billion (4.3%) has ranked fourth (it is noteworthy that this field of endeavour ranked earlier as sixth). More than USD 1.4 billion USD (3.7 %) has been invested in pulp, paper, printing and publishing. An influx of more than 1.3 billion USD (3.4 %) has been registered in the chemical sector. Between 1.4% and 1.0% of the overall direct foreign investments in Poland's manufacturing sector have been earmarked for machinery and equipment not classified in other group of commodities, for rubber and plastics, metal and metal products and commodities not included in other categories. The share of the other subsections in the branch structure amounts to less than 1 %.

The second major sector of the economy with the largest inflow of direct foreign investments has entailed financial services. The accumulated value of investments recorded in that sector by PAIZ at the end of June amounted to more than USD 9.2 billion USD, that is 23.7 % of the overall inflow of direct investments into Poland.

Investments to the tune of USD 38 billion (9.7%) have been invested in wholesale and detail trade as well as in the repair sectors. More than 5.8% (that is USD 2,3 billion) of foreign capital has been invested in the construction sector.

The least number of companies with foreign capital has been involved in real estate and business services (USD 269.6 million), in mining and quarrying (USD 68.3 million) and agriculture (USD 30.1 million), with investment outlays in the two last sectors remaining on the same level.

Foreign Direct Investment in Poland –breakdown by activity (at the first half of 2000)

Activities according to the European Classification of Activities (ECA)	Capital invested (millions of USD)	Planned investment (millions of USD)
Manufacturing:	18177,9	5476,3
Food, drinks and tobacco products	4755,9	966,9
Transport equipment	4454,6	1062,4
Other non-metal goods	2263,9	1178,5
Electrical machinery and apparatus	1668,0	416,2
Pulp and paper, publishing and printing	1443,8	431,3
Chemicals and chemical products	1325,0	447,6
Machinery and equipment	532,1	207,5
Rubber and plastics	467,2	251,4
Metals and metal product	383,4	200,1
Furniture and consumer goods	380,4	263,0
Fabrics and textiles	246,7	32,7
Wood and wooden products	240,0	36,2
Leather and leather products	16,9	0,5
Financial intermediation	9218,6	1473,6
Trade and repairs	3791,1	1767,0
Construction	2254,8	841,0
Transport, storage and communication	2181,7	656,5
Community, social and personal services	1585,2	479,1
Power, gas and water supply	788,1	1111,0
Hotels and restaurants	537,1	225,2
Real estate and business activities	269,6	210,1
Mining and quarrying	68,3	4,4
Agriculture, hunting and forestry	30,1	8,0
Total value of FDI over 1 mln USD	38902,5	12270,2
Estimated value of FDI below 1 mln USD	4114,8	
Total FDI in Poland	43017,3	

Table 2

Largest foreign investors in the first half of the 2000

NO	Investor	Capital invested (mln USD)	Country of origin	Activity
1	Citibank	750,6	USA	financial intermediation
2	Shell	433	Great Britain	retail trade,power,gas,water supply
3	General Electric Corp.	291,4	USA	banking,electrical. machinery and apparatus
4	Philips	251,9	Netherlands	electrical machinery and apparatus
5	Vattenfall	232,3	Sweden	power, gas and water supply
6	Skanska Group	146,2	Sweden	construction, real estate
7	RAO Gazprom	137,3	Russia	construction
8	Allianz AG	105	Germany	insurance
9	Tesco	85,0	Great Britain	retail trade
10	Telia AB	84,6	Sweden	telecomm.,publishing and printing

Table 3

4. What do foreign investors think about Poland?

PAIZ systematically monitors perception of foreign companies' representatives regarding Poland. In the year 2000 the sample (814) was selected from among all entities with foreign participation which are active in Poland. According to the data of the Central Statistical Office, at the end of December 1998 the number of such companies reached 12,649. Extrapolation of the research results to the whole group of companies with foreign capital should not (with 95.5% probability) lead to measurement mistake larger than 3.38 percentage points.

4.1. Investment Attractiveness of Poland. Opinion on investment conditions in Poland.

4.1.1. Factors which encourage foreign investors to engage in business in Poland

During the researches conducted in 1993, 1995 and 1997 one third of foreign investors pointed five factors encouraging to engage in business activity in Poland as very important ones. The mentioned elements were: good perspectives for economic growth of Poland, low costs of labor, the size of the Polish market, large supply of labor and the possibility of reducing production costs.

According to the research completed in 2000 the most important factors which encourage foreign investors to engage in business in Poland include: good perspectives for economic growth of Poland (49.8 percent), low costs of labor (46.4 percent), the size of the Polish market (44.6 percent), large supply of labor (39.3 percent), the possibility of reducing production costs (39.3 percent), qualifications of labor force (35.7 percent), favorable investment climate (33.0 percent), legal security (32.3 percent), ownership guarantees (30.5 percent) and future membership in EU (30.5 percent).

A comparison of the results of the research completed this year with those obtained in 1995 leads to conclusion that importance of the size of the Polish market as a factor decreased, while significance of perspectives for economic growth increased.

Most important factors encouraging to business activity in Poland (%)

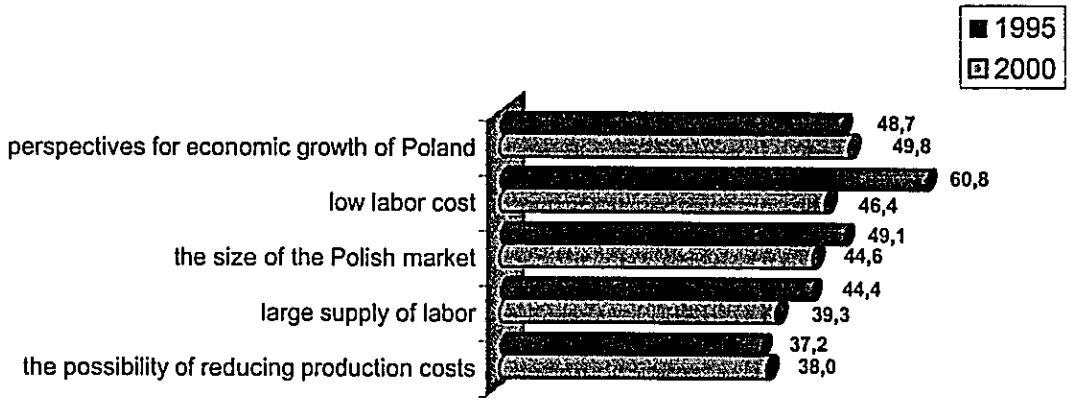


Figure 1

4.1.2. Opinion on political situation in Poland

The majority of respondents think that the political situation and social climate in Poland are favorable investment. Over 56 percent of representatives from companies with foreign capital think that the climate for investment in Poland is good. A separate opinion has been voiced only by 19.7 percent of managers. 22 percent of respondents do not have a clear opinion on this situation, or did not want to reveal it.

In 1995 only 10.9% of respondents perceived the political situation and social climate in Poland as favorable investment.

4.1.3. Opinion on legal conditions of business activity

Only 17.3 percent of the participants thought that the regulations referring to foreign capital are right. The most frequent criticism regarded: legal loopholes and lack of system's cohesion (44 percent); uneven application of regulations by the authorities (39.6 percent); too frequent changes of the regulations (30.5 percent) and excessive detail level of the regulations, which obstructs the activity of companies (27.5 percent). One of ten respondents considers legal regulation as unfavorable foreign investment.

Opinion on legal conditions of business activity (%)

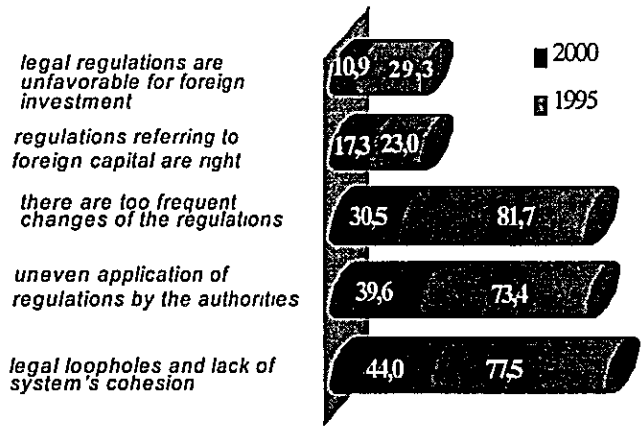


Figure 2

49.3 percent of foreign investors think that the program of reduction of the corporate income tax rate (up to 22%) is right. According to 7.6% of respondents the program should be continued. When asked about the barriers the investors usually quoted administration procedures regarding building permissions (36.7 percent) and real estate acqusition (34.5 percent). The other difficulties mentioned during the research are work permit (28.9 percent) and residence permit (34.7 percent) obtainment.

4.1.4. Opinion on financial conditions of business activity

The research included opinion on financial conditions of business activity in Poland. The majority of positive opinions referred to banking system (59.3%). The best opinions came from French, German and Dutch investors.

In comparison to 1997 the perception of financial conditions of business activity in Poland has improved.

Opinion on financial conditions of business activity (%)

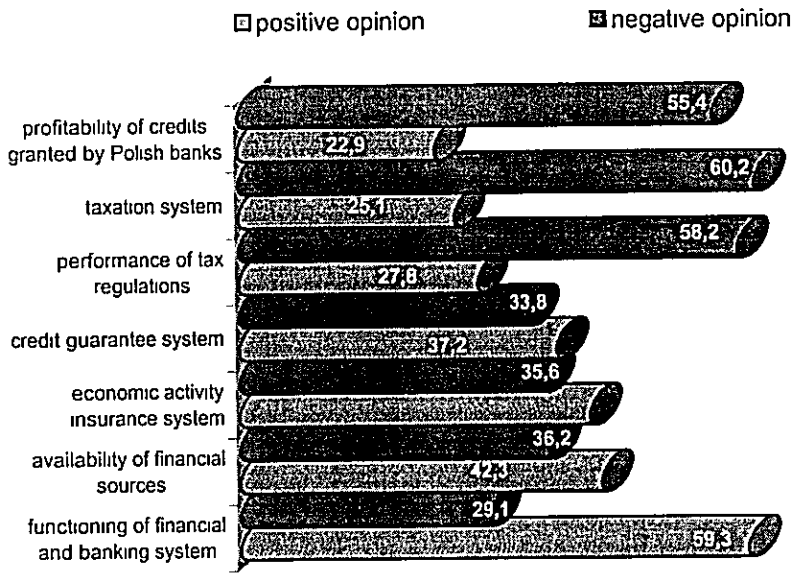


Figure 3

4.1.5. Opinion on labor force qualifications

The report presents a very positive assessment of Polish managers and white-collar workers (over 55 percent of „good" ratings). The foreign investors also have a very good opinion on the qualifications of Polish workers (40.5 percent of „good" rating). Only 2 percent of respondents think that skills of Polish managers are not good, while 11.1 percent of investors have a negative opinion on Polish workers.

Opinion on labor force qualifications (%)

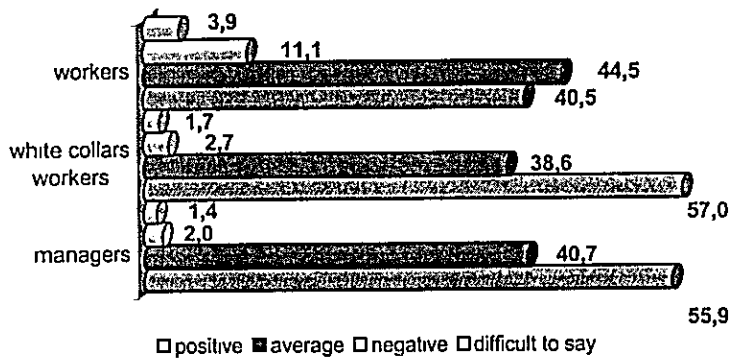


Figure 4

4.1.6. Opinion on infrastructure in Poland

The infrastructure in Poland is perceived by foreign investors as average. In comparison to 1997 more positive opinions referred to mobile phones system (20 9 percent), satellite communications (14.4 percent), internet (10.3 percent) connections.

5. Characteristics of companies with foreign capital participation (selected elements)

5.1. Initial capital of companies with foreign capital participation

The structure of companies with foreign capital participation in terms of value of initial capital improved in the last free years. The presence of foreign companies in Polish economy has clearly grown. The research has shown that the number of companies with high initial capital (over 2 million PLN) increased six times over the last seven years. This is a proof of increased involvement in the Polish economy. In 1993, only 7 percent of companies had initial capital exceeding 2 million PLN, and now such companies amount to 40.8 percent of all companies with foreign capital that are operating in Poland. It means that a number of foreign companies increased almost six times in the seven years.

5.2. Export of companies with foreign capital participation

The share of export in sales of companies with foreign capital participation is quite small. Over 44.3 percent of entities do not export. 29 percent of them exported less than 25 percent of their total sales value. Foreign companies sell their products mainly to Germany. The research confirmed the rule that in a majority of cases companies with foreign capital export to the countries of their origin.

5.3. Import of companies with foreign capital participation

Similar rules exist in import activity. Germany are the main supplier of commodities and services for foreign companies in Poland. Beyond that majority of companies with foreign capital import from the countries of their origin. The value of their import has increased recently. 26.7 percent import commodities for over five million zloty each.

5.4. Technologies used by companies with foreign capital participation

The majority of companies with foreign capital participation use the latest technologies (63.4 percent), while in 1997 only 55.6 percent of them used modern ones. The increase amounted to 7.8 percent. At the same time the number of entities using old technologies (10 years and so) decreased from 20.3 percent in 1997 to 11.2 percent in 2000.

5.5. Quality systems

One third (32.3 percent) of companies with foreign capital use quality standards and procedures, mainly ISO 9001 (22.1 percent) and ISO 9002 (17.1 percent).

5.6. Co-operation with Polish sub-contractors

About 41 percent of companies with foreign capital participation use commodities and services offered by Polish sub-contractors. In their opinion Polish sub-suppliers offer the cheapest and best products and services. The most important reasons which encourage to co-operation with domestic companies are: good competitive offers, competitive prices, tradition and positive experience, convenient location.

38.1 percent of managers who use the services of Polish sub-contractors think the quality of components is good or very good; and in opinion of 29.7 percent respondents the deliveries are executed on time. In more than half of the companies with foreign capital, which co-operate with Polish sub-contractors, the share of Polish-made components is at 50 percent or higher. This confirms the high share of domestic products in the commodities produced by foreign companies in Poland.

5.7. Factors determining location of companies in particular regions of Poland

The location of companies with foreign capital participation is determined by the following factors: good location and transportation system (46.8 percent of respondents considered this factor as very important), large consumer market (30.8 percent), large supply and low cost of labor (30.2 percent), availability of industrial buildings (25.4 %).

The factors implementing limited inflow of foreign direct investment to gmina most frequently are: weakness of market infrastructure, small local market and low purchase power of inhabitants.

5.8. Elements that might increase inflow of foreign direct investment

The research shows that, in spite of a significant improvement in many fields of activity, foreign investors still face obstacles. When asked about their start-up the investors usually quoted preparing necessary documents and registration of a company (37.7 percent), ensuring good technical and organizational conditions for starting up a business activity (31.1 percent), recruitment process and employment of proper staff (20.3 percent), obtaining permissions for business activities from authorities (18.4 percent), finding business partners (16.7 percent).Improvement of elements mentioned above can affect an increase of FDI inflow into Poland.Foreign investors have defined how to stimulate development of foreign companies business activities. The list of postulates concerning the public support for entities with foreign capital participation includes: development of technical infrastructure (63.6 percent), granting tax incentives (50.4 percent), working out regional and local development plans (47.9 percent), development of social infrastructure (44.2 percent), activities for environmental protection (36.7 percent), support in searching business partners (27.9 percent). The investors complain of lack of information on: local environment (41.5 percent), Polish economy (36.1 percent), companies specializing in supplying details on business partners (34.0 percent), companies offering business services (18.1 percent), consulting firms (14.5 percent), marketing agencies (8.8 percent), advertising agencies (6.9 percent).

6. Appendix - Tax Exemptions and Incentives Prevailing in 2000 in Poland

1) Pursuant to the Act on Corporate Income Tax (Journal of Bills No. 106/93, item 482 with later amendments)
   a) Income tax rate was reduced from the level of 34% in 1999 to 30% taxation base in 2000. In the subsequent years further reduction of the tax is planned to reach **the level of 22% in 2004** (reduced income tax rates were introduced in place of investment relieves);
   b) Rules for depreciation of fixed assets – amongst other things, number of depreciation rates was reduced to 10, annual rates regarding fixed assets were increased and value of fixed and intangible assets was increased.

2) Pursuant to the Act on Local Taxes and Fees (Journal of Bills No. 101/91, item 444 with later amendments)
   a) Reduction of tax on real estate (maximum up to 50% of the upper limit of the rate) is dependant upon the subject regarding amongst other things buildings and lands related with functioning of technical infrastructure and lies within the competencies of communal councils in the municipality of which business activity is carried out
   b) Reduction in tax rates on means of transport lies within the competencies of communal councils.

3) Pursuant to the Act on Special Economic Zones (SSE) (Journal of Bills NO. 123/94, item 600 with later amendments)
   a) There are tax relieves in the corporate and individual income tax granted to the entrepreneurs starting their business activity in the area of SSE.

4) Pursuant to Act on supplements to interests on some bank loans (Journal of Bills No. 13 /95, item 60 with later amendments)
   a) Supplements to interests on investment loans in branches referred to in the Act.

5) Based on the Act on Employment and Counteracting Unemployment (Journal of Bills No. 25/97, item 128 with later amendments - unified text)
   a) Supplements to training and partial reimbursement of costs of creation and maintenance of the place of work.

6) Pursuant to the Act – Customs Code (Journal of Bills No. 23/97, item 117 with later amendments) developed based on the rules of Customs Code of the European Community contains instruments regarding facilities to investors amongst other things concerning:
   a) **Customs duties and other tariffs.** Average customs duty on industrial goods totals approx. 1.84 %. A number of industrial goods is subject to zero customs duty, which is related with agreements entered upon by Poland based on which free trade zones were created. In the year 2000, there are also economic contingents, amongst other things for the following investment products or raw material for production related with the investment in progress, i.e.:

- Some machinery and investment installations for automotive industry,
- Some commodities imported for the purpose of car industry,
- Some commodities imported for the purposes of plants manufacturing spare parts,
- Machinery and installations imported for the purpose of electronic and telecommunication industry,
- Chemicals imported for the purpose of electronic and telecommuni-cations industry,
- Some commodities imported for the purpose of pharmaceutical industry,
- Commodities for the purpose of metallurgic industry.

b) **Customs relieves.** Art. 190.1.34 of the Customs Code provides for exemption from customs duties of the non - monetary inputs made by foreign entity.Such exemption covers fixed assets that are the subject of non - monetary input made by the foreign entity subject to non - withdrawal for the period of three years from the date of admission to trading. In practice, the subject of the non - monetary input may be complete technological (production) lines as well as other equipment of the building production plants under foreign investments. This instrument is not fully compliant with the regulations of the European union. Currently there are works at the Polish Parliament regarding amendments to the Act Customs Code with a view to adapt, amongst other things, this regulation as of 1 January, 2002. Amended regulations shall enable exemption from the customs duties of the fixed assets owned by entrepreneurs, if related with transfer of the business operation to Poland.

c) **Use of economic customs procedures.** One of the economic customs procedures is interim clearance with partial customs duty exemption which may be used by foreign investors interested in use of, in the specified time scales, means of transport and production on the Polish customs area. Procedure of interim customs clearance is related with the obligation to pay for each month commencing of the interim clearance of 3% customs duties that would have been due, if the commodity was admitted to trading on the date when it was covered with interim clearance procedure. The subject of interim clearance with partial exemption can be:

- Means of production, means of transport necessary to perform services rendered in relation with realisation of turn key buildings and construction and assembly works based on the contract concluded,
- Means of transport and production except for the passenger vehicles, leased or given for use, imported in relation with the business activity.

d) **Carrying out business activity in duty free zones.** In the area of duty free zone, there may be rendered services to foreign entities in respect of warehousing and distribution of commodities. In addition, duty free zones are attractive places to make direct investments. In the area of duty free zones any industrial, service or commercial operation is allowed including retail trading. Retail trading is possible only within the duty free zone established in the area of air, sea or inland waters border. Benefits to foreign investors resulting from carrying out business activity within Duty Free Zone (WOC) are as follows:

- Duties and other fees are not taken on crossing the border of DFZ, only on the moment of admission of a given commodity to trading or covering it with a different procedure resulting in customs debts.

- Exemption from the obligation to provide backing in respect of tax and customs duties while introducing commodities to DFZ,
- Possibility to carry out regular activities without consent of the customs authority,
- Introduction of commodities to DFZ allows for application of 0% VAT rate, if such commodity is to be exported.

e) **Payment facilities**. Foreign investors who started business activity on the Polish Customs Duty Zone and obtained the status of the domestic corporate entity can use the payment facilities on the terms and rights equal to the rights of the Polish business entities, i.e.:

- Exemption from the obligation to provide backing for tax and customs liabilities. Customs regulations allow customs authorities to exempt reliable exporters from the obligation to provide backing while using procedure of 'active refinement' under the system of suspensions in the situation where the procedure covers commodities whose import is not related with higher exposure.
- Deferment of payment of customs duties by 30 days. Decisions in this matter are taken by the customs authority upon request of entrepreneur who satisfies certain defined reliability terms.
- Split of payment into instalments. Split of payment of part of the customs liabilities into instalments can be granted by customs authority for the period not exceeding six months. Such facility may be requested up to two times within calendar year. Split into instalments can also concern up to maximum 50% of the liability.

7) Pursuant to the Act on Tax on Commodities and Services and Excise Tax (Journal of Bills No. 11/93, item 50 with later amendments)

a) Payer of the tax on commodities and services has the right to reduce the output tax by the amount of tax calculated at purchase of commodities and services (Art. 19.1). This also concerns purchase of investment goods.

In the case of investment goods purchased on a domestic market, the amount of input tax is the total of amounts of tax determined on invoices confirming purchase of commodities and services. Whereas in the case of import, it is the amount of tax resulting from the customs document (Art. 19.2).

Reduction of output tax shall be effected not earlier than at settlement regarding the month in which the tax payer received invoice or customs document no later than however with the settlement regarding the following month. In the case of import of services, reduction of amount of tax shall be at settlement of the month in which the tax liability became effective (Art. 19.3).

Pursuant to Art. 21 of the Act, in the case when the amount of tax calculated in the fiscal period is higher than the amount of output tax, tax payer has the right to diminish the output tax by this difference in the output tax in the subsequent periods. The difference in this tax shall be reimbursed by Tax Authority when the whole or a part of sale is subject to 7 % or 0 % tax rate (Art. 21.2). Whereas, tax payers selling commodities subject to 22 % tax rate, whose input tax is higher than output tax, have the right to reimbursement of the amount not exceeding the amount of input tax at purchase of commodities and services which, under separate regulations, are regarded by tax payer as fixed assets and intangible assets subject to depreciation (Art. 21. 3).

Tax payer who purchased commodities and services regarded by him, under separate regulations, as fixed and intangible assets subject to depreciation, should indicate the input tax, resulting from invoices documenting such purchases in accordance with general rules, on the tax return regarding the month in which the invoice or SAD document was provided to him or in the subsequent month, in the same manner as in the case of other purchases.

Direct reimbursement shall be granted to the tax payer who, in a given month, effected sales with the tax rate lower than 22 % and at the same on the tax return regarding this period there was an excess input tax over the output tax or when tax payer purchased fixed assets and intangible assets subject to depreciation.

Return of the difference in the tax shall be effected to the bank account of the tax payer within 25 days from the date of submission of settlement by the tax payer. Upon request of the tax payer, tax authority shall be under obligation to return the difference in tax within 15 days from the date of submission of settlement. if the tax payer in the period of 12 months before the date of tax return paid tax on commodities and services, excise tax and other tax liabilities payable to state administration in a timely manner (Art. 21. 6 & 6a).

b) There is also a possibility to reimburse input tax calculated in the form of advance before tax liability is effective in the case of investment purchases. Detailed terms and conditions and manner of tax reimbursement are defined in the Ordinance of the Minister of Finance as of 22 December, 2000 on Execution of Some Regulations of the Act on Tax on Commodities and Services and Excise Tax (Journal of Bills No. 109, item 1245 with later amendments).

Pursuant to Art. 31 of the Ordinance, reimbursement of input tax shall be to the entities who jointly satisfy the following terms:

- Presented registration application and have tax id number (NIP),
- Did not undertake activities subject to tax on commodities and services except for import of commodities,
- Effected investment purchases whose value without tax totals at least PLN 600,000,
- Paid the full amount due under investment purchases and in the case of import - paid input tax on such import,
- Have invoice or correcting invoice from which the input tax is derived and in the case of import - SAD document,
- Presented declaration that:
  - Investment purchases shall be used while performing activities subject to tax,
  - After commencement of activities subject to tax, the entity shall not use the subjective tax exemption from the VAT,
  - Before the date of first sale the entity shall not chose exemption for the protected work plants,
  - The entity keeps register for the purpose of VAT, in part regarding investment purchases,
  - First activities subject to tax shall be carried out not earlier than after the lapse of six months from the date of first investment purchase.

Reimbursement of input tax shall be effected in the form of advance upon request of the entity that made the investment purchase. Such request shall be appended with a copy of document confirming payment of tax due calculated in relation with investment purchases, and in the case of import - with a copy of a document confirming payment of output tax on such import and declaration referred to in Clause 6 (Art. 31 of the Ordinance).

Advance is paid to the bank account in two equal instalments: first instalment within 15 days after the lapse of a quarter in which the application was made, the other instalment - within 30 days, starting from the date of payment of the first instalment (Art.33 of the Ordinance).

Pursuant to Art. 34 of the Ordinance, entity shall be under obligation to return the advance received inclusive interests, if:

- It fails to satisfy all the terms determined in the declaration referred to in Clause 6,
- Within three years from the date of receipt of the first instalment, the investment purchase was donated, re - sold, issued in return for debt or for activity not subject to tax or in place of monetary service or given to a free of charge use,
- Business was liquidated, bankrupt or ceased (it to be understood as suspension of the performance of investment in the period longer than six months) within three years from the last day of the month in which payment of the first instalment was made,
- Sells the company within three years from the date of receipt of the first instalment of the advance.

  The rules described above, are favourable for the entrepreneurs as they allow for reimbursement of the tax in the investment phase.

  Solutions adopted with regard to VAT giving right to reduce the output tax by the amount of input tax and reimbursement of the tax are consistent with the rules adopted in the EU countries.
- Pursuant to Art. 22 of the Act of 29 August, 1997 Tax Order, the Minister of Finance may renounce the part or the whole of tax due or may suspend collection of tax in the cases justified from the point of view of public interest or important interest of the tax payer.

  Whereas tax authority, upon request of tax payer, may renounce a part or a whole of tax liability when payment of tax impede important interests of the tax payer and in particular his existence (Art. 22.2).

  Tax authority in view of important interests of the tax payer, upon his request, may defer the payment of tax and split the payment of tax into instalments or tax liability including interests for delay (Art. 48.1).

  In situations justified by the interest of the tax payer or public interest, tax authority, upon request of tax payer may redeem the whole or part of tax liability or penalty interests (Art. 67.1).

8) Pursuant to the Act on Creation of Agricultural Restructuring and Modernisation Agency (Journal of Bills No. 1/94, item 2 with later amendments)

   a) Supplements to interests on bank loans, guarantees and loan sureties defined in the financial plan, purchase of bonds referred to in the Act.

9) Pursuant to the Act on Protection and Moulding of Natural Environment (Journal of Bills No. 48/94, item 196) and Ordinance of the Minister of OŚZNiL on Detailed Rules of Financial Management of the National Fund for Protection of Natural Environment and Water Management and provincial funds for natural environment protection and water management (Journal of Bills No. 3/99, item 17)

   a) Giving subsidies and sureties and making available financial assets to banks designated for granting loans and subsidies for performance of tasks referred to in detailed plans.

FDI, International Trade and the Adjustments to World Markets in a Small Open Economy of Transition: The Case of Czech Economy

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1. Introduction

Since the outset of economic transition in Central and Eastern Europe, there have been widespread expectations that foreign direct investment (FDI) would play an important role in the process of convergence. The long-term nature of FDI motivates investors to take an active part in the decision making process, and often necessitates basic changes in the targeted firm's structure and strategy. In addition, FDI brings with itself various positive externalities that help the host economy overcome its shortages outside the host enterprise with foreign capital.

A major problem faced by the transitional economies was the level of knowledge of new technology and its organisation. They displayed 'idea' and 'object' gaps (Romer, 1993), which the transition process clearly needed to bridge. This problem can be addressed in a number of ways that were also reflected by alternative strategies to economic transition and restructuring. On one hand there is a "national" approach, relying on own (already existing) capital, domestic management and local improvements in education. On the other hand there is an "international" approach, relying primarily on importing the missing technology and know-how. The first approach has many national variants that can be represented by concrete policies, as observed for example in Czechia (1990-1997), Slovenia and Poland, and Belarus and Serbia, respectively In many aspects the sole "national" approaches proved insufficient to bridge the mentioned gaps. They either failed completely or their potential was soon exhausted. Therefore, in the majority of cases they were complemented or replaced by an international orientation and the reliance on FDI.

Prior to the recent transition in the Central and East European countries (CEECs), strict limitations were imposed on the access to foreign technology, though the local education was at a high technical level. This posits that lifting the barriers to foreign capital, combined with an expansion in trade linkages with the major industrialised economies, would create the potential for rapid increases in productivity and promotes the introduction of necessary reforms to market structures. FDI may, therefore, be of particular importance in the transformation of the formerly centrally planned economies. It can also act as an ideal supplement to domestic savings, as low levels of savings combined with credit rationing and financial market failures are likely to keep investment levels sub-optimal.

Many 'ideas', coming as a complement of FDI, are an inherent feature of the technology introduced by foreign firms, and reflect 'ways of doing' that are specific to the firm. Other ideas are more appropriable, but may be kept under the control of their proprietor by licensing. In both cases, the involvement of FDI incorporates also the inflow of information, R&D and skills. Inflows of FDI can improve the prospects for growth both by introducing more productive technology and techniques and by increasing the level of capital investment in the economy. However, the success of FDI is more easily acknowledged by the host society if the foreign capital direct investments have spillovers outside the particular firms. The success of FDI becomes somehow a "national" success and a part of the national esteem.

It can be the managerial and labour skills, along with the R&D know-how, that spill over to indigenous firms practically free. Firms with foreign capital may also discipline the corporate governance in the indigenous supplying firms by pressing them to upgrade the quality of their material supplies. Also the local political, administrative and social system may become more stable, once the firms with FDI enter into a mutually favourable interaction with their hierarchies. In addition, FDI in tradable sectors helps to integrate a country into the networks of world economy, as nearly two-thirds of global trade is conducted by or with multinational firms. The widening access to world markets, on both the export and import sides, is an act widening the window of opportunities for other domestic firms.

This study is a follow-up of a part of research that was conducted by the author in the past two years and which dealt with international adjustments of the Czech economy. Although the Czech economy went already during 1994-96 through its period of growth and self-confidence, now in 2000, ten years after the toil of restructuring and adjustments, one cannot claim that its transformation has been completed yet. The available time series for 1993-97, on which the majority of our analysis was performed, is too short for allowing us to draw general conclusions that could be valid even in the long-run. We must be aware that the Czech economy is still in a flux of changes and many developments can be only transitional[1].

2. FDI as an Engine for Survival

Czech economic transformation had its ups and downs. In 1990 it commenced in a hind position, with hardly any experience from entrepreneurship under its "reformed" central planning and with households lacking capital for the initiation of large-scale investments. With these adverse endowments being given, betting on FDI would be a very promising strategy for securing the future growth. Nevertheless, Czechoslovak government opted at that time for a very different strategy in the large-scale businesses. By giving priority to the voucher privatisation scheme and the scheme of sales to Czech owners (Mejstrik [1996]) it set forth for a highly unorthodox avenue of self-reliance. The ensuing intransparent ownership and perverse objectives of the quasi-owners had a long-term impact on the performance of firms and the Czech society. Though still accepted as an important means of privatisation, the FDI remained a less-favoured child that was assumed to be strong enough to care for himself.

Without doubt, the stress on one's own capacities was a dire undertaking, which was at first criticised by IMF and the World Bank, but very soon it became the Czech most admired achievement. Unfortunately, in 1996 there were first signals that indigenous Czech firms lagged behind the firms with foreign capital [2]. Czech privatisation strategy was a bet on odds that it could be possible to build capitalism without capital. This was an impossibility theorem, which had to fall down on the new Czech capitalists-to-be. The accumulation of capital was a necessity and the indigenous firms had to act in such a way that instead of concentrating on the restructuring of production, they had to cope with corporate property control, equity transfers and the acquisition of assets under their own management.

Many of these acts were illegal [3] and their effects on the firms were negative.

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[1] Benacek, Visek (1999), Benacek (2000), Benacek, Zemplinerova (1999) and (2000).

[2] The first studies in this respect were by Benacek, Zemplinerova [1996] and Zemplinerova, Benacek [1996] and [1997]. These studies covered the full sample of firms with employment over 24 employees (altogether over 3000 enterprises) and their conclusion was less optimistic than what was found in the study by Djankov and Hoekman [1998] who used a selected pattern of 513 firms.

[3] The word "tunnelling" became a synonym for ingenious schemes of asset stripping and rent-seeking, which have left the majority of indigenous corporations and banks in debts. On top of its inefficient acquisition, the extracted "authentically private" capital was often either sent abroad or spent on imports of consumer goods.

The necessity to close the widening trade balance deficit during 1994-97, the government had to proceed with restricting both the monetary and the fiscal policies. That brought the frail Czech firms to a test of survival during 1997-98. In the same period there was a sharp change in the views on ownership. The openness to FDI became the most-favoured policy for not only all liberal parties, but also for the trade unions and Socialists. Unfortunately, foreign investors became very cautious and the changeover to a new strategy remained to a large extent without practical response.

Now it looks evident that those firms that succeeded in attracting FDI were those more lucky ones where the growth of production was combined with high wages and high profits. Since only a minority of firms succeeded in that, the Czech economy was slowly progressing into a system of dual set of firms distinguished by speed. On one hand there are the indigenous firms that press for low wages, government bailout schemes and the soft legislation. On the other hand there are firms with foreign capital that can withstand appreciating exchange rate and still increase its market competitiveness and capital returns. Under this "division of roles" in entrepreneurship there is a rising danger that the gap between these two groups will even deepen and thus perpetuate the existing split.

Thus in 1999 approximately a half of the firms in the Czech economy were firms able to stand on their own with a prospect for gaining profits. The majority of these were firms with foreign capital. The remaining half (or a third, in the better case) of all firms is now challenged by either pending restructuring or liquidation. Since it is not very likely that the weakened indigenous Czech corporate sector would be able to recover with the help of their own means, there are two alternatives left which may do the job. The first one is the government bailout. Because the Czech propensity to save is extremely high and also the taxes are very high, the means so available are substantial. The present Czech government thinks that there may be a hope for chance. Their problem is only managerial: who are those clerks and entrepreneurs who will administer and use these means productively? With the lack of them one can have doubts there may be anything perspective in this scheme.

The other chance left to the ailing indigenous enterprises rests in their association with the foreign capital, either in joint-ventures or by their direct takeovers by foreign firms. Unfortunately we can doubt that the FDI entry into Czechia would change its strategy and, instead of concentrating on green-field investments (as was clearly the situation since 1996), it would return back to acquisitions and mergers. If this would not be the case, the only possibility then remains that **the FDI firms, which have now become leaders in the Czech economy, would have positive spillover effects on the rest of the economy.** So, at this stage of development, the Czech economy would be helped more by means of externalities spinning off from foreign to indigenous firms than by direct effects on productivity in the firms under foreign control. It is the aim of this study to analyse more closely how the foreign investors behaved in the past, what were the determining factors for their activity, what were the industrial patterns, which attracted their attention and how was it with their effects on the economy.

3. Foreign Direct Investment into Accession Countries

Though not very high, if compared with the FDI flows to the developed market economies or to some newly industrialised countries in Asia, the FDI to many post-Communist countries of Europe was significant. It was close zero in 1989 and $ 5 bn in 1994, but in 1998 and 1998 the annual inflows reached $ 18.5 and $ 17.5 bn respectively. UNCTAD estimates that the total FDI flows in the world were $ 644 bn in 1998 (UN [1999]). The recent increasing trends of FDI inflows to Central and East European countries (CEECs) notwithstanding, the results for the whole region in 1998 still represented only 2.7 % of that amount.

The standing of CEECs would be even weaker if we considered their share on total accumulated stock FDI in the world (estimated at $ 4088 bn in 1998). UN (1999) statistics indicate that the FDI stocks in European post-Communist countries reached altogether $ 83 bn at the end of 1998. That would indicate that these 5.1% inhabitants of the world received only 2% of the total world FDI stock in 1998. However, one should keep in mind that there is a deep variation in the FDI absorption among CEECs. The main recipients belong to the accession countries of Central Europe. They received a flow of 4.5 bn $ in 1994, 8.1 bn $ in 1996 and $ 11.6 bn in 1998. Their FDI stock in 1998 was $ 63 bn.

It is clear that the amount of FDI inflows depends on the stage of transformation to market-based economies. The countries (including Russia, Ukraine, Belarus, Lithuania, Latvia and the Balkan countries, altogether with approximately 260 mil inhabitants) have all received in 1998 $ 5.9 bn, what makes $ 23 of FDI flows per capita only. Their total FDI stock is estimated at $ 23 bn. On the other hand, the most intensive FDI total absorption at the end of 1998 was in Hungary ($ 18.3 bn), Poland ($ 24.8 bn) and Czechia ($ 13.5 bn). These countries represent over 60 million inhabitants what makes approximately 940 $ of FDI stock per capita, what is quite an imposing record achieved in mere 8 years.

As the economies of the accession countries keep proceeding in their process of restructuring, modernisation and openness, we can assume that the inflows of FDI to them would continue at an abated intensity or even increase. It can be also expected that, due to past financial shocks, the attractiveness of many Pacific Rim countries and some Latin American countries will get under an abatement. The stabilisation of Germany after the shock of absorbing Eastern Germany and the present expectations of increased German growth rates when the planned new taxation scheme into operation, these are factors that could strengthen the position of Europe in the world three super-power conquest. Then one could conclude **that the Central European accession countries might soon become candidates for one of the world's most attractive and the most important destinations of foreign capital investment outside the club of industrially developed countries.** Thus we can expect an acceleration and not a slow-down in the future FDI activities in that region. Recent FDI annual inflows of the mentioned accession countries, with $ 173 per capita in 1998, was already higher than what was achieved in 1998 in Latin America ($ 145) or the world average (109) – see UN [1999].

4. Foreign Direct Investment into the Czech Economy

The average annual volume of Czech FDI inflows, measured as a percentage of GDP in the period 1993-1998 (converted to US$ at commercial exchange rate), is comparable with recipients as successful as Spain or Portugal. The Czech average of 3.6% was higher than what was received during 1991-96 by Spain (1.4%), Portugal (2.5% - see Corado et al. [1996]) or Chile (2.5% of GDP during 1990-95). A less satisfactory result will be received if the FDI per capita or FDI per GDP in PPP were used as a criterion. Here, until 1998, the Czech FDI relative intake lagged behind both Spain and Portugal. However, the inflows of 1999-2000, reaching nearly exactly the same amount as in the previous 10 years (i.e. $ 11.2 bn) stroke with an intensity that was not expected by any optimist.

The accumulated amount of incoming foreign direct investment to the Czech Republic reached only $ 5.7 bn in 1995. At that time approximately 60% of all FDI were deals negotiated with the government. After 1995 the initiative was moving to stock market and private transactions. This also brought with itself an uncertainty about what was and what was not an FDI and the problems of measurement were mounting. The total stock of FDI at the end of 2000 is estimated to reach $ 22 billion.

Table 1 (in Appendix) suggests that FDI was not an exclusive foreign funding coming to Czech economy. Long-term foreign credits, with a net contribution of over $ 9 bn during 1990-99, became a very important element of restructuring of the Czech economy. Also the inflows of foreign portfolio investments were significant, though the institutional arrangement at the Czech capital market was ailing chronically. The net inflows of foreign capital of all kinds, (including the consolidation with the negative balance on the factor payments), amounted to $ 23.8 bn during 1991-99. That was more than any of the annual volumes of domestic savings in the post-Communist period.

As far as the industrial composition of FDI is concerned, financial services, hotels, telecommunications, trade networks and business services attracted at least 38% of all FDI. The attraction of the financial service sector has been on a rise in the last two years. However, the remaining services have been burdened with low level of prices. The EU accession will press for a speedy price convergence what will also attract the attention of the foreign capital. Until 1999 the manufacturing industry was the most important beneficiary - attracting approximately a half of all FDI. The highest attention of foreign investors was dedicated to automobile industry, electronics, glass, building materials, plastics, rubber and the food industry. The remaining 10% went to various unspecified services. Agriculture, mining, furniture, shoes and textile industry received lesser attention. It is evident that the distribution of FDI was not distributed proportionally among all industries.

The location of FDI in a small open economy is subject to factors reflecting the comparative advantages, factor endowments, market structure and institutional conditions. Taken from the theoretical point, the problems of location and long-term growth have been dealt with most intensively by the analysis of determining factors of specialisation and trade. Closely linked with that there was the analysis of determining factors of FDI. Let us now bring more attention to these problems.

5. Factor Intensities of Czech International Trade

According to the neo-classical trade theories, the patterns of specialisation are given by relative factor endowments and factor intensities of domestic production. The relative nature of the factor endowments means that, once a country abandons its original integration block and integrates its economy with a different set of countries, its comparative advantage in factors can change. This could have happened once the Czech economy switched in its trade alignments from COMECON to an OECD partnership. Also the government interventions could distort the comparative advantages and lead to a biased trade patterns.

The analysis of factor intensities of exports, imports and total production is therefore important, once our aim is to map the circumstances of changing patterns of trade. There were already several studies that quantified the Czech trade factor intensities before and after the transition (Drabek (1984), Benacek (1987), Hanel (1995), Landesmann (1996), Hoekman, Djankov (1997) and Stolze (1997)). Unfortunately all of them worked with data prior to 1995. Our analysis aims to find out how the factor requirements have changed in the period 1993-1997. Usually the following factors are used for such purposes: physical capital, unskilled labour, human capital and natural resources.

We have adopted for that purpose the classification of factor contents by industries, as designed by Neven and Wyplosz (1994). Accordingly, the industries in a 3-digit NACE classification were clustered into five categories that are indicated in Table 2 in the first column. Our task was to find out what was the growth rate in the given five groups and how this influenced their structure at the end of 1997.

The share of commodity groups classified by factor requirements in production (Q), imports (M) and exports (X) in 1993 versus 1997 (in %)

Commodity group	Q 1993	Q 1997	M 1993	M 1997	X 1993	X 1997	Trend
1 – advanced technologies	14.2	12.9	27.6	23.3	15.4	12.7	↘
2 – human capital	18.4	21.3	32.9	31.0	20.1	26.7	↗
3 – labour	19.4	21.5	14.2	18.7	24.3	27.3	↗
4 – physical capital & labour	35.0	32.3	20.4	22.9	33.1	29.1	↘
5 – physical & human capital	13.0	12.0	4.8	4.1	7.1	4.2	↘
All commodities	100%	100%	100%	100%	100%	100%	

Table 1

Source: Czech Statistical Office enterprise database (for Q),customs statistics (for M and X)

As one can see in Table 2, during the whole studied period the position of exports of physical capital intensive commodities weakened while exports of commodities with high contents of labour gained. That would be consistent with general expectations in the evolution of comparative advantages in post-Communist countries (Hanel (1995), Stolze (1997). The buildup of capital intensive industries during the period of central planning (1948-1989) was artificial and the majority of the huge volumes of physical capital endowments falling behind in the parameters of technical efficiency. Thus they qualified more as sunk costs than a capital that had an economic usage. The falling tendency is industries with advanced technologies can be partially explained from the point of view of consumer behaviour. As the country was experiencing a fall in income and the budget constraint was becoming tighter, the expenditure on advanced technologies was treated as expenditures on a luxury that should fall at such a situation. It was also discovered that advanced technologies have lesser space in domestic production since their engagement lacked the comparative advantage.

The most surprising finding, however, concerned the usage of the human capital. While at the beginning of transition (1990-93) both the gross domestic production and the production for exports orientated to products with lower contents of value added and lower contents of human capital, the later stages of transformation have signalled that the role of the human capital was rising significantly. We can interpret this finding as a signal that the processes of real adjustment required six years before gaining momentum and set the economy on a new qualitative path.

We have also confronted the above findings with results of a different method of analysis. We have estimated an econometric model where we tried to "explain" the revealed comparative advantages in exports (we have used exports per sales as an endogenous variable) divided into 93 industries (NACE classification). The data were for the year 1994. Results are summed up in Table 3 where UE/VA, LE/VA and K/VA are relative factor requirements of university educated labour (proxy for the human capital), lower educated labour and physical capital.

CR3 is the concentration ratio (estimated as the share of the three largest firms on total output in given industry), TFP is the total factor productivity, BAL is the Balassa index of intra-industrial specialisation and DP is the index of inflation in given industry. In fact, the above specifications cover the basic determining factors of trade, as they are explained by the mainstream of theories of industrial location and specialisation.

The results are compatible with the previous findings. The labour usage (both as skilled and unskilled) is positively correlated with exports while the capital usage is influencing the exports in an opposite direction. The total factor productivity variable is highly significant, what stressed that the costs are important for the competitiveness of exports.

Regression coefficients from the analysis of export intensities

Statistics	b_1 (UE/VA)	b_2 (LE/VA)	b_3 (K/VA)	b_4 (CR3)	b_5 (TFP)	b_6 (BAL)	b_7 (DP)
slope coefficients	11.89	7.41	-0.027	0.127	0.006	0.002	0.190
t-statistics	6.75	2.88	-9.98	5.15	9.78	1.24	12.98
probability of 0 hypothesis	0.00	0.01	0.00	0.00	0.00	0.22	0.00

Table 3 R-squared: 0.940 F-statistics (probability of 0 hypothesis): 0.00

The variable DP describing the change of nominal prices during 1991-94 deserves a special attention. It is assumed that the difference in indices of the industrial inflation reflects the narrowing of the gap between the world prices and the former prices under central planning. The index of DP reflects how the domestic relative prices changed after opening up to the West and how it converges to the price levels on world markets. This is also closely related with the improvements in terms of trade and the improvements in quality. The higher is the imported "inflation" in the given industry, the higher is the growth in its exports. The Stolper-Samuelson and the Haberler theorems are consistent with this hypothesis. There, after the opening-up of an autarchic economy, the highest price increase is in the industries with comparative advantage. On the other hand, the industries with comparative disadvantage are challenged with a domestic price decrease. Our econometric test did not refute our hypothesis and the positive relationship between export intensity and inflation in industry is statistically most significant from all selected variables. This finding refutes the common sense offered by the PPP hypothesis where inflation (if uncompensated by exchange rate depreciation) is taken as a sign of a losing competitiveness in exports. In case the „inflation" comes from abroad as an increase in export prices, the PPP hypothesis gives a false conclusion.

The results of the mentioned estimation, based on robust technique of estimation, are consistent with another intuitive hypothesis: that the Czech economy in 1994 had a dual character. There can be observed two parallel patterns of behaviour among producers. In the first group of industries there prevails the behaviour similar to that in stabilised market economies. That means, the behaviour of firms, as far as their parameters of economic performance are concerned, was compatible with standard economic theory of resource allocation. The second group consisted of industries where the restructuring was at the beginning and the behavioural pattern of their firms was similar to one under socialist "ownership". First, it was characterised by lower profits and higher debts. Second, their estimated parameters were either insignificant or they had an opposite sign that would contradict the rational behaviour. For example, the allocation of their resources did not show a tendency of substituting between the usage of labour and physical capital.

The problem of a two-speed economy can be of paramount importance, dominating the economic policy issues, if we could find out what were the sources of such peculiar differences.

We have to turn to the analysis of FDI in order to uncover some other aspects of these observations.

6. Determining factors and effects of FDI in the Czech economy

The recent study of Benacek and Visek (2000) tested for the factors behind FDI inflows and effects of these investments. One of the tests was based on explanatory variables characterising the comparative advantages, efficiencies and the economies of scale. The model was specified in the following way:

$$FDI_{it} / VA_{it} = a_0 + a_1*(K_{it}/L_{it}) + a_2*(\pi_{it}/L_{it}) + a_3* IRS_{it} + a_4* DP_{it} + \varepsilon_{it}$$

where the intensity of FDI per value added (as the endogenous variable, i.e. FDI_{it} / VA_{it}) in the given industry *(i=1, 2, ..., 15)* was explained by a list of variables, such as the capital per labour ration (K/L), profits per labour (π /L), increasing returns to scale (IRS) and the price level changes (DP). Data covered the period t = 1991, 1992, ..., 1997.

Its results, based on OLS regression analysis, were more than disappointing. The only statistically significant variable was the matrix of PPI deflators represented by DP. It seemed as if the inflows of FDI into industries behaved at random. The vast majority of variations remained virtually unexplained by our model.

The technique of OLS has a general weakness – it is designed to uncover "regularities" that are supposed to be invariant (uniform) for all variables simultaneously. That condition need not be always satisfied. For example, in the relationships between FDI and some variable determining the FDI location need not be valid for the whole duration of the time series or need not be relevant for all industries. The reason can rest in the very nature of economic transition: the relationships between variables can be reversed in time or some industries can be influenced in their behaviour by different objective functions. In such cases the collection of data into one data set may become a mistake caused by an insufficient recognition of qualitative anomalies determining the relationships between them. Since in our case we cannot exclude such a situation in the analysis of FDI, we decided to inquire into the behaviour of foreign investors by means of a more sophisticated econometric technique than is the method of OLS [4].

[4] The technique we have applied belonged to the so-called robust methods of analysis based on least trimmed squares (LTS). For more details see Benacek and Visek (2000).

By using the robust method of analysis we have found that there have been only very weak causal links in the Czech economy for the attraction and the success of FDI. Especially the presence of FDI in a particular industry could have been explained only partially. There was a strong random (or here undisclosed) influence on the choice of investment ventures. Most probably it was a mistake to assume that investments grouped into 15 industries could reveal the full scale of causes of investments. Many investments were determined at the level of firms, especially if a privatisation deal could be achieved under advantageous conditions for the evaluation of assets. Nevertheless, at least some general observations could be drawn even at the given level of industrial break-up.

Contrary to the findings concerning the trade specialisation pattern before 1996, the FDI seems to be attracted more by capital intensive production. Most probably the stabilisation of the Czech economy after 1994 and extremely high investments resulted in a break in the factor comparative advantages. Labour is now no longer the dominant factor that offers an explanation of Czech economic (comparative) advantages. Its place was slowly replaced by physical capital. As was found in the analysis of determining factors of Czech trade (Benacek, Zemplinerova (1999)), there was yet emerging another important factor after 1995 – the human capital. These trends, however, were in buds during 1995-97.

On the other hand, the majority of phenomena decisively distinguishing the firms (industries) with FDI from indigenous firms could be found on the side of effects of FDI. Generally the presence of FDI means higher efficiency (e.g. profitability, total factor productivity or, increasing returns to scale) and higher competitiveness (e.g. higher quality or terms of trade). If this trend would continue, the gap between the foreign and the indigenous enterprises would be further widening. As a consequence, we cannot expect that indigenous firms would enjoy the same natural "comparative advantages", which were observed to have been developing in firms with FDI. The benefits of FDI could be then internalised exclusively in recipient enterprises and the indigenous firms could fall out off the competition.

7. Predictions and Challenges for the Next Developments

The fast growing importance of FDI in the Czech economy, their profitability and re-investment activities, can lead to a prediction that approximately in 2003 the foreign-owned enterprises will become the decisive actors in the Czech economy. This will be a final closure of the "Czech way" of privatisation that dominated the domestic economic policy-making during 1990-96. It is already evident that the privatisation strategies, that were set for supporting the indigenous ownership, have failed in the majority of its objectives. It was generally believed in the local political circles that the prescriptions for bringing a transient economy into high growth and prosperity pivot around the macroeconomic stabilisation, liberalisation of trade and prices, and privatisation defined as a de-etatisation (i.e. the release of the capital assets out of the hands of the State). While the Czech macroeconomic policy was extremely successful throughout 1990-96, the poorly implemented privatisation brought an extremely heavy price on the whole economy.

The Czech approach to privatisation was based on the belief that any initial de-etatisation (redistribution) of property was a sufficient condition for finding final owners guaranteeing an optimal usage of given assets. It was argued theoretically, by using both the theory of factor location and the Coase theorem, that the initial misallocation of resources did not matter, once market negotiations and trade could lead to their more efficient redistribution. The desired outcome would require that the transaction costs be very low both in acquiring the liquidity and in the equity trading. It was somehow forgotten that there were two additional essential conditions: that the property rights are clearly defined and enforceable, and the capital markets are efficient. Once that was not achieved in both cases because the drive of economic actors for the re-distribution of property found it contrary to their objectives, the first two conditions became aggressively counter-productive. They headed to soft credits, debts and heavy government bailouts.

The crucial importance of the Government throughout the process of privatisation caused that the capital markets were not developed and the whole privatisation was dominated by the interaction with bureaucracy. The role of bureaucrats, either in semi-state banks or in public administration (ministries) became more important than the performance of markets. Then the restructuring became too demanding and uncertain, if compared with an easy alternative represented by asset stripping. A large part of the indigenous firms even switched in their objectives from redistributional aims to destructive aims.

As the Government was too heavily involved in the privatisation, both in orchestrating the deals and in guaranteeing the bailouts, the moral hazard prevailed at the level of decision-making. Under such arrangements also the privatisation of banks, introduction of strict bankruptcy laws and the state supervision over the capital markets would be a threat to the stability of the Government. That was why such decisions were constantly postponed until the break-out of the financial and economic crisis in April 1997.

Some important changes were introduced in the economic policy afterwards and some more are still pending. It is undisputed now that it is the foreign capital that became the engine of growth in the Czech economy. Though important, the FDI incentive schemes (implemented since 1998) are not the decisive factor behind the acceleration of FDI inflows since 1999 [5]. What also matters is the stabilisation of the economy after 1999, prospects of future growth, quality of the labour market and the Czech geography where the advantages of a periphery are combined with an easy access to the core of EU markets. The success of transition is not guaranteed unless further reforms are implemented that will transform Czech Republic into a modern prosperous society. The scope of these reforms in discussed shortly in the Supplement to this paper.

[5] Let us look at the case of Philips investment into household electronics production at Hranice (North Moravia). The plant will be built as a replacement of capacities relocated from Wales (GB) due to rising labour costs and appreciating Sterling relative to Euro. The FDI commitments are $ 200 mil in 2001 with an extension to $ 600 mil in the second stage of development. The incentives represent an injection of $ 40 mil mediated by the Czech government which represents approximately 7% of the FDI. In addition to that there will be a corporate tax exemption and concessions for the payment of tariffs granted under free customs zones arrangements.

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9. Appendix

9.1. List of Pending and/or Proposed Reforms

In order to bring the country to stability (both macro and micro-economic) and on the path of a fast growth, the following problems should be brought under scrutiny. The list reflects some essential current issues discussed in the Czech society. The majority of them have been already officially investigated and some pending reforms will be even soon introduced.

a) The **political system** should generate politicians that would consider politics and the Government services as a service to the public and not a service the vested interests of their own or of their parties. The present generation of politicians in their 50s and 60s should be replaced by a more innovative structure of power. Recent Czech elections has shown that parties at the right from the centre have been gaining more power and the power reshuffling may not take long time.

b) The existing social incentive schemes, opening too large a window of opportunities for rent-seeking, re-distribution of property and appropriation, should be turned into the preference of creative activities, productive entrepreneurship and co-operation. This can be called a **moral revival** of the society that can be associated with the changes in the political structures.

c) The **role of the state,** involved in the redistribution of the GDP (approximately 50% of the GDP is taxed or appropriated by the government) should decrease. This will give less power to the bureaucracy and offer more opportunities to the private sector.

d) The past attempts to **re-vitalise** the economy by relying on the state capitalism are ill fated, leading only to the growing indebtedness of the state. The government bailouts should be superseded by a reliance on **private initiative** and healthy banking sector.

e) The pre 1998 lukewarm or even suspicious relationship to the **EU accession** has been recently changed at the level of the Government to a more co-operative pragmatic attitude.

f) The **legislation and the judiciary** should become the underpinnings of the rule of order, superseding the present frail (and in some respects practically non-existent) enforcement of the law. The past tendency to leave the contracts incomplete, what resulted in general defaults among trading partners, is no more tenable politically because the public opinion is opposing it.

g) A new wave of a **real privatisation** (mostly by foreign owners) will continue and redress the fatal errors of the voucher privatisation, which led to dispersed ownership and weak corporate governance.

h) The **privatisation of banks** should improve the functioning of the **financial market,** helping thus transfer the large fund of savings available into efficient investments.

i) A reform of the **pension system** should proceed during the next 7 years when the ratio of retired persons (the wave of the post-war baby boom) on the working population will dramatically increase. This reform is also closely connected with the help to the ailing **capital market.**

j) The system of **taxation** is inefficient and the tax evasion should be eliminated. The tax burden should be reduced to approximately 40 or even 35% of the GDP.

k) An effective **regulation of the capital market** should halt the market imperfections caused by insider trading and moral hazard that damaged this economy so much during 1993-96.

l) The whole strategy of preparation for EU accession should be overhauled and transferred into a manageable system. The **adjustment of the local legislation to EU** legislation should be speeded up urgently, otherwise Czechia may be delayed from the entry.

m) The **regional administration**, included in the constitution since 1993, is due to be established in 2001-2.

n) The principles and the organisation of the **public service** are undergoing a process of overhauling and the present practice will be soon regulated by a new law.

o) The number of employees in the public sector should be substantially decreased (e.g. by 30%) so that the **power of bureaucracy** be reduced.

p) The **incentive scheme for foreign direct investment** should be revamped in order to bring an even more open environment for investments from whatever sources (foreign or domestic). The incentives should be extended to include the promotion of subcontracting of indigenous firms by more successful foreign-owned firms, so that the spillovers from the latter to the former are significantly higher than it was in the past.

q) The **price deregulation** in energy, fuels and some government services should be speeded up.

r) The **prices of housing and land** should be deregulated so that a normal market in real estates can be established.

s) The **natural monopolies** (such as electricity grids and public utilities) should be regulated once the markets are not effective in those fields. The regulation should be accompanied by their **privatisation.**

t) The **health system and the health insurance** need a global change that would increase their efficiency, as its system of financing and incentives was neglected and delayed for long.

u) The regulation of farming products and the system of **subsidies to agriculture** should be adjusted to the regulatory norms of the EU (even though one has doubts whether this is a rational system).

v) The reform of **basic and secondary education** should be quickly initiated because these schools fail in providing the necessary skills required in globalised societies.

w) The fee-free **university education** excludes 60% of applicants because of the Government controlled quotas. The result is a corruption and a low quality of high education. The system should be changed and more open approach introduced.

x) A new system of financing the **basic and applied research** should be implemented, allowing for competition and efficiency. The system separating the high education from R&D should be abandoned and the incentive schemes for research should promote more the applied character of R&D and reward the performing researchers.

y) The development of **small and medium-sized enterprises** should be promoted especially by institutional changes that would decrease the burden of bureaucracy falling on that sector and offer a better access to credit lines from the banking sector.

z) The **depreciation and investment policy** should be simplified and deregulated. The small and the profitable firms will then have a better access to cashflow needed for investments and restructuring.

9.2. Review of the Czech FDI

Review of the Czech FDI, portfolio investments, long-term credits and deposits from abroad (in million USD):

Item	Foreign financial flows	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	1990-1999	*2000 estim.*
1	FDI annual inflows (in current $)	49	546	1003	653	868	2562	1428	1300	2719	5108	16236	*6000*
2	Growth rate of FDI (prev. year=100 %)	-	1,114	184	57	152	297	56	91	209	188	-	*117*
3	FDI flow per capita (in $)	4.8	53	97	55	84	250	139	127	265	498	1584	*585*
4	Cumulated FDI stock from abroad	49	595	1,598	2,251	3,119	5,681	7109	8409	11128	16236	-	*22236*
5	FDI / GDP in current prices (in %)	0.09	2.25	3.54	1.80	2.18	5.05	2.52	2.50	4.88	9.63	27.4	*10 00*
6	FDI / total gross investment	0.7	11.7	14.1	6.5	7.4	16.3	8.0	6.9	13.1	20.0	-	*22.0*
7	Net flow of portfolio inv. (liab.-assets)	n.a.	n.a.	-23	1600	855	1362	726	1086	1069	-1395	5280	
8	Net long-term credits (liabilities-assets)	n.a.	n.a.	215	806	1109	3367	3110	407	-918	-316	9014	
9	Net short-term financial transactions	n.a.	n.a.	-1274	56	659	971	-927	-1687	122	-716	-2806	
10	Annual gross capit. inflow (1+7+8+9)	49	546	-79	3115	3491	8262	4337	1106	2992	2681	27,724	
11	Current account balance	n.a.			456	-787	-1369	-4292	-3156	-1822	-1058	-12,028	
12	Net factor payments (incl. dividends)	n.a.	n.a.	-560	-118	-20	-106	-723	-650	-983	-739	-3899	
13	FDI flow abroad (outgoing)	n.a.	n.a.	n.a.	-90	-120	-37	-41	-25	-110	-197	-620	

Table 1

Source: Bulletin of CNB, Annual Report of CNB, Balance of Payments [1993-99]

What Exists is Possible: FDI Prospects and Policies in Bulgaria

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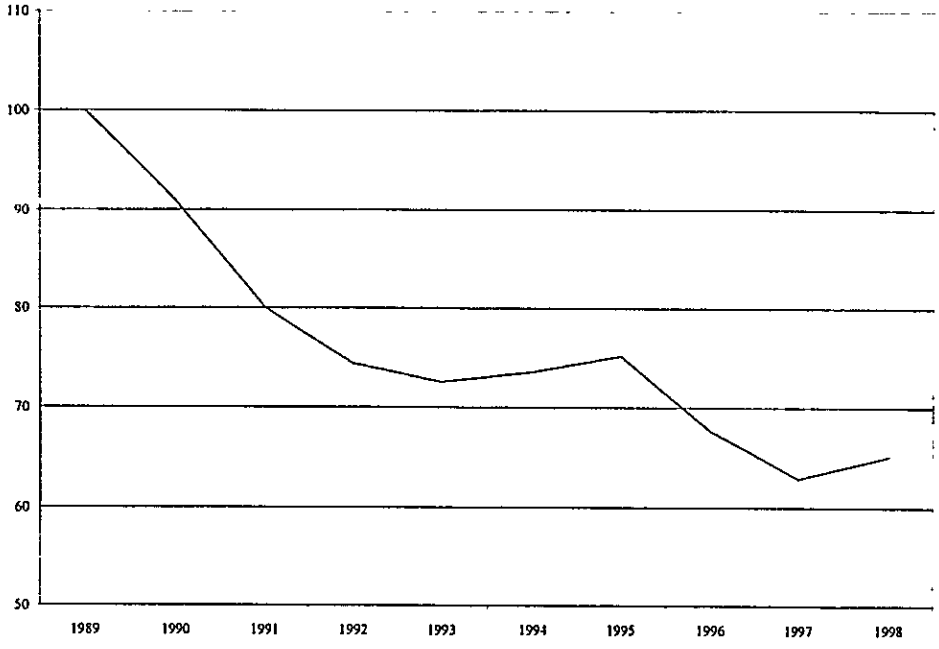
1. Introduction

Bulgarian economy happened to be resilient to external shock, but more so after the introduction of the currency board arrangement in 1997. It is not simply a merit of the arrangement per se but, practically speaking, it has helped to follow set of policies, which eventually offset negative developments on the international markets. It is no accident – in early and mid-1990's more crucial domestic policy deficiencies and constellations mediated external shocks. In the cases of embargoes etc. they aggravated the negative impacts. In cases of international market turbulence, they prevented the chocks. In the post 1997 period, the economic restructuring is taking off from the limbo of the previous period. At the same time, besides structural inefficiencies and the ambivalent impacts of external factors Bulgarian economy managed to reorient its markets from the ex-Eastern Block countries to the EU and the European free trade zone, and domestic economic structure is adjusting itself to this circumstances through increased FDI after 1998.

2. Mismanagement of reforms (1990-1997).

After 1989, only four years registered growth in real GDP. In 1994, 1995 the growth was modest but fueled by indebtedness of the state owned enterprises, quasi-fiscal subsidies and international conjecture. It reemerges in 1998 and 1999 on sounder fundamentals (stable currency, low inflation, bankrupted loss making enterprise, etc.). 2000 is likely to register growth of about 5% of GDP, thus completing a three-year test period for growth sustainability. At the same time, since 1989, real GDP has lost more than one-third of its initial volume and the recovery is slow, reaching in 2000 72% of the pre-reform level.

Real GDP Index (1989)=100



Graph 1

Source: NSI, IME calculations

3. Growth factors in 2000

Bulgaria in 2000 is registering a third year of economic growth. It is a sign of sustainability.

Demand-side structure of GDP (1991, 1999 and 2000)

	1991	1999	2000
Private consumption	55.9	82.3	
Government consumption	17.2	8.4	
Investments	22.6	19.0	
Net exports	4.3	-7.7	

Table 1

Source: NSI

The table above compares the demand driving Bulgarian GDP since the start of the reforms in March 1991. Preliminary data for 2000 demonstrate a restoration of the role of exports as a factor of GDP. The significant fact is that it is the first development of the sort for ten years. The big question mark, however, is whether it marks a beginning of a trend or simply due to conjecture factors.

To answer this question, one should look at different domestic factors that are likely to support greater trade and growth potential. For different factors I allocate different terms of contemporaneity. As factors I select:

- Average growth of GDP for certain periods, although there was a growth in 1998 of 3.5%, I categorize this year to the previous period in order to "discount" a provisional impact of the economic inertia, and not to take into account the factor of the low starting point (the contraction of 1996 real GDP was 10.9%, in 1997 – 6.9%);
- Average export growth for the same periods;
- Average growth of savings to GDP, this time the contemporary period includes 1998, and it is compared to the years between 1995-1997 in order to avoid the sharpest decline in saving at the beginning of reforms;
- Foreign direct investment and gross domestic investment (taken for the period of 1994-1997 in order to skip the disinvestments in first reform years).

Comparisons of selected growth factors for selected periods

Indicators	[Period] / percent	[Period] / percent
Average GDP growth	1990-1998 / - 3.9	1999-2000* / 3.3
Average export growth	1990-1998 / 6.7	1999-2000 / 9.7
Average savings to GDP	1995-1997 / 13.16	1998-2000 / 13.13
Gross domestic investment	1994-1997 / 11.6	1998-2000 / 18.03
Foreign direct investment	1990-1998 / 3.3	1999-2000 / 4.4

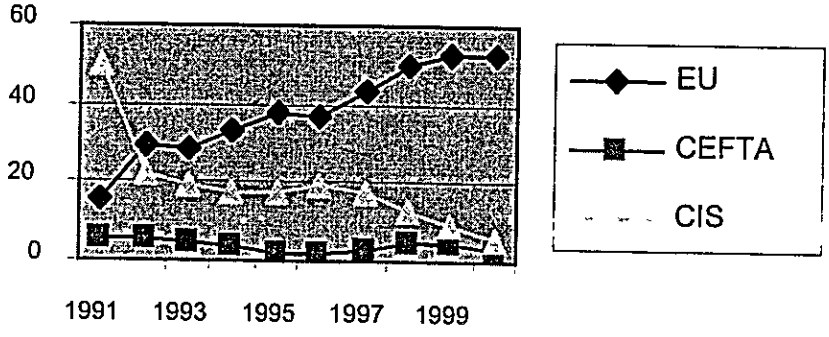
Table 2

Source: IMF, NSI, own calculations
(*) – 2000 forecast

Growth trend seems to be reversed. Investment is steadily higher in the last three years than in the previous period. Foreign investment is higher than in years before 1998 but still unused factor. Institutional background was also providing for greater government discretion, which allow eventually to mismanage the exchange rate and restored price controls and protectionism in 1995. In addition, by the end of 2000 90% of Bulgarian banks are private and 70% of them – foreign. No domestic political party is advocating major changes in the monetary or trade policies. External policy framework of EU accession is an additional institutional constraint to domestic temptation for radical policy reversals.

In addition, Bulgarian trade was converted from East to West under circumstances less favorable in 1998 – 2000 period, than they could be at early years of transition.

Geographical distribution of the Bulgarian exports



Graph 2

Source: NSI
[Data on years before creation of CEFTA are for the member-countries.]

Compared to Slovenia, which in 1991 had close to 60% of its trade with EU and EFTA, Bulgaria had to re-orient its trade from the same trade volume to then at the eve of dissolution CMEA, seeking other markets. Bulgaria's starting point of reforms was significantly worse than that of other emerging economies. Also, Bulgaria lost markets in Iraq, Libya, and Iran. Sanctions against Iraq and Libya blocked USD 2 billion of their debts to Bulgaria.[1]

4. What exist is possible

It is possible to compare the demographics of Bulgaria with its global share in FDI's. Such a measurement has been proposed as a part of general bench-marking on Bulgaria's economy by J.A. Austin Associates (JAA). JAA compares Bulgaria's FDI for a selected year with its share in the global population. In 1998, the first year of a relative break through after the crisis of 1996-1997, Bulgaria attracted USD 401 million FDI's, which put her on 61st place out of 162 countries on which information was available for the World Development Indicators of the World Bank. Between EU accession countries behind Bulgaria in that year we only three countries: Latvia, Slovenia and Cyprus.

Bulgaria's share in global FDI flows[2]

Country	FDI in US$ Millions	Populatin Millions	Share of World Popu-lation	Share of global FDI	FDI per capita	FDI Populatin Ratio	Perce ntile Rank
Singapore	10,326	3,164	0,05%	0,78%	3264,20	14,43	95
Ireland	4,038	3,705	0,06%	0,30%	1089,88	4,82	88
Spain	32,539	39,371	0,67%	2,45%	826,47	3,65	83
Czech Repulbic	2,609	10,295	0,18%	0,20%	253,42	1,12	75
Hungary	2,414	10,114	0,17%	0,18%	238,72	1,06	73
Romania	2,040	22,503	0,38%	0,15%	90,65	0,40	53
Macedonia,FYR	118	2,010	0,03%	0,01%	58,52	0,26	42
Bulgaria	**401**	**8,257**	**0,14%**	**0,03%**	**48,61**	**0,21**	**37**

Table 3

Source: World Development Indicators, JAA calculations

JAA assumption is that FDI/population ratio might be considered "fair" if it is at least close to 1. Obviously this is a conventional assumption, but it helps comparisons. While Bulgaria's FDI share is six times smaller the share of the world population, Hungary and Czech republic, although with similar sized of population look considerably different.

[1] It happened simultaneously with the default on foreign debt payment in March 1990, announced unilaterally by then communist cabinet. It also happened at the eve of the first democratic general elections of the post-communist history of the country, held in June 1990. Then elected new set of government had still to establish itself and simultaneously, in a condensed time-period, with the reorientation of trade to deal with debt rescheduling, launching reforms and constitution making. The immediate victim of this agenda was not the constitution making, political reforms or the international relations but the consistency of economic reforms

[2] Martin Webber, Kevin Murphy, Bulgaria's Competitiveness Beyond 2000, J.A Austin Associates, Washington DC, Sofia, 2000, p. 14. WDI figure for 1998 Bulgaria FDI is different from that officially accepted by Bulgaria's Foreign Investment Agency; WDI does not takes into account reinvested earnings and credits, if we add to them the figure would be USD 620 million.

The development is the following. In 1998, FDI's as percent of GDP constituted 3.3%. A year later it almost doubled to 6.1%. In the years after 1998 the inflow of FDI is on average 30% higher per annum. Accumulated stock of foreign direct investment in 2000 would be at least 21% of the GDP. It would be twice less than the share of FDI's to the GDP of Hungary but roughly the same percentage as in Poland.

FDI's per country of origin give more information on provisional trade developments. Presumably, the trade would be sustained or even improved if trade partners interweave respective economic entities and cooperate.

In 1999 EU capital had 60% of the FDI's in Bulgaria, in 2000 this share will be already 63-64%. (In terms of per capita the figure would almost double the amount of 1998.) Similar but higher shares of EU investment have Central European countries.[3] On the SEE scene similar is the performance of Croatia and Romania.[4] An interesting development is that of the Italian investment. Italia use to be a prime trade partner for the last ten years, but in terms of direct investment she has been at bottom of the list with only USD 35 million. In 2000, the fourth biggest Italian bank, with a major presence at the emerging European markets, Unicredito Italiano, bought the biggest Bulgarian bank. Thus Italy's Bulgarian position as a second trade partner converted itself into a third investor. The structural impact of such development cannot be underestimated: it has finalized the privatization of the Bulgarian banking sector, diversifying the foreign presence in accordance with the major trade and investment partners.[5] As of the end of 2000, Germany, Belgium and Italy would amount to over 40% of the investment in Bulgaria.

FDI by source and year (USD for 1992-2001)**

	Privatization	Portfolio	Greenfield	Total per year
1992			34	34
1993	22	n.a.	80	80
1934	134.2	n.a.	76	200.2
1995	26	n.a.	136	162
1996	76.4	n.a.	180	256.4
1997	421.4	29.7	185	636.1
1998	155.8	64.2	400	620
1999	305.7	53.1	447	805.7
2000*	480	20	500	1,000
2001**	400	25	450	875
Total period	**2,021.5**	**192**	**2,488**	**4,701.5**

Table 4

Source: Foreign Investment Agency (FIA), IME
[*- FIA forecast, ** - IMEforecast.]

Earlier foreign investors, like Belgium based Solvey and Union Miniere, have bought respectively major chemical plant producing soda and a copper smelter. They build up their advantages on the originally subsidized in mid-1990 markets, restructured the enterprise and provided a bridge to a sustained exports without relying on quasi-fiscal transfers. Similar developments take place in the textile and knitwear industry.

[3] Gabor Huya, FDI in SEE: Implementing Best Policy Practices, WIIW, 2000, p. 5.

[4] Ibid., p. 5-6.

[5] The EU ownership of the Bulgarian banking system is about 70%, with other investors like Societe Generale, National Bank of Greece, AIG, Raiffaisen Bank, ING, etc. Structurally significant Italian investment is taking place on a smaller scale as well, e.g. a leading Italian woolen textile producer bought earlier this years one of the biggest Bulgarian factories (with 30% of the assets in the sector and 25% market share), inducing domestic rivalry and thus changing the future of the entire sub-sector in the textiles.

5. Some additional comparisons and conclusions

In 1999, FDI increased in Croatia and Bulgaria but declined in some other countries, e.g. in Macedonia and Romania. Per capita inflow for Bulgaria is approximately 2.5 times less advantageous than for Croatia but as a percent of GDP the volumes are roughly comparable. But it is also important that the combined FDI inflow for Southeast Europe in 1999 is 62% of the FDI to Czech Republic FDI for the same year.

Cumulative inflow per capita since 1989 is comparatively very low, more than seven time less than in Hungary or six time less than in Czech Republic.

Indicators of foreign direct investment in SEE economies (1998-1999 in million USD)

Country	FDI										Cumulative	
	Inflow		FDI abroad		Net		Inflow per capita		% of GDP		USD	Per capita
	1998	1999	1998	1999	1998	1999	1998	1999	1998	1999	1999	1999
Albania	45	41	-	-	45	41	14	13	1.5	1.1	424	138
BiH	100	60	-	-	100	60	27	16	2.4	1.3	160	42
Bulgaria	537	739	-	-5	537	734	64	89	4.4	6.1	2,228	269
Croatia	873	1,332	-83	-43	781	1290	195	298	4.0	6.6	3,552	793
Romania	2031	961	9	-12	2,040	949	90	43	4.9	2.8	5,441	243
Macedonia	118	40	-	-	118	40	59	20	3.4	1.1	217	108

Table 5

Source: UN/ECE secretariat

EU has promptly become Bulgaria's most important trade partner with relative share of Bulgarian trade of 74% for the period between 1993 and 1999. At the same time the price for the trade reorientation was the low value added and losses in previously complex factors of production due again to the lack of FDI to compensate for these development. The second trade partner for Bulgaria is SEE (including Turkey and Greece) with average share of 31% of Bulgarian trade over this seven years period. On both EU and SEE Bulgaria had already repeatedly registered more exports than imports, and they constitute a natural venue of the domestic market enlargement. This seems to be a major advantage for attracting FDI.

Regarding Bulgaria peculiar history of FDI suggests that for the government there is limited space to maneuver relying predominantly of domestic savings and investment. Even in best years since 1998 FDI remain 3-4 lower than domestic investment.

Privatization in pipeline includes limited number of high valued big companies in telecommunications, transport and power infrastructure, natural gas and tobacco monopolies. Some of these companies, e.g. in telecommunications, are overstuffed with outdated equipment, and would be difficult to restructure. Investment in power generation and distribution has the advantage of a large and provisionally greater SEE market. Related to privatization circumstances for foreign investment are opportunities for re-privatization. It stems from otherwise unfortunate fact that in 1998 and 1999 large amount (74 and 39% of respective annual "sales") of formerly government owned companies were distributed to insiders, government appointees: many of them have already opted for resale.

The second natural FDI channel, the capital market, remains underdeveloped. The situation is not likely to be improved in 2001.

Since 1997, green-field FDI significantly outnumber investment through privatization and portfolio mechanisms. For the time being opportunities have been and are expected to remain significant in the following areas:

- Equity investment in competitive private companies; they are like everywhere and easy to recognize: they avoiding poor domestic demand, have strong forward integration, do not rely on government preference, apply strict internal quality control, innovate and perfect their product and services and work with education institutions;
- Private provision of former government services in pensions and healthcare;
- High-tech green-field in manufacturing, software industries, electronics, biotechnology and genetics, and ether-oils;
- Electricity production and distribution, energy efficiency projects and services.

Romania – FDI policy, Advantages and Points at Issue

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Director
National Agency for Regional Development

1. Evaluation of the performance of FDI over the past 10 years

During the period 1990 – 2000 (August) FDI in Romania reached the level of 4.89 billion $, an additional 1,12 billion $ being effectively invested in the privatization process. Given the fact that the source of data for FDI in joint ventures or green field investments is represented by the National Trade Register, while the source of data for the FDI in privatization is the State Ownership Fund, the two sets of data will be presented and commented separately.

The level of FDI stock in Romania is definitely much lower than in some other countries in the area [1] (Poland – 30 billion USD; Hungary – 19 billion USD; Czech Republic – 16 billion USD; data for the end of 1999). At the same time, the level is also low in relation to the economic potetial of the country.

As one can see from Table 1, FDI in joint ventures and greenfield investment was characterized by a sinuous evolution, with a clear downturn trend in past three years. During the first 8 months of 2000 historically low level of FDI have been achieved (a little over 3 million US$ per month – that is much less than 1991 levels).

Evolution of setting-up companies with foreign participation: Dec 1990 – Aug 2000

	Number of companies with foreign investment		Total of amount of registered capital		Of which : in convertible currency	
	No.	%	million lei	%	thousands U.S. $	%
Total	76931	100	60797830.8	100	4898143.5	100
Year 1991	6326	8.2	15758641.7	25.9	779610.6	15.9
Year 1992	12194	15.9	3287315.7	5.4	377249.5	7.7
Year 1993	10793	14	3207886.3	5.3	417434.2	8.5
Year 1994	11521	15	5874128	9.7	913472.7	18.6
Year 1995	3795	4.9	1917121.5	3.2	245961.4	5
Year 1996	4056	5.3	7986439.6	13.1	738908.2	15.1
Year 1997	5752	7.5	6588024.8	10.8	484684.3	9.9
Year 1998	9114	11.8	5287596	8.7	344845	7
Year 1999	7862	10.2	6866085	11.3	393135.9	8
Year 2000	5518	7.2	4024592	6.6	202841.7	4.1

Table 1

Source: Oficiul National al Registrului Comertului, Investitia Straina in Romania – Sinteza Statistica nr 31.

[1] World Investment Report 2000 – Cross Border Mergers and Acqusitions and Development, UNCTAD, New York and generva, 2000, Chapter II – Regional Trends, p.64

As for the FDI in the privatization process, recent data as of early October 2000 from the State Ownership Fund reflect the following situation on the actual cashed amounts related to privatization (Table 2)

Actual cashed amounts in privatization 1993 - 2000

	CHF	DEM	ITL	USD
1993				2,005,000
1994				3,900,000
1995			355,169,621	14,865,827.19
1996		16,508,050		7,642,862
1997		4,341,540		401,728,564.1
1998		4,493,678.33		606,001,987.17
1999	132,779.38	1,061,156.79	27,773,544	56,536,983.47
2000		272,849		6,906,108.20
Totalby currency	**132,779.38**	**26,677,274.12**	**382,943,165**	**1,099,587,332.13**

Table 2

Source: State Ownership Fund (SOF)

Note: Other sources indicate a much higher amount of FDI in privatization, but they refer to commited and not actually paid in amounts. For instance, according to SOF data, for the period 1992 – September 2000, the amount of foreign investments committed as result of privatization contracts has been of 2.216 billion USD. The data above refer to amounts that were effectively paid in the privatization process.

1.1. Causes of FDI evolution in Romania during 1990 - 2000

The level of FDI in any country is definitely influenced by a number of factors such as: the level of economic development, infrastructure (both physical and institutional), geographical location and the existence of functional market economy institutions and mechanisms. From these points of view Romania presented in the last decade a number of positives and negatives.

The **positives** were mainly the following:

- geographical location;
- size of the country (similar with Great Britain);
- size of the domestic market (22.5 million inhabitants, second place in the area after Poland);
- some natural resources (including oil, natural gas, salt, minerals, fertile agriculture land);
- diversified industrial infrastructure;
- skilled, low cost labor;
- association with European Union and strong NATO support.

The **negatives** refered to:

- unequally developed infrastructure across the country;
- lack of proper market institutions (especially in the banking sector);

- legal and instituional instability;
- slow privatization process.

Anyway, besides the above, the evolution of FDI in Romania can be primarily explained by other causes. These causes can be linked to the two election cycles: 1992 – 1996 and 1997 – 2000 and they represent a particular situation for Romania.

1.2. The Romanian offer for foreign investors

In order to understand the importance of this element, we should note that the large inflows of foreign investment in Central European countries (Poland, Hungary, Czech Republic) during the period 1992 – 1996 were mainly determined by the privatization of large companies (like Skoda in the Czech Republic), of some public utilities (such as telecommunication and electricity networks), airline companies or state banks.

From this point of view, the Romanian offer during 1992 – 1996 towards foreign investors was definitely poorer and less attractive. The broadening of this offer after 1997 was tardive, affected by negative international circumstances (like the war situation in Yugoslavia) and undermined internally by legislative, institutional and, even, during certain periods of quasi-governmental crisis due to tensions among the membres of the coalition in power, political instability.

The attempt to explain this improper offer towards foreign investors leads us to the core issue, which is, in our opinion **the political factor.**

The analysis of the FDI evolution in Romania in correlation with the election cycle and the legal and institutional approaches specific to each period reveal the existence of two distinct situations:

a) **1991 – 1996.** In Romania there was a stable and even attractive legal framework for FDI, but the privatization offer was very limited and did not include public utilities or banks. During this period, foreign investors benefited of positive discrimination (more incentives than local investors), automatic registration of investment in case no official answer to the request for investment eas given in 30 days, as especially, the guarantee that the law applicable to the foreign investment will be the same for the whole existence of the investment, with the only exception that a new law would provide better terms and conditions. As result, Romania recorded until the end of 1996 a large number of foreign investors (over 50,000), in fact the largest number in Central and Eastern Europe, but these investors were small ones, the majority being natural persons. This situation comes to argue against the statements about a high and deterring level of corruption during that period, given the fact that the small investors (and the more so natural persons) do not have the economic or political clout that may accompany large investors like Coca-Cola, Siemens, DAEWOO, Shell, ABB, etc. and they have to pass through all the steps of the bureaucratic procedures. The fact that these foreign investors came to Romania in such a high number during the 1991 – 1996 period is the best proof that they did not face an un-mountable level of bureaucracy.

   The large foreign investors of that period, that came in a very limited number, were determined mainly by:

   - the size of the market, especially in case of consumer goods (Coca- Cola, Colgate-Palmolive);

- internationally funded projects (like in infrastructure, telecommunications – ABB, Siemens);
- regional strategy of the investing company and/or the Romanian offer of incentives (Daewoo, Unilever, Kraft Jacobs Suchard).

Due to the very limited privatization offer, during this period FDI in privatization recorded the insignificant amount of 33.1 million USD.

b) **1997 – 2000**. During this period, a reversal of the previous situation occurs, namely the legal and institutional framework for investment became extremely volatile and even unpredictable, but privatization offer increases considerably. The overall result of this combination proved to be negative, fact reflected in the level of FDI in joint ventures and green field investments which recorded during 1999 – 2000 the lowest levels of the whole 1991 – 2000 period (Table 1). It is to be noted that even in privatization, the receipts declined substantially in 1999 and 2000 (Table 2).

The volatility of the legal and institutional framework strongly affected foreign investors both directly and indirectly: directly by discouraging the investment initiative due to the impossibility to prepare and implement a business plan and, indirectly, due to the negative evolution of the business climate and of the whole economy which became totally unattractive (decline of investment in economy, sharp decline of purchasing power, etc). It is known the case of Colgate Palmolive which closed during this period (in 1999) its soap production facility in Bucharest due to the long term decline of local demand as result of the growing poverty of the population.

During the period 1997 – 1999 the GDP declined with more than 14 %, an unusual reduction during peace times, fact that further generated a strong circumspection from the part of foreign investors. The resuming of the economic growth in year 2000 (1.3 – 1.5 % over the previous year) is yet to be confirmed and has not made any immediate and significant impact on the foreign investors.

2. Evaluation of FDI policy and its implementation process

A number of general comments can be made refering to the whole 1990 – 2000 period. Aside of these general comments, there are then specific aspects for the two election cyccles, 1992 – 1996 and 1997 – 2000.

2.1. General comments

The attractivity of Romania for FDI has been negatively affected by a number of aspects related to the evolution of reform process.

The main limit, both as regards attraction of FDI, and the evolution of economy in general, was represented by **the absence, during the whole period 1990 – 2000 of an industrial policy** which would have extablished a number of priorities in the deelopment of industrial branches and sectors and would have allowed an active policy of stimulation of economic activity on the basis of qualitative criteria.

The absence of an industrial policy has meant implicitly **the absence of the instruments** by which such a policy would have been implemented (fiscal and financial instruments, effective means of intervention for smoothing the way for the foreign investor on the Romanian market, etc.). The lack of these concrete instruments led to the situation in which the activity of FDI promotion limited to general promotion activities (mainly consulting support and production and dissemination of information and promotion materials) and promotion of micro-economic investment projects.

The absence of an industrial policy, with a clear component regarding FDI, has also determined **an attitude from the part of Romanian fiscal, customs and administrative bureaucracies that was not always friendly or coherent** vis-à-vis foreign investors (and, for that matter, domestic investors too).

It is likely that the most important impact on the volume of FDI in Romania has been made by **the slow privatization process**. As we have mentioned above, in the countries neighbouring Romania it was noted, at least during some periods, a direct correlation between the rithm of privatization and the volume of FDI, over 80 % of those FDIs being determined by the sale of some large state companies.

As for Romania, an economist [2] remarked that "until mid 1999 28.3 % of the assets owned by the state has been privatized. Extrapolating the results obtained during the latest period, we reach the conclusion that we need further 15 – 16 years to conclude the privatization process."

The high level of fiscality, as well as the lack of transparency also represented a less encouraging factor for foreign and domestic investors.

Another limit, with implications more of a psychological nature, has been represented by the maintenance until the beginning of 1997 of **a certain lack of clarity regarding the possiblity of the foreign investors to buy the land related to the foreign investment in Romania.**

After 1997, the persistence of the legal and procedural problems related to the restitution of nationalized buildings and lands has determined in certain cases a reluctance from the part of foreign investors.

For the period 1997 – 2000 a specific problem has been represented by **the extreme institutional and legislative instability** which prevented foreign investors to make medium and long term assesments on the profitability of their investments in Romania.

A series of hesitations recorded in the management of the economic reform has accentuated the reluctance of the foreign investors towards Romania, while the **repeated downgrading of Romania during the period 1997 – 1999 by the international rating agencies** as result of the economic decline contributed also to the increase of the reluctance of foreign investors.

At the same time, the lack of a clear mandate (respectively of a clear transfer of authority) to the investment promotion agency (Romanian Development Agency) during the period 1991 – 1996 and the de facto dissapearance of the agency immediately after 1997 have determined during the first phase a low efficiency in attracting foreign investors and, in the second phase a state of confusion among them as a field of activity can not be a priority for a government as long as the specialized institution is abolished.

[2] Dragos Negrescu, Un deceniu de privatizare in Romania, in volume "Tranzitie economica in Romania", coord. Christof Ruhl, Daniel Daianu, CRPE, World Bank, Bucharest, 2000, p.489

The insuficient international promotion of Romanian offer for foreign investors. This phenomenon became acute since 1997, when practically no funds were allocated any longer for this activity, and by the abolishing of the investment promotion agency at the end of 1997 Romania eliminated itself from the financing granted by the European Union (van der Broeck facility) exactly for the attraction of foreign investment, the respective funds being thus directed by the donor to the competing countries in the area. In 1998 Romania became the only country in Europe and maybe in the world which had no specialized institution for attracting foreign investment. The re-establishment in 1999of an institution with the former name (Romanian Development Agency) but with different attributions could not compensate for the loss of this useful instrument for the attraction of FDI. The year 2000 brought about new institutional changes that eliminated both de facto and de jure any formal activity related to attraction of FDI.

2.2. Legal aspects 1991 – 1996: a European beginning

An organized and systematic activity related to attraction of FDI in Romania has started in March 1991 once with the promulgation of the Law no.35/1991 – Foreign Investment Law and with the beginning of activity by Romanian Development Agency.

Anyway, Romania did not start from zero in this so complex domain of activity, having in view both the experience gained from the activity of joint ventures starting in 1972 (a premiere at that time among socialist countries) and the experience accumulated in the new conditions of market economy since 1990 from the activity of the Romanian Agency for the Promotion of Investments and Assistance from Abroad (ARPIAES).

An important element in marking towards the international circles the wish of Romania to attract foreign investments was represented by the publishing in 1992 of a Statement of the Romanian Government regarding the support, encouragement and guarantee of foreign investment.

Romanian Development Agency, in fact an investment promotion agency, has represented for Romania, from an institutional point of view, a pioneer work.

What made Romanian Development Agency a distinct entity in the Romanian institutional framework has been the fact that it was structured and organized in its fundamental aspects during 1991 – 1992 period a an institution specific to the market economy, being completely harmonized with the legislation and practices of the European Union.

Thus, the organization of Romanian Development Agency was initially based on the support from British Know How Fund and then, in the medium term, from the European Union PHARE Programme. This support was materialized in the preparation of a feasibility study by Irish Development International (IDI) which also provided the training and technical assistance for about 3 years. Further assistance was provided for the development of promotion techniques and materials as well as for promotion of concrete investment projects.

From this point of view, Romanian Development Agency has been an "integrated" and " associated" institution to European Union avant la lettre, as it was established no only according to the European model, but also with the direct participation of the representatives of the most successful investment promotion agencies in Western Europe, those from Ireland and Scotland.

2.3. Achievements and international recognition during 1991 – 1996 period

Among others, Romanian Development Agency was the first government institution in Romania to publish an annual report starting 1991, the first government instituion with a Western organizational chart (quasi-governmental agency), the first government institution to start promoting foreign investment in Romania by Internet in December 1995 and the first to produce a promotion material on CD-ROM also in 1995. Romanian development Agency has also been the first systematic supplier of promotion materials and information regarding the investment climate and investment opportunities in Romania. From this point of view, a number of materials were produced starting 1991: law digest for foreign investors, invetment guides, a magazine (Romanian Investment Review), slides, video presentations, multimedia materials on CD-ROM or floppy support, an Internet site.

As an international recognition of the promotion efforts made by this new instiution, in September 1994, Romanian Development Agency was granted the "AWARD FOR PROGRESS" on the occasion of the fourth annual reunion of the investment promotion agencies organized in Amsterdam by Corporate Location.

At the same time, the Internet site of the Romanian Development Agency, launched in December 1995, has been recognized as being of professional level on the occasion of the annual convention of investment promotion agencies from September 1997 in Chicago, the siote being ranked at the same level with the sites of Rank Xerox and British Airways.

The pioneer activity of Romanian Development Agency has determined a lot of difficulties in the relations with other institutions still influenced by the old procedures and mentalities and, in the end, its complete rejection after 1997.

2.4. Implementation of attracting FDI during 1991 – 1996

During this period, the activity of Romanian Development Agency for attracting foreign investment in Romania, and therefore of supporting foreign investors, mainly consisted in:

- supply of reference and information materials regarding the legal and institutional framework for foreign investors (guides, brochures, translations of economic legislation, etc.);
- suppy of complex consulting services for potential foreign investors, services that could include organizing of site visits to government and non-government institutions, to Romanian companies, participation to negotiations between Romanian and foreign partners, assisting the foreign investors in fulfilling the formalities needed for setting up a company, etc.;
- providing an interface between the foreign investor and the Romanian institutions and companies, especially for securing the amicable solving of various problems related to the establishment and further operation of a company with foreign participation.

Romanian Development Agency also provided services for Romanian companies and institutions, such as :

- assisting Romanian companies in preparing their investment projects according the international practices (UNIDO standards);
- assisting Romanian companies in evaluating the offers made by foreign companies in order to secure an objective evaluation of the contribution of the parties to the joint venture;
- preparing studies and analises regarding international practices in the field of foreign investment for the Romanian Parliament, Government,President, etc.;

- cooperation with other Romanian institutions in the implementation of complex foreign investment projects.

The attraction of foreign investment in Romania has been achieved by two main mechanisms:

- granting of incentives (tax exemptions and customs tax exemptions for the in kind contribution of the investor) that were substantially reduced after January 1, 1995;
- directly supporting the foreign investor through Romanian Development Agency in its approach for setting up a company in Romania by:
  - providing compelte information on the investment climate in Romania;
  - providing investment projects according to UNIDO standards to potential foreign investors;
  - systematic organization of foreign investment promotion activity.

To conclude, it is also to be noted that between March 1991 and July 1997, FDI in Romania was regulated by a single law, Law no. 35/1991.

2.5. 1997 – 2000: Legal uncertainty, policy and institutional change

The Romanian governments after 1997 have kept a strange silence on the FDI subject. Aside of some rare statements on public occasions, FDI is not even a subject included in the medium term (2000 – 2004) strategy.

Starting early 1997 a number of changes regarding the legal and institutional framework for FDI has taken place, all of them converging towards a diminishing attention given to the subject by the Romanian authorities.

Thus, in January and February 1997, some important political figures of the newly elected coalition in power announced in the media the possible closing of the Foreign Investment Promotion Agency (Romanian Development Agency). Then, Law no.35/1991 regarding foreign investment, a law that was in force for more than 6 years, was replaced by the Emergency Ordinance no 31/1997. This Ordinance could not be enforced because its application norms were enacted only on December 29, 1997. At the same date, December 29, 1997, the institution nominated to implement the Emergency Ordinance no.31/1997 (Romanian Development Agency) was abolished.

One day later, on December 30, 1997 was issued Emergency Ordinance no.92/1997 regarding the stimulation of direct investment. This Ordinance introduced the national treatment (the equality of treatment for Romanian and foreign investors) but, at the same time, drastically reduced the incentives (mainly fiscal) granted to investors.

The Emergency Ordinance no.92/1997 was debated in the Romanian Parliament during 1998 and it was promulgated as Law on direct investment no.241 in December 1998. Law no.241/1998 was the unhappy subject of the worst case scenario for an investors: the retroactive application of the law. Despite the fact that Law no.241/1998 stipulated that its provisions would not be changed for a period of 5 years (a rather unusual provision), only 3 months after its promulgation, in March 1999, the incentives granted to investors were suspended by the Budget Law. The fact that, although adopted in March, the budget law was considered in force since January 1, 1999 determined a retroactive application and hence a suspension of the incentives already and legally granted to investors. Particularly affected were some companies that had signed privatization deals on the specific assumption that the law was indeed to be maintained for at least 5 years.

Further on, in May 1999, by Emergency Ordinance no.67/1999 regarding some measures for the development of economic activity, a number of incentives were re-established for the investments in excess of 50 million $. Only one month later, in June 1999, Government Decision no.519 established (following discussions with the Internationally Monetary Fund) un indefinite moratorium on the granting of incentives. Quite luckily, Renault was, at that time, the only beneficiary of the incentives provided by Ordinance no.67/1999 although other investors were also eligible.

The year 2000 brought with it the complete disappearance of the institutional activity of attracting FDI in Romania once with the final closing of the little activity that was yet in existence in the former foreign investment promotion agency. An institutional vacuum was thus created exactly when a number of international initiatives (the Balkan Stability Pact, the starting of the negotiations for the accession to European Union) required as a counterpart the existence of a foreign investment promotion agency in Romania.

This rapid succession of changes in the foreign investment regime has determined extremely negative effects, generating a strong reserve of the foreign investors to operate in such a volatile climate. Known examples are: Solectron (large US company in electronics sector) that had in view to create 5,000 jobs in Timisoara and had to reduce its plans in order to adapt to the current environment; Continental AG that delayed for more than one year its decision to invest due to the volatility of the legislation.

To summarize, we can also mention a study made by a reputed specialist in Romanian FDI [3] who mentioned as causes of the low level of FDI in Romania after 1997: the volatility of the political environment, the inefficiency of the administration, the generalized corruption. Quite interestingly, the study includes among the causes the absence of a foreign investment promotion agency which was seen as one of the solutions for improving the current situation.

3. Impact of FDI on the national economy including regional development

A specific aspect of FDI in Romania is represented by the fact that investments over 500 thousand USD represent over 80 % of all foreign investments. It is to be noted a polarization function of the size of capital invested, respectively, about 1 % of the number of companies with foreign participation own over 80 % of the invested capital, while about 95 % of the number of companies with with foreign participation own about 12 % of the invested capital.

This aspect is also reflected by the structure of FDI in Romania by type of investors (legal or natural persons) in the total number of companies with foreign participation. Only 7.7 % of the foreign investors in Romania and 8.3 % of the Romanian partners are legal persons (companies), the rest of 92.3 % and respectively 91.7 % being natural persons.

As regards the structure of the capital in foreign currency invested in companies with foreign participation during the period 1990 – May 2000 by types of investors, 81.1 % belongs to legal persons (companies) and 18.9 % to natural persons.

The polarization of FDI in Romania in very small companies (usually having as foreign investors natural persons) or very large (having as investors companies) is explained under the circumstances of a transition economy like the Romanian one in which the functioning of the market mechanisms and institutions is far from normal.

[3] Dr. Costea Munteanu, From recession to growth through FDI, International Center for Entrepreneurial Studies in Bucharest, November 1999

The large investors can operate on an imperfect market because they can afford long term strategies that allow for loses during the first years of operation. At the same time, these large companies may have acces to the government institutions and have technical and legal assistance that help them solve the various problems that they encounter.

On the other hand, the small companies and the individual investors can operate on an imperfect market because they have a minimal inertia, they are not involved in large investments, with long technological cycles and they can capitalize fast on favourable, short term circumstances.

In this context, one can expect that the increase of the weight of the medium sized companies among the foreign investors will represent a real barometer for the normal functioning of the market economy in Romania.

As we mentioned before, a simple explanation for the very significant difference between the level of FDI in Romania and those from other neighbouring economies is given by the different evolution of ther privatization process. In the transition economies in which the level of FDI is high took place during 1994 – 1996 privatizations of public utilities (electrical energy, telecommunications), banks or large industrial companies. In Romania, these large privatizations started only in 1998 (Romtelecom, Banca Romana pentru Dezvoltare, Dacia – Pitesti), under unfavourable circumstances from the point of view of the internal and international climate.

The main sectors of activity to which FDI have concentrated in Romania were: industry (mining, processing, machine building, tools and equipment) – 25.9 %; professional services – 20.6 %; wholesale trade – 14.5 %; food industry – 13.0 %; light industry – 10.8 %; retail trade – 7.8 %; agriculture – 2.7 %; transport – 2.0 %; constructions – 1.9 %; tourism – 0.8 %.

These options reflect in fact the caracteristics of the Romanian economy during the '90s: a transition economy, with an internal market of 22.5 million inhabitants (second largest in the area) with a low and dimishing purchasing power, the existence of a high industrial pitential in a series of branches, significant natural resources.

From the point of view of territorial distribution, FDI in Romania during the period 1990 - May 2000 showed a high concentration in Bucharest (about 51.3 % of the total foreign capital invested and about 53.5 % of the total number of companies with foreign participation established).

The orientation of the foreign capital in Romania, during the mentioned period, by historical provinces was the following: Transilvania – 10.5 %; Muntenia – 8.7 %; Banat – 7.6 %; Moldova – 5.4 %; Oltenia – 4.6 %; Crisana – 3.1 %; Dobrogea – 3.0 %; Maramures – 1.3 %.

This distribution mainly follows the degree of development of the infrastructure and industrial concentrations proving that FDI goes to the areas where the business environment is more advanced.

3.1. Origin of FDI in Romania

From the point of view of the foreign capital invested in Romania, the geographical origin is the following: Europe – 79.4 %; Asia – 10.2 %; North America – 8.3 %; South America – 1.1 %; Africa – 0.5 %; Oceania – 0.5 %.

As regards the number of commercial companies with foreign participation, the geographical origin is: Europe – 57.2 %; Asia – 34.6 %; North America – 4.6 %; Africa – 2.5 %; South America – 0.6 %; Oceania – 0.5 %.

4. Impact of FDI on the development of domestic industry and other issues related to FDI

The current level of FDI in Romania compared to the size of its economy is too limited for determining a significant impact on the domestic industry.

At the same time, it is worth mentioning that Romania has had a very diversified industrial base in 1990, with almost every industrial activity having excess capacity and a relatively outdated technology. The Romanian industrial structure as of early 1990 included consumer electronics and telecommunication equipment, automotive industry (cars, trucks, tractors), aviation industry (airplanes, helicopters), shipbuilding, oil extraction equipment, chemistry, textile, furniture and wood processing, etc.

After a decade, the analisis of the large FDI projects in Romania indicate a significant impact in a number of sectors in which the impact mainly consisted in the revival of existing industries and not in the emergence of new ones.

Examples of industrial sectors and of foreign investors with a significant impact are given below. The investors mentioned are not the only ones in the respective fields.

- automotive industry: the investments made by Daewoo and Renault;
- tyre production: Continental AG;
- electronics and telecommunication: Solectron, Siemens, Alcatel, Telrad;
- GSM networks;
- machine building sector: ABB, Kverner, Bilstein Compa, Koyo, Timken;
- shipuilding: Daewoo;
- textile sector: various investors;
- food stuffs: Coca-Cola, Kraft Jacobs Suchard,
- detergents: Unilever;
- pharmaceuticals: several investors;
- wood processing: IKEA.

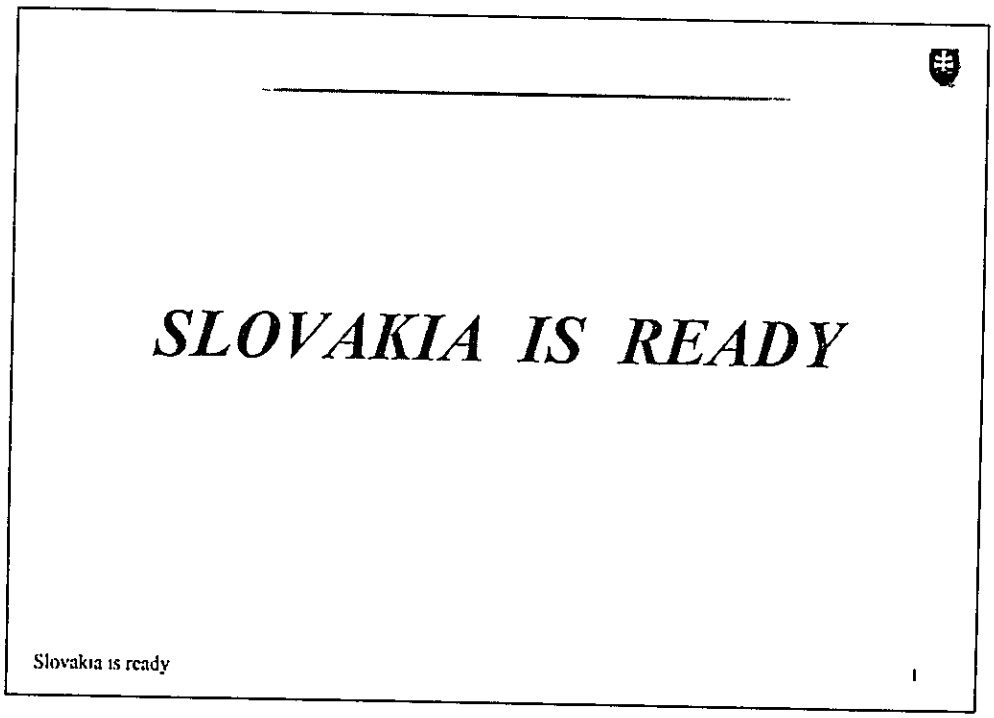
4.1. Prospects for the near future

On November 26, 2000 Romania holds general and presidential elections. Given the very short time till this moment it is clear that no changes of the current FDI situation are to be expected.

What will be after elections depends a lot on the configuration of the next Parliament. We can only comment that it is very likely the new Romanian government will put much more stress on FDI promotion and that the gradual harmonization with European Union will further increase the attractivity of Romania as an investment location.

Slovakia is ready

Mr. Alan Sitar, Slovak Republic
Advisor to the Prime Minster
Office of the Government of Slovakia



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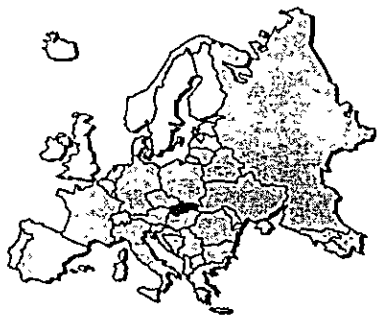
Slovakia - Key Facts



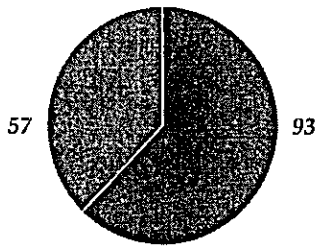
- **Location :** Central Europe
- **Population:** 5.4 million
- **Area:** 49,035 sq. km.
- **Capital:** Bratislava
- **Currency:** Slovak koruna (SKK)
- **GDP per cap:** approx. USD 4000 (1999)
- **Rating:** S&P : BB+
  Moody's : Ba1
  Fitch : BB+

Political Situation

Parliament and the Government :

- **President:** **Rudolf Schuster**
- **Prime Minister:** **Mikuláš Dzurinda**
- **Current coalition holds 93 seats (62%), a constitutional majority**
- **Current coalition is determined to serve its full term**
- **Next Presidential Election : 2004**
- **Next Parliament Election : 2002**

Slovak Parliament (150 seats)



Political Situation

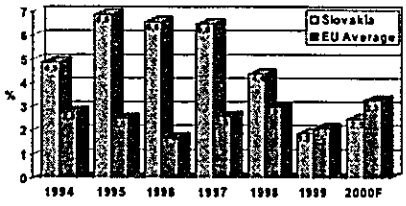
Political Orientation - Europe's Top Convergence Story :

- **First wave applicant to join the EU:**
  - **November 1999: Invited to start negotiations**
  - **February 2000: Negotiations commenced**
  - **Negotiation on 9 Chapters are concluded, 3 other Chapters are being negotiated**
  - **OECD membership achieved in October 2000**
- **Candidate for NATO membership, supported across political parties**
- **Member of UN, WTO, CEFTA and Council of Europe**

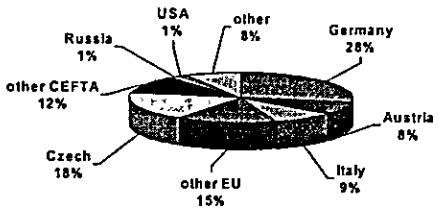
Economic Situation - GDP

- **GDP 1999 outperformed expectations, growth rates compare favourably in the region**
- **61.1% of exports directed to EU and Switzerland, and 91.5% to OECD countries**
- **Exports up by 14.0% y-o-y in USD by Jan. 2000, including 10.8% increase into EU**
- **Higher economic growth in EU will aid future economic performance of Slovakia**

Annual Real GDP Growth



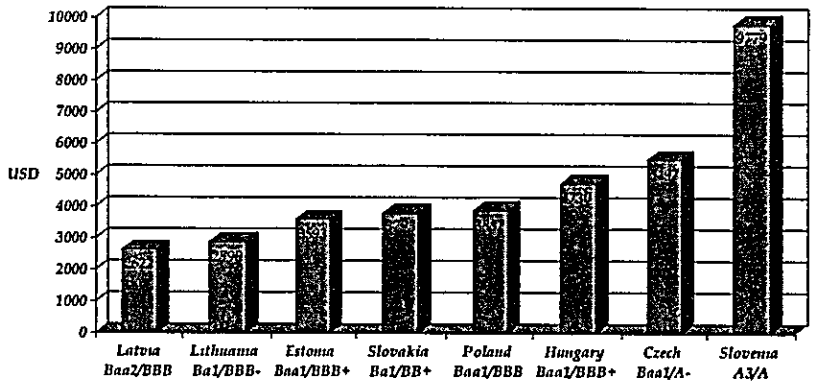
Export by Countries in 1999



Economic Situation - GDP

- **Slovak GDP per capita compares favourably with higher rated peers**

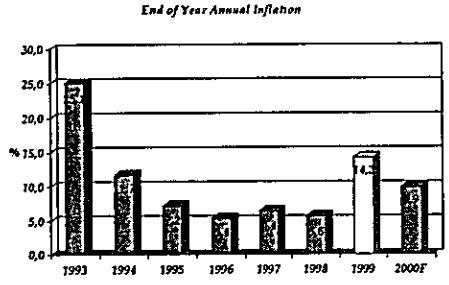
GDP per capita in 1998

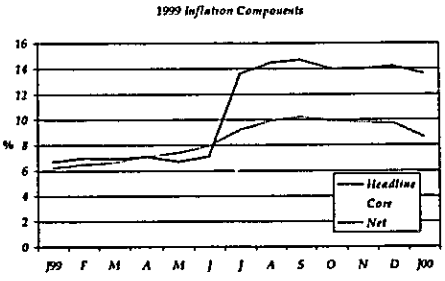


Economic Situation - Inflation

Government successfully cuts inflation :

- **Price deregulation caused a one-off rise in overall inflation in 1999**
- **Net inflation remains under control at 5% y-o-y in July 2000**
- **End-2000 core inflation target is 4.9-5.8%, core inflation is 4,9% in July 2000**



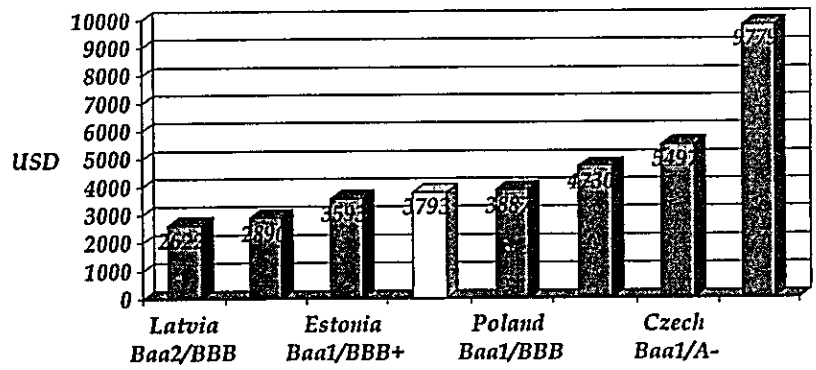


Slovakia is ready 8

Economic Situation - GDP

- **Slovak GDP per capita compares favourably with higher rated peers**

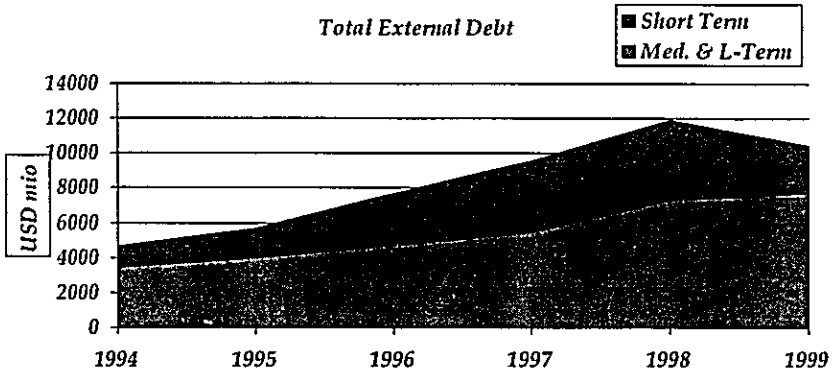
GDP per capita in 1998



Slovakia is ready 7

Economic Situation - External Debt Reduced

- Slovakia's total external debt stood at USD 10.4 billion in November 1999, down by USD 1.5 billion from end of 1998
- Proportion of short-term debt fell to 13.3% (end of June) from 26.51% in end of 1999.

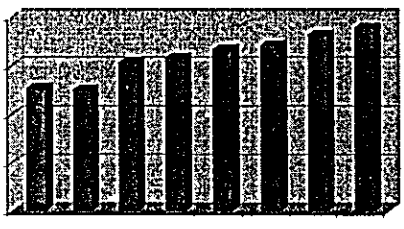


Slovakia is ready 10

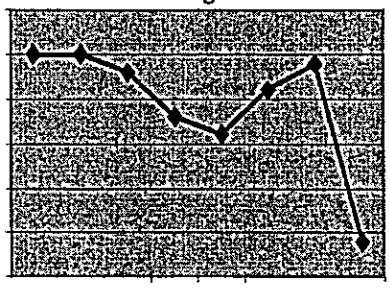
Unemployment

- Increase in unemployment in 2Q 99 reflects the consequences of corporate restructuring efforts of the government
- Positive development of unemployment thanks to special governmental measures

Unemployment in % from 3Q 98 to 2Q 00



Unemployment in % from Jan.00 to Aug.00



Slovakia is ready 11

Economic Situation - Privatisation Program

- **Government is moving forward according declared intention to sell stakes in Telecommunications, Financial Institutions and a number of Utilities:**

Slovenské Telekomunikácie	*3Q 2000*	*51%*
VÚB - Všeobecná Úverová Banka	*2000*	*84.5%*
Slovenská Sporiteľna (bank)	*2000*	*66.6%*
Transpetrol (oil pipeline)	2000	49%
SPP (gas utility)	2000/2001	49%
Slovenské Elektrárne (non-nuclear parts)	2001	49%
IRB - Investičná a Rozvojová Banka	2000	69.5%

- **Other companies sold to strategic investors :**

Slovnaft (oil refinery)	*MOL (Hungary)*	*May 2000*
Globtel (GSM operator)	*France Telecom*	*July 2000*
VSŽ Košice (steel maker)	*US Steel (USA)*	*Oct 2000*

Slovakia is ready 12

Economic Situation - Corporate Restructuring

- **Restructuring of corporate sector on the back of banking sector restructuring**
- **Corporate tax lowered to 29% to reduce tax burden and stimulate business environment**
- **Improved bankruptcy procedures will speed up bankruptcy execution**
- **Government committed to promotion of SME sector**
- **Independent regulation authority to be established for the telecommunication and energy sectors**
- **New capital market watch dog to improve access of companies to long term capital**

Slovakia is ready 13

Economic Situation - Corporate Restructuring

- Government has successfully concluded debt restructuring of the VSŽ Košice steel maker
- Proposal to Government on restructuring in the energy sector was adopted in September 2000
- Long-term goals of restructuring in the corporate sector are:
  - Increase competitiveness and efficiency
  - Attract foreign capital and expertise
  - Improve microeconomic situation in Slovakia

Economic Situation - Delivered Economic Reforms

- Successful implementation of austerity measures:
  - Deregulation of prices
  - Import surcharge
  - VAT and excise tax changes
  - Freeze on wages in the state sector
- The twin-deficits curbed:
  - Current account deficit fell from -10.1% in 1998 to -5.6% of GDP in 1999
  - Budget deficit improved to -1.9% of GDP in 1999 from -2.9% in 1998

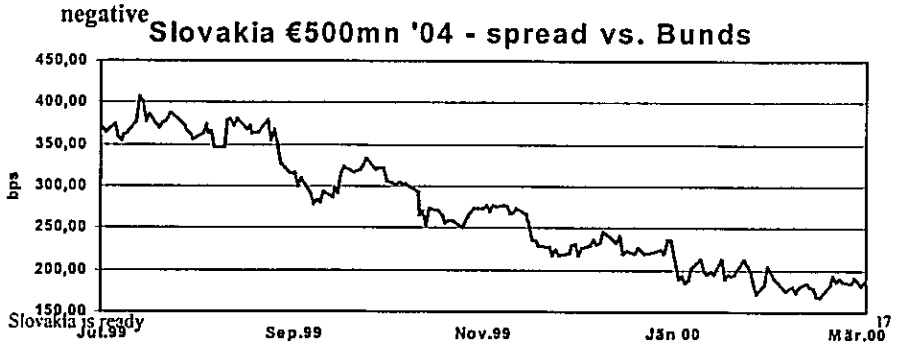
Economic Situation - Delivered Economic Reforms

- **Inflation kept within monetary targets of the National Bank of Slovakia**
  - **Net inflation stayed at 5% y-o-y in July 2000**
  - **Overall inflation boosted by price deregulation to 14.7% y-o-y in July 2000**
- **1999 GDP growth of 1.9% at a high end of Government forecast**

Economic Situation - International Markets View

Slovakia - Europe's Top Convergence Story :

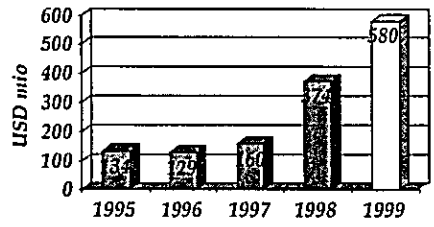
- **Privatisation of major state-owned banks and utilities**
- **Liberalisation completed and economic reform under way**
- **Rating outlook by Moody's and S&P improved to stable from negative**



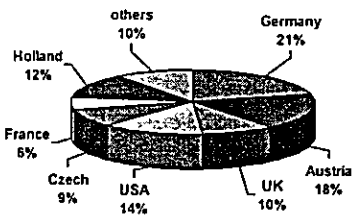
Foreign Direct Investments

- **Government programmes designed to stimulate FDIs include tax incentives and support of green-field projects**
- **Sale of 24% stake in Československá Obchodní Banka (ČSOB) boosted the FDI flow in 1999**

Foreign Direct Investment Flow



Cumulative FDIs by Countries as of 09/1999



FDI by industry

Total stock	*$ 2.044 billion*
Manufacturing and service enterprises	$ 1.735 billion
Financial sector	$ 0.309 billion
♦Manufacturing	47.5%
♦Financial Services	21.6%
♦Trade	18.9%
♦Transport and Communication	3.0%
♦Building and Construction	2.7%
♦Real Estate	2.6%
♦Raw Materials	1.4%

Top Investors in Slovakia by Sector

Food – processing:

Tesco Stories (UK)
Coca – Cola (Netherlands)
Heineken (Netherlands)
Tate &Lyle Plc (UK)
Kraft Food International (USA)

Metallurgy:

US Steel (USA)
Hydro Aluminium (Norway)

Construction:

MF Beteiligung (Germany)
Winerberger (Austria)
Hebel (Germany)
Heraklith (Austria)
Berger Holding(Germany)

Textile:

Ecco (Denmark)
GFT (Italy)
Texcel (Netherlands)
Schiesser (Switzerland)

Top Investors in Slovakia by Sector

Chemical industry:

Aventis (France)
Bank of New York (USA)
Durapack (Austria)
Contitech (Germany)
Continental (Germany)
SL Pharma (Austria)

Bank and Insurance:

ING Group (Netherlands)
Allianz (Germany)

Engineering:

Stowline Overseas (USA)
INA Kraftwerke (Germany)
Whirpool (USA)
Siemens (Germany)
Sauer Sundstrand (Germany)
Sachs (Germany)

Generali (Austria)
Amslico (USA)

Top investors from Japan in the Slovak Republic

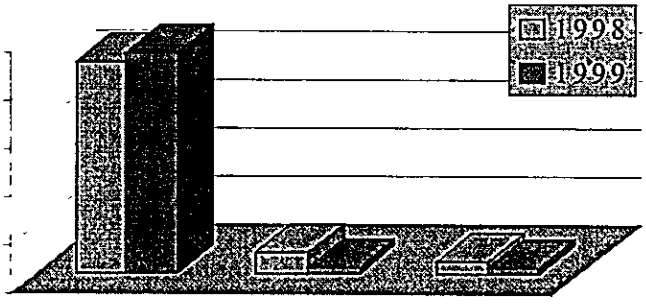
Name	*City*	*Sectors*
Yazaki Debnar Slovakia	Prievidza	Production of cables for Automotive Industry
SONY Slovakia	Trnava	Electrotechnical Industry
Hosokawa Vertriebsbüro	Bratislava	Real estate
Matsushita Electronic Components	Trstena	Electrotechnical industry
PANASONIC Slovakia	Bratislava	Commercial Representations
TOYOTA Tsushu Slovakia	Bratislava	Automotive Industry

Slovakia is ready 22

Do you have expansion plans in Slovakia?

- Response of Foreign Investors (invested in Slovakia) to the question :

„ Are you planning to expand your investments in Slovakia ? „



Slovakia is ready 23

FDI - Government Approach

Slovak Government adopted proactive approach to FDI :

- Government defines support of FDI influx as one of its top priorities
- Government adopted in march 1999 Strategy for support of FDI influx
- Government adopted First Incentive Package in April 1999
- Government adopted First Incentive Package in April 1999
- Since 01/01/2001 Slovakia is on par with Czech Republic, Hungary and Poland in incentives offered to Foreign Investors

Slovakia is ready 24

FDI - First Incentive Package (valid now)

Conditions to apply for incentives :

- Minimum 75% foreign ownership
- 5 mil. EUR investment in region with less than 15% unemployment
- 2,5 Mil. EUR investment in region with more than 15% unemployment

Benefits for qualified investors :

- 100% tax relief on profits during the first 5 years,
- 50% tax relief on profits during the subsequent 5 years.
- Abolition of VAT.
- Zero import duty on high technology.
- Job creation/training contributions - upon agreement with National Labour Fund

Slovakia is ready 25

FDI - Second Incentive Package (since 01/01/2001)

Conditions to apply for incentives (SME Companies) :

- Minimum 75% foreign ownership
- 5 mil. EUR investment in region with less than 15% unemployment
- 2,5 mil. EUR investment in region with more than 15% unemployment

Conditions to apply for incentives (Multinational Companies) :

- No conditions on ownership
- cca. 10 mil. EUR investment in region with less than 10% unemployment
- cca. 5 mil. EUR investment in region with more than 10% unemployment

Slovakia is ready 26

FDI - Second Incentive Package (since 01/01/2001)

Benefits for qualified investors (SME Companies) :

- 5 years tax holidays (no procedure applied)

Benefits for qualified investors (Multinational Companies) :

- 10 years tax holidays (all incentives granted through Memorandum)
- Job creation subsidies (paid in monthly instalments - next page)
- Land acquisition subsidy / Access to the Industrial Parks Program
- Infrastructure building subsidy
- Permanent Local Authorities assistance
- Permanent SARIO assistance

Slovakia is ready 27

FDI - Second Incentive Package (since 01/01/2001)

Benefits for qualified investors (Multinational Companies) :

- 10 years tax holidays (all incentives granted through Memorandum)
- Job creation subsidies (paid in monthly instalments)

Grant / per job		Unemployment in the region
160 000 Sk	—->>	higher than 30%
130 000 Sk	—->>	25 - 30%
100 000 Sk	—->>	20 - 25%
70 000 Sk	—->>	15 - 20%
40 000 Sk	—->>	10 - 15%
30 000 Sk	—->>	bellow 10%

Slovakia is ready 28

SARIO - Vision & Goals

SARIO - Slovak Agency for Foreign Investments and Trade :

Agency of the Government of the Slovak Republic with the aim to provide services for foreign investors as well as Slovak exporters on the "one-stop-shop" principle, while promoting image of Slovakia abroad.

Goals :

- Create and promote image of Slovakia
- Promote and support Foreign Direct Investments (into Slovakia)
- Promote and support Slovak Exports

Slovakia is ready 29

SARIO - Services to Foreign Investors

Services listed are provided on the "one-stop-shop" principle :

- Access to the all relevant information. important to investors
- CDs, brochures. newsletters. reviews - regular coverage
- Direct connection to all relevant ministries (system of co-ordinators)
- Direct connection to all Local Authorities
- Comprehensive Information databases (Regions. Partners)
- Project Management co-operation (one client - one manager)
- Local advisors search and recommendation
- Industrial site localisation
- High state representatives co-operation

Conclusion and Outlook

Slovakia - Strong Upside Potential :

- Restored internal and external balances stabilised macroeconomic situation
- Economic recovery in Europe will further drive economic performance of Slovakia
- Falling interest rates with inflation under control will provide additional stimulus to growth
- Structural changes in banking and corporate sector aimed to improve microeconomic fundamentals
- Accelerated privatisation will ensure sustained FDI flows and bring foreign expertise

Conclusion and Outlook

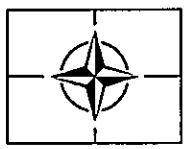
Slovakia - Strong Upside Potential :

- Political stability assured under current coalition
- Low external and internal debt burden provides flexibility to Government
- Continuation of structural and economic reforms is likely to result in Slovakia's re-gaining of investment grade rating
- EU accession goal will keep the momentum behind recent developments

Conclusion and Outlook

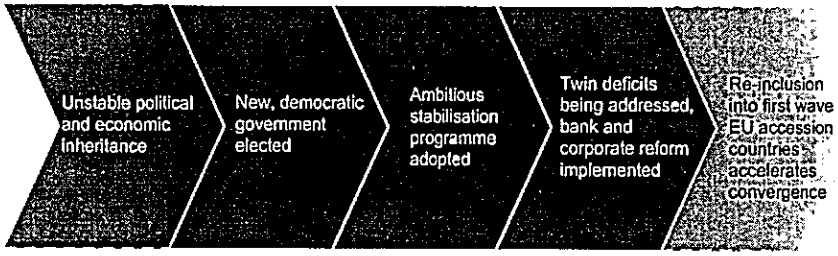
A Unique Convergence Story :

- Current government delivers on promises
- Slovakia's progress approved by EU's invitation to accession talks
- OECD membership imminent
- Existing Euro-Atlantic links will be further strengthened by NATO membership



Conclusion and Outlook

The dramatic turnaround is working



Conclusion and Outlook

Slovakia - Environment for FDI :

- Skilled, available and competitive priced labour force
- Lowest FDI in the Central Europe Region - biggest attention to investors
- Back on track with all accession processes
- Investment friendly and proactive Government approach
- Competitive Investment Incentives Package
- History of Industrial Production
- Sufficient Infrastructure next to EU Markets


SLOVAKIA IS READY
for
FOREIGN DIRECT
INVESTMENTS
Slovakia is ready
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SARIO - Content

- SARIO History
- Vision & Goals
- Services - Promotion Slovakia
  - FDI
  - Foreign Trade Development
  - Information Resource and Library Services

SARIO - Content

- FDI - Government Approach
- FDI - First Incentives Package
  - Second Incentives Package
- FDI - Services
- Success stories
- Outcome

SARIO - History

SNAZIR

PIU Phare **SARIO – 26th June 2000**

Foreign Trade Support Fund

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- **Create and promote image of Slovakia (international public)**
- **Promote and support Foreign Direct Investments into Slovakia (foreign investors)**
- **Promote and support Slovak Exports (Slovak exporters)**

SARIO - Services - Promotion Slovakia

Promotion Slovakia and SARIO and its services within Slovakia and abroad by marketing tools

- Image Building & Investment and Export Generation
- Relations with Institution
- International and Regional Delegations
- Training & Education

Slovakia is ready 41

SARIO - Services - FDI

Activities which support the inflow of FDI

- Identification of potential foreign investment partners
- Assisting potential foreign investors with their investment appraisal and leading negotiations between local and foreign partners
- Providing daily management information to investors
- Construction of an investment opportunities database
- The analyses of selected industries of Slovak economy

Slovakia is ready 42

SARIO - Services - Foreign Trade Development

Substantial growth of Slovak export through increasing the export effectiveness of existing Slovak exporters

- **Provide up-to-date information**
- **Export Development Services**
- **Event Management**

SARIO - Services - Information Resource and Library

Maintained, updated and available information

- **Request and organise a needs assessment for further development of IT, Internet retrieval and homepage development**
- **Prepare technical specification for new tender to upgrade IT and standard SW**
- **Identification, selection, and renewal of subscription of information sources**

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Slovakia is ready 45

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Slovakia is ready 46

FDI - Second Incentive Package (since 01/01/2001)

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30 000 Sk	—>>	bellow 10%

Slovakia is ready 49

FDI - Services

SARIO is prepared to help to the foreign investors

Green-field, Brow-field and Joint Venture Project:

1. investment climate consults
2. a. Green-field project -key site selection assistance

   b. Brown-field project - key building selection assistance

   c. Joint venture project - contact Slovak and foreign enterprises with the complementary plans
3. district or region studies
4. contact with the representatives of state administration and local government
5. consultancy

Slovakia is ready 50

SARIO - Success stories

Implementation of the investment projects in the Slovak Republic in period 1999 - 2000

PLASTIC OMNIUM – France

- *Green-field project* - (bumpers, fenders, carriers, fuels systems)
- *First contact*: October 1999
- *Investment intention*: production of exterior automotive components and fuel systems
- *Total amount of investment expenditures*: 60.000,000 EUR
- *Creation of new jobs*: 600 employees
- *In September 2000* company has started to build production halls in location Lozorno.

SARIO - Success stories

EISSMANN - Germany

- *Brown-field project*
- *First contact*: August 1999
- *Investment intention*: production of interior automotive components from leader, plastic
- *Total amount of investment expenditures*: 6 millions DM
- *Creation of new jobs*: 350 employees
- *In May 2000* company bought the production hall in the town Holic and started with the reconstruction of this building.

SARIO - Success stories

MATSUSHITA – PANASONIC – Germany/ Japan

- *Brown-field project*
- *First contact*: September 1999
- *Investment intention*: production of components for audio-video
- *Total amount of investment expenditures*:
- *Creation of new jobs*: 250 – 1000 employees
- *October 2000* – company decided to set up subsidiary company in the town Krompachy

Slovakia is ready 55

SARIO - Success stories

TODENCO – France /Japan

- *Brown-field project*
- *First contact:* May 1999
- *Investment intention*: production of wiring harness
- *Total amount of investment expenditures*: 5 millions DM
- *Creation of new jobs*: 100 employees
- *November 2000* - company decided to set up subsidiary company in the town Puchov and rent production hall

Slovakia is ready 54

SARIO - Outcome

Slovakia welcomes foreign direct investments

- Assistance in negotiations with executive administration as well as with local and foreign partners for or on behalf of about 150 foreign investors - „one-stop-shop"
- Creation of new investment opportunities, green-field and brown-field premises database and maintaining of this existing databases
- Presentation of investment opportunities of the Slovak companies willing to co-operate with foreign partner in international fairs, seminars or conferences
- Recommendations for in sphere of legislation to improve existed conditions
- Providing of follow up of established foreign companies to provide the review and monitor of effectiveness of Governmental scheme

Slovakia is ready 55