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Intereconomics

Suggested Citation: Hany, Csilla (1995) : Foreign direct investment in Central Eastern Europe: Some lessons for Poland from Hungary, Intereconomics, ISSN 0020-5346, Nomos Verlagsgesellschaft, Baden-Baden, Vol. 30, Iss. 1, pp. 36-43, <https://doi.org/10.1007/BF02926360>

This Version is available at:

<https://hdl.handle.net/10419/140485>

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Csilla Hany*

Foreign Direct Investment in Central Eastern Europe

Some Lessons for Poland from Hungary

Foreign direct investment (FDI) has a significant role to play not only in the process of accelerating privatization, but in the development and strengthening of the emerging market economies of Central Eastern Europe (CEE). The inflow of FDI into Poland up to 1994 was marginal as compared to Hungary and the Czech Republic. The following paper examines the situation in Poland and outlines what lessons can be learnt from the Hungarian experience.

Foreign direct investment (FDI) in Poland, as in all Central Eastern European (CEE) economies, can be the driving force behind a number of objectives connected with the transformation of the economy, including privatization, capital inflows, the introduction of modern technology and management techniques, and the supply of quality products to local and international markets. Until recently, none of these had lived up to expectations, and while Hungary and the Czech Republic can be considered relatively successful, the economic impact of operational inward investments in Poland has been marginal.¹ The year 1994, however, can mark a turning point. The shock therapy reforms begun in 1990 seem to be paying off; with 4 per cent growth in 1993, Poland boasted the most dynamic economy in recession-struck Europe. This achievement, along with other encouraging economic indicators for 1994, should give a positive signal to foreign investors, particularly now as western interest in Central Eastern Europe is re-igniting – providing that the socialist-led Polish coalition government can continue to strengthen the institutional underpinnings of the emerging market economy.

This paper aims to give an overview of some important developments since 1986 concerning FDI in Poland, without claiming to be comprehensive.² After a brief examination of the role of foreign capital in the CEE countries, the paper first focuses on the

legal framework of Polish FDI between 1986 and 1994, followed by a brief examination of the growth trend of FDI. The political, economic and historical underpinnings relating to the conditions for FDI are then discussed in the context of Poland by using some of the author's own survey material from Hungary. The paper finally highlights some important recent developments which place Poland in a potentially favourable position for attracting FDI vis-à-vis its smaller neighbours.

It is well known that after some apparent success in catching up with the West in the 1950s and 1960s, due to the growing international role of heavy industry at the time, the socialist command economies of CEE have fallen behind since the early 1970s as the core fields of innovation and production moved to electronics, software development and the services industry. The socialist economies were unable to generate and diffuse technological progress sufficiently, and technical underdevelopment became widespread. The whole chain of innovation dynamics

¹ While almost 2,000 state firms changed hands through liquidation, leasing and domestic capital buy-outs from 1990 up to January 1994, fewer than 100 state firms have found strategic foreign investors. Cf. Reuters News, January 4, 1994.

² It is reasonable to assume that some of the recent statistics used in this paper underestimate the amount of FDI which entered CEE, as the accuracy of the data is questionable for a variety of reasons. Some have to do with the statistical system's inadequacy, some are due to confidentiality on behalf of the foreign investors, and some are simply too "raw" to analyse in an accurate way. Note also that portfolio investments through securities will not be discussed in this paper.

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in the form of inspiration, invention, investment and competition was missing. Innovation can only develop in an open society, where the competition of ideas, individuals and institutions along with vertical and horizontal mobility generate a continual flow of new ideas.³

Many CEE countries, particularly Poland and Hungary, survived in the period of low production efficiency combined with exaggerated distribution demands of the 1970-80s only by continually increasing their indebtedness. The austerity policy that followed led to a reduction in domestic capital formation, which in turn created further technical underdevelopment.

The influx of FDI under these circumstances can be doubly advantageous, as it simultaneously counterbalances low domestic capital accumulation and narrows the productivity gap by modernizing the means of production. During the introduction of equity capital, the investor is concerned not only with a passive portfolio investment, but also desires to actively improve the market conditions of the enterprise. By the introduction of marketable products and by the advancement of production and marketing techniques, cooperation with foreign investors can improve the market positions of previously state-owned enterprises. Therefore, foreign capital has an indispensable role in accelerating the privatization process while it aids in the development and strengthening of the nascent market institutions of the CEE economies.

It is well-known that FDI in Poland lags behind flows into its smaller neighbours. Hungary, as usual, led the way in attracting FDI in 1993, with a net inflow of \$ 1.2 billion, while Poland had only about \$ 600 million.⁴

It may seem that the country has suffered from its uneasy relations with foreign creditors. But as some foreign observers⁵ argue, the remnants of some bureaucratic red tape may also hinder development.

³ For some important points on the weak technological progress in the CMEA countries cf. L. Balcerowicz: *Innovationsspezifika, Wirtschaftssystem und Innovationsleistung von Wirtschaftssystemen*, in: L. Balcerowicz and J.J. Welfens (eds.): *Innovationsdynamik im Systemvergleich*, Heidelberg 1988.

⁴ The Economist, June 18, 1994; and March 19, 1994. Hungary also had the biggest draw in terms of investment per capita, at \$ 130 in 1992-93, while Poland ranked only 5th on the scale of Eastern European countries after Hungary, the Czech Republic, Slovenia and Estonia. Foreign companies invested a total of \$ 1,069 million in Poland since 1986, less than in one year in Hungary. One may also note that with worldwide FDI flows of some \$ 200 billion, the inflow of \$ 3-4 billion annually into CEE economies is not at all impressive.

There have been some encouraging economic developments in 1993-1994, however, and if they can be sustained along with further steps toward the liberalization of FDI, they could change the future of the entire Polish transition. What has changed in 1994, and can the changes be channelled into an acceleration of FDI in Poland? Before we answer these questions it is perhaps useful to highlight some previous events in the Polish experience with FDI, beginning with its legal context since 1986. #

Legal Aspects of FDI in Poland

The Polish economy opened to FDI in the post-war period in 1976, when the First Joint Venture Decree was passed by the Council of Ministries. The 1976 legislation can be considered as a cautious move towards allowing inward foreign investment, and contrasted significantly with the more liberal laws of that time in Hungary. The decree was designed for foreign companies established by citizens of Polish origin. The ventures became known as "Polonia" firms to emphasize that most participants had a common Polish and foreign background. By 1986, 693 companies were operating under the "Polonia Firms Law", most of them relatively small; they were restricted to domestic trade, hotels, restaurants and some other services.⁶ While some restrictions were lifted in the 1979 Law, most basic industries remained blocked to foreign capital.

The 1986 law on joint ventures extended the fields of activity for foreign investors to most sectors of the economy, with the exceptions of the defence industry, railways and air transport, communications, telecommunications, insurance, banking, publishing and foreign trade. This represented a significant departure from the 1979 legislation which excluded joint ventures in heavy engineering, basic chemicals, micro-electronics and metallurgy. Moreover, the new law allowed for the transfer abroad of foreign currency profits resulting from the excess of export earnings over import outlays in proportions commensurate with the partners' entitlement to company profits. Notwithstanding the above improvements, many limitations remained: the equity participation of the foreign partner was limited to 49 per cent; 15-25 per cent of the hard currency earnings had to be sold to a Polish

⁵ Suzanne Gahler, an economist at J. P. Morgan, an American bank, shares the same view.

⁶ For further information cf. J. G. Scriven: *Joint Ventures in Poland: A Socialist Approach to Foreign Investment Legislation*, in: *Journal of World Trade Law*, 1980, No. 14.

Table 1
Joint Ventures Registered in Eastern Europe,
1988-1990

	Population 1988 (million)	1 Jan. 1988	1 Jan. 1989	1 Jan. 1990	1 March 1990	1 July 1990	31 Dec. 1990
Soviet Union	296	23	191	1,261	1,480	1,734	2,800
Hungary	11	102	270	1,000	1,000	1,600	5,000
Poland	38	13	55	918	1,000	1,550	2,400
Czech. Rep.	16	7	16	60	60	60	n/a
Bulgaria	9	15	25	30	30	30	n/a
Romania	23	5	5	5	5	5	n/a
Total	383	165	562	3,274	3,575	4,979	10,000

Source: European Commission.

foreign exchange bank; 10 per cent of the profits were automatically transferred to the reserve fund; and, finally, the chairman of the Board of Directors had to be a Polish national.

The most radical legislative change came about with the Joint Ventures Act of December 1988. This law, which became operative on 1 January 1989, had important implications for FDI in Poland. It altered the principle of profit repatriation, established new supervisory authorities, raised the ceiling on the foreign partner's share of the joint venture's capital to 100 per cent, liberalised the registration procedure by shortening the time-period required for issuing permits, permitted foreign nationals to be elected as chief executives and extended tax holidays from two to three years (up to six years for priority projects). Table 1 clearly indicates the radical increases in the number of registered joint ventures in Poland during the operating period of this law: from January 1989 to January 1990 the number of joint ventures multiplied more than sixteenfold, and from January 1989 to December 1990, forty-three-fold.

Conditions for FDI were further liberalised by the law of 28 December 1989, but this only added some superficial changes to its 1988 predecessor, primarily with regard to the repatriation of profits. The law allowed the unrestricted transfer abroad of all profits from sales and permitted an additional 15 per cent repatriation of profits from goods and services sold on Polish markets.

Today, foreign investment in Poland is still regulated by the Law on Foreign Investment (also known as the Joint Ventures Act) of 14 June 1991, which replaced the Joint Ventures Act of December 1988. Significantly, while the new law can make certain exemptions with the permission of the Ministry of Finance, it abolished the automatic tax holidays of the previous Joint Ventures Law.

Exemptions are granted if the company operates in an area of the country with high unemployment, if it transfers new technology, if at least 20 per cent of the company's sales are for export, and if the contribution of the foreign party has a value in excess of ECU 2 million. To be eligible for the tax exemption, foreign investors must establish their participation prior to January 1, 1994.⁷

Growth of Joint Ventures since 1986

The authorities received 3,330 applications from foreign investors, in response to which only 1,886 registration permits were granted with a total initial capital value of \$ 547 million between April 1986 and December 1990. Figure 1 illustrates that 50 firms were approved in 1987-88, 860 in 1988-89, and 1005 in 1989-90. There was a tendency, however, for a decrease in the average size of firms, when measured against initial investments. The reluctance of large transnational companies (TNCs) to enter the Polish market was clearly visible in 1990, in the first year of the transition to the market economy.

The largest firms were those established in 1987-1988, when the average initial capital amounted to \$ 576, 900; this fell by over 40 per cent to \$ 237, 339 in 1989-1990.

Figure 2 shows that in the period 1987-88, 58 per cent of joint ventures had investments in excess of \$ 200,000; this fell to 6.5 and 11.2 per cent respectively in the next two periods.

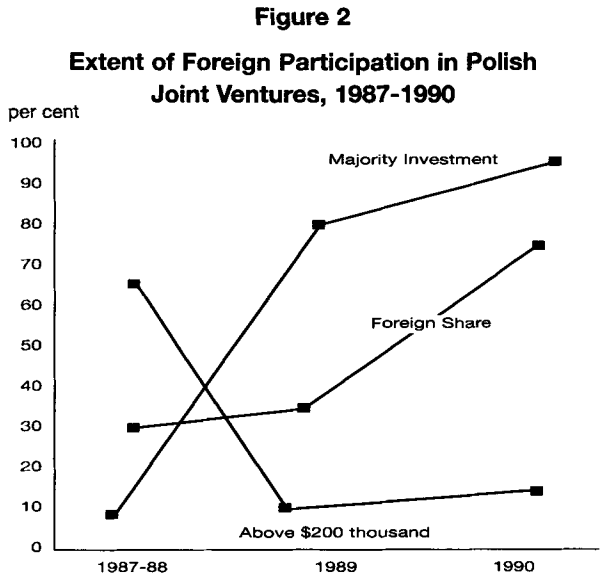
A noticeable positive development, however, was the increase in the average share of foreign capital participation in joint ventures. The elimination of ceilings on the foreign partner's share under the 1988

⁷ Roman Frydman, Andrzej Rapaczynski and John S. Earle (eds.): *The Privatization Process in Central Europe*, Central European University Press, London 1993.

law led to an increase in foreign ownership. It can be seen from Figure 2 that the proportion of foreign firms holding a majority investment in joint ventures increased from 9.6 per cent in 1987-88 to 76.7 per cent in 1988-89 and 88.7 per cent in 1989-90. In the last period the number of foreign firms with wholly-owned Polish subsidiaries increased to 25 per cent. The above data are confirmed by the share of foreign capital in the joint ventures' total investment measured as a ratio of foreign to total capital in Figure 2. This increased from 30 per cent in the first period, to 41 per cent in the second and 74 per cent in the third.

Within the same time-span, growth was also recorded in the registration index (defined as the ratio of issued registrations to the number of applications received). The increase in registrations reflected the Polish government's readiness to encourage foreign firms in areas previously excluded from foreign penetration (such as banking and insurance), but also some improvements in the handling of applications for the establishment of new firms.

To sum up, we can say that an increase in the absolute numbers of joint ventures was accompanied by a lowering of the average foreign investment, which implied a rapid fall in the size of new firms up to 1990. There was a visible reluctance on the part of transnational companies to enter the Polish market in 1990. The contributing factors at the time – which will be further examined in the following – apart from political and economic uncertainty, can be summed up under the following two headings:



Source: Polish Investment Agency, December 1990.

- the absence of a mechanism for the full repatriation of profits abroad; and
- the absence of investment incentives in the form of state support for large investors.

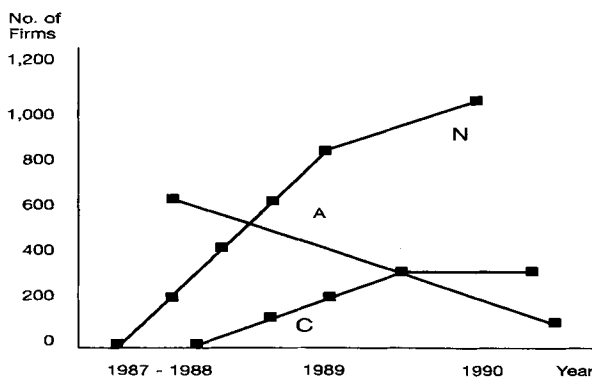
Attracting FDI

It can be said that in spite of similarities in the systemic background of the CEEs, the potential for attracting FDI will vary between countries and depends on a number of factors: the level of political and economic stability; the level of market-oriented changes, i.e. the privatization framework; the attractiveness of the legal infrastructure, fiscal policies and banking facilities; previous experiences of foreign investors in the region; the state of the telecommunications infrastructure; the development of human capital (managerial, marketing and organizational experience, knowledge of foreign languages etc.); the attitude of the host country's population etc. A few of these points will be examined briefly below, in the context of Poland and Hungary.⁸

Since the collapse of the last communist government in Poland in 1989 there have been five democratically elected governments (the fifth one, the socialist-led coalition, is still in power at the time of writing) struggling to build a stable foundation for a market economy, while in Hungary – although not without some struggle – the previous coalition had

Figure 1

Number, Size and Initial Investments of Foreign Firms in Polish Joint Ventures, 1987-90



Note: A = average size; C = capital invested; N = number of firms

Source: Polish Investment Agency, December 1990.

⁸ The data concerning Hungary in the following section rely on a survey which was conducted during the author's research stay in Hungary in the early months of 1994. The full results are forthcoming.

managed to keep a certain amount of stability for four years. This fact does not need much explanation.⁹ The political climate of a country can be an extremely important factor in the foreign investor's point of view. It should not be a surprise, therefore, that some 70 per cent of the sample of 50 foreign partners of the joint ventures operating in Hungary believe that the political stability of the country is one of the most decisive factors in their investment decisions.

Concerning the economic climate, it can be said that while Hungary is struggling to resume growth this year, Poland on the other hand, following the necessary tight monetary measures of 1990 and a period of recession, is the winner of the region, which places Poland in a highly competitive position vis-à-vis its smaller neighbors in attracting FDI. In fact, some would even argue that its position is a potentially better one.¹⁰

Pace and Form of Privatization

It has been well documented that the anti-nomenclatura campaign was a great deal stronger in Poland than in Hungary during 1988-1990.¹¹ The roots of this can be found in the relative success of the previous reforms in the latter and the anti-reform turnaround in the former. The fact that such manager-led privatization, or "spontaneous privatization" as it is called, met with less opposition in Hungary and was more or less allowed by the new regime led to major differences not only in the mode and speed of privatization but also in the inflow of FDI compared to Poland. Table 1 shows that the number of registered joint ventures in Hungary was eight times as high as in Poland in 1988, at the time of the spontaneous privatization.

There is sufficient evidence on the advantages of the manager-led mode of privatization.¹² The first and foremost is that this form of ownership change attracts foreign investment. Most spontaneous privatization in Hungary occurred in the form of joint

Table 2

Joint Ventures and 100% Foreign-owned Companies in Hungary

1987	1988	1989	1990	1991
130	227	1,350	5,693	11,000

Source: Hungarian Central Statistical Office.

ventures with FDI. The process created thousands of new corporate structures and channelled in an exceptional amount of FDI. As early as 1990, joint ventures accounted for 10.7 per cent of total sales in Hungary, and in 1991 this figure was nearly 20 per cent. Moreover, while most Hungarian companies have been making workers redundant (unemployment is still rising), joint ventures doubled the number of employees to 4.5 per cent of the workforce at the end of 1990.¹³

My own research, as well as other studies, points out that one of the important reasons for the rapid growth in FDI in the years 1988-1989 was that spontaneous privatization (or, as it is now called, "enterprise-initiated privatization") provided a flexible legal framework and a favourable business infrastructure for many foreign investors. Table 2 shows that the number of joint ventures and 100 per cent foreign-owned companies in 1988 was 1.7 fold the 1987 figure, it then surged six-fold by 1989, and increased four-fold to 1990 (1988-90 was the time of the spontaneous privatization). The rate of increase then dropped, so that the 1991 figure was slightly less than double the figure for 1990. Thanks to spontaneous privatization there was an incredible twenty-five-fold increase between 1988 and 1990. Although there have been some disadvantages (mostly concerning corruption, and the fact that no revenue was generated for the government), the other advantages are that, due its decentralized nature, enterprise-initiated privatization is less bureaucratic, and therefore faster and cheaper, benefiting both the domestic and the foreign partner. These are extremely important features when we consider that state-

⁹ Notwithstanding the economic achievements of 1993 and 1994, Poland was still ranked 4th highest among the high risk countries on 30 May, 1994. Cf. PAP Business News, Poland, 30 May, 1994.

¹⁰ Adam Jolly: Poland - the First European Tiger?, in: CBI News, May 1994; Dr. Ernst-Moritz Lipp of Dresdner Bank, chairman of the London Club, shares this view. Cf. also Rzeczpospolita of June 1, 1994.

¹¹ The new political elite and the public regarded the process of nomenclatura privatization as politically and morally unacceptable and the government took steps to halt it. This, however, along with the sensitive issue of German investments in the ex-German territories, adversely affected the flow of FDI. While this paper does not go into the details of this, one must clearly take into account the sensitivities of Polish citizens concerning German investors, which cannot be ignored by any Polish government.

¹² Cf. for example, Kalman Mizsei: The Challenge of Privatization in East Central Europe, in: Michael P. Claudon and Tamar L. Gutner (eds.): Comrades go Private, New York 1993; Tamas Sarkozy: A Privatizacio Joga Magyarorszagon (1989-1993), Budapest 1993; Eva Voszka: Spontaneous privatization in Hungary, in: John S. Earle, Roman Frydman and Andrzej Rapaczynski (eds.): Privatization in the Transition to a Market Economy, London 1993. It is also important to point out that no matter which route is chosen towards privatization it will not be free of corruption and/or mishandling.

¹³ David Young: Foreign Direct Investment in Hungary, in: Patrick Artisien and Matija Rojec (eds.): Foreign Investment in Central and Eastern Europe, London 1993, p.119.

owned enterprises are losing their value, and hence their attractiveness, rapidly. It must also be realised that the management is in the best position to assess the future possibilities of an enterprise, since it is aware of the firm's financial capabilities and the available potential domestic or foreign partners.

Previous Experience of FDI

As Hungary has a long history of market-oriented reforms, including FDI legislature, dating back to 1972, it should not therefore come as a surprise that so far foreign investors have favoured Hungary over any other CEE country. This author's research in this field, which was begun in early 1994, so far reveals that western firms' decision-making has been greatly affected by their previous contacts with many Hungarian firms. Over 65 per cent of the sample of fifty joint ventures have had previous associations with Hungarian enterprises, largely through exports and/or imports, and have been involved in industrial cooperation with firms from other CEE countries, mainly in the form of imports/exports and joint ventures. The survey also shows that Hungary, with its relatively low-cost, but well educated¹⁴ labour force is in a favourable position to attract FDI.

Attractiveness of Government Policies

As the early parts of this paper indicated, Polish governments were by and large slow and cumbersome before 1988 in their policies on attracting FDI. The changes in FDI regulations since 1991, which are still in force at the time of writing, while aimed at further liberalizing the inflow of foreign investments, were (and still are) insufficient. Many important restrictions still remain, including the abolition of automatic tax holidays, the variety of bureaucratic permit requirements, such as restrictions on the acquiring of land; regulations concerning the establishment of joint ventures with state enterprises in cases where the state enterprise is to be assigned shares in the joint venture in exchange for a contribution in kind of real estate or a production plant, including a long-term lease, just to mention a few.

According to the Prime Minister's Privatization Council, at the end of April 1994 the existing barriers were still significant and hampered the prospects of FDI in Poland; he pointed out that the June 1991 Law

¹⁴ Hungary stands out in CEE with its relatively high standard of education, particularly in the fields of foreign languages, marketing and business management.

¹⁵ PAP Business News from Poland, 30 May 1994.

on Companies with Foreign Participation is not in tune with the requirements of today, and should be liberalized further, particularly concerning the acquisition of real estate, due to its bureaucratic nature.¹⁵ Foreign entities have to follow the procedure of acquiring real estate ensuing from the Law of 24 March 1920 on the Acquisition of Real Estate by Foreigners. While the cases of refusal by the Minister of International Affairs are considered to be marginal, the administrative process is extremely long, which at times reduces the potential investor's chances of participating in privatization bids. The fact that the real estate title is usually a precondition for opening credits by foreign banks further hampers the foreign investor's chances and capabilities. Changes are also needed in the existing Foreign Exchange Law to ease the process of drawing on medium and long-term credits abroad and to allow foreign entities to make deposits at Polish banks. Concerning investment tax relief, it can be said that apart from certain conditions the foreign investor is to be able to take advantage of the regulation.

There are similar restrictions in Hungary concerning real estate with the added difficulty of the problems concerning the convertibility of the Forint, which is on the government's agenda at the time of writing.¹⁶ Concerning property relations this author's research shows that 80 per cent of the 50 joint ventures in the sample in Hungary considered the law far too restrictive, while only 10 per cent were happy with it; on the issue of fiscal policy, at least 50 per cent of the sampled firms regarded the previous government's tax incentives¹⁷ for the re-investment of profits in the joint ventures as reasonably attractive and 14 per cent said they were very attractive, while only 5 per cent regarded them as inadequate, and the remaining 31 per cent were reluctant to answer, presumably because they were quite content but feared that revealing this would prompt a change in the government's policies.

Country Origins of FDI

Data on the sources of FDI in Poland and Hungary are difficult to obtain. The consensus, as Table 3 also shows, is that by far the largest number of joint ventures have been formed by Austrian and German

¹⁶ On the absence of the convertibility of the Forint and real estate acquisition cf. Tamas Sarkozy, *op. cit.*, p.119.

¹⁷ Tax legislation as of 1 January 1992 sets a deadline, however, after which tax concessions on foreign investment will no longer be granted. The Law states that foreign investors will not be able to qualify for tax concessions after 31 December 1993. This move will quite naturally slow down FDI in Hungary.

Table 3
Foreign Stake in Privatization
in Hungary, 1990-1993

Country	Forint (billion)	No. of companies
Austria	43.8	96
Germany	34.95	56
Netherlands	14.96	9
UK	14.89	29
France	13.49	33
CIS	5.24	13
Others	48.96	92
Total	176.29	328

Source: MIT - ECONEWS, 21 January, 1994.

companies, and with a few exceptions they have entered the market with small ventures targeted at weak spots in the domestic market.¹⁸

The trend is similar in Poland. In the period 1989-1990, while the presence of US firms and multinationals steadily decreased, rapid growth was recorded in the numbers of German, Austrian and other firms. In 1989, 41 per cent of newly registered foreign firms were of German origin. The data also confirm that in spite of a certain amount of growth firms with German capital remain the smallest among the total group of foreign-owned firms.

The Frankfurt Agreement

It seems that Poland's agreement with the London Club in Frankfurt in the first week of March 1994 concerning the reduction of its \$ 13.2 billion commercial bank debt, could go a long way to encourage FDI in the country.¹⁹ While the agreement still had to be followed by some months of detailed research on the exact amounts of debt and occurred

¹⁸ The Hungarian Matav's deal with the Magyar-Com consortium (German and US concern) of December 1993 proves to be the third largest investment in CEE economies (with \$875 million) after the Chevron-Kazakhstan and Volkswagen-Skoda joint ventures, which is not only about to accelerate the modernization of the Hungarian telecommunications system, but the deal has already attracted other foreign partners for the German Deutsche Telekom. Cf. Heti Világagazdaság, December 1993. It may be noted that the largest amount of capital up to 1990, namely 35 per cent, has been brought into Hungary by US firms such as Ford, General Electric, General Motors, Sara Lee, which have concentrated on strategic investments, often aimed at markets outside Hungary.

¹⁹ Cf. Financial Times, March 15, 1994, and The Economist, March 19, 1994. The agreement with the London Club of creditor banks was to be signed in Warsaw on September 13. The Banks had until June 29 to declare which of the restructuring options they wish to follow. According to Dr Ernst-Moritz Lipp of Dresdner Bank, chairman of the London Club, Poland will be more attractive to German investors than Hungary or the Czech Republic, due to its size and economic development. Cf. Rzeczpospolita, June 1, 1994.

interest owed to each of the 400 or so banks involved, it foreshadowed that the banks could write down 42.5 to 45 per cent of the net present value of the debt. The Frankfurt agreement will facilitate access to foreign capital markets on normal commercial terms. It sends a powerful message to foreign investors that investment in Poland is a normal risk. This opportunity is essential to fund the infrastructure investment needed to update rail, road and telecommunication links, which is often cited as one of the main impediments to foreign investment in Poland. The above agreement will also stimulate equity investment, which is likely to bring modern technology and skills to produce exportable products in the hope of better access to world markets.

Some Comments

For Poland the Frankfurt agreement is a watershed as it is expected to spur an investment boom, which can only reinforce and improve the current positive economic figures. Thanks to the shock therapy reforms and the lower debt payments²⁰ which stemmed from the reforms,²¹ Poland boasted the most dynamic economy in recession-struck Europe, with 4 per cent growth in 1993, and Warsaw as well as western experts expect growth to continue at 4-5 per cent per annum over the next two years,²² while Hungary could be expected only to resume growth in 1994. Poland already shows other benefits of the tough financial and monetary policies.²³

Industrial output in Poland in the first four months of 1994 was 10 per cent higher than in the same period of 1993, while unemployment fell for two months in succession to 2.9 million, i.e. from 15 per cent in 1993 to 13.7 per cent in early 1994. While exports continued to lag behind imports, foreign currency reserves also continue to grow to more than 4 billion.²⁴ Moreover, as inflation fell to 25 per cent in 1994, down from 35 per cent in 1993, the budget deficit remained under control, which in turn allowed the bank to lower base interest rates by a point or two

²⁰ This refers to the Paris Club agreement of April 1991 which allowed a 50 per cent reduction of Poland's foreign debt.

²¹ It is important to point out that, with only a few modifications, all post-communist governments followed the Balcerowicz Plan, and the present socialist finance minister Grzegorz Kolodko is firmly pressing ahead to fight inflation and to strengthen the institutional underpinning of the capitalist economy via the development of investment and pension funds.

²² Charles Harman of CS First Boston predicted that Poland, the Czech Republic and Hungary could sustain real growth of 6 per cent in 1994. Cf. The Economist, March 19, 1994.

²³ The data in the following paragraph relies on the Financial Times, July 8, 1994; on PAP Business News, June 18, 1994; and on The Economist, July 2, 1994.

in May.²⁵ The private sector employs almost 60 per cent of the labour force and produces 50 per cent of GDP.

All the above are positive signs indeed and Poland with its market of 39 million people, its strategic position and now with the help of the Frankfurt deal is poised to compete effectively against Hungary and the Czech Republic in attracting FDI.²⁶ As FDI increases it will further accelerate the country's economic growth, which will attract both professional and non-professional investors who want to acquire ownership shares in state-owned institutions, particularly now as western interest in CEE is currently warming up again. Following the slow start of portfolio investment following the collapse of communism, the funds are currently making a comeback, largely due to the economic recovery in Poland, but as has already been noted Hungary and the Czech Republic also were expected to return to growth in 1994. The region's stockmarkets also show positive signs: while Poland's markets only listed two dozen shares, it was still the world's best performer in 1993; booms were also experienced in Prague and Budapest, and after an 18 per cent dollar gain in 1993, the Budapest exchange index jumped a further 45 per cent by March 1994.²⁷

At the time of writing, Hungary – the best FDI performer of the region – is led, similarly to Poland, by a socialist-liberal coalition, sworn in on 15th July, 1994.

While the socialist majority coalition headed by Gyula Horn will be under strong pressure from its voters to deliver on its electoral promises, the new government, as far as future economic policy is concerned, is not likely to steer far away from its predecessors. Laszlo Bekesi, the economic expert of the Hungarian socialist party, has already pronounced that the party hopes to follow the Polish socialist-led coalition government's policies.²⁸ It is

likely, however, that due to the heavy debt burden and with the responsibility on the socialist party, the Hungarian government will have less room to manoeuvre than its Polish counterpart, which may force the Hungarian leadership to follow Poland's footsteps and explore some form of debt relief, an idea not contemplated by the previous government which could further accelerate the inflow of FDI into Hungary. It remains to be seen what exactly the new Hungarian government's steps will be, but it is already clear from their early statements that foreign investments will be encouraged and even accelerated. One may also add that, right now, foreign investors feel confident with the direction of the new Hungarian coalition, which can only add to the present successes.

For Poland, however, there are strong indications that after its long recession and feeble past performance in attracting FDI, it is "coming out from the cold" and is shaping out to be the strongest competitor, if not the best performer, in its effort to attract FDI within the CEE economies. To keep some past experiences from Hungary in mind, Poland can further speed up FDI if

- the socialist-coalition government can maintain and improve political and economic stability,
- consistent efforts can be made to decentralize privatization (i.e. to widen enterprise-initiated privatization), since this kind of ownership change is cheap, fast and can generate FDI,
- attractive government policies are in place for foreign investors,
- modern bank and credit facilities are available, and
- the telecommunications system is further developed.

If the Polish government is persistent in its advancement with regard to the above requirements, Poland will not only be able to compete but will supersede the other smaller CEE economies, like Hungary and the Czech Republic, in attracting FDI in the months and years ahead, which will be well deserved.

²⁴ PAP Business News, June 18, 1994. Documentation also mounts on the adjustments of the state-owned enterprises and Brian Pinto, Marek Belka and Stefan Krajewski show in their extensive research that the hardening of the budget constraints and import competition – which are a significant part of the Balcerowicz Plan – can put enough pressure on the state-owned enterprises, in the early period of transition, even without radical ownership change. For more on this study, cf. *Transforming State Enterprises in Poland: Evidence on Adjustment by Manufacturing Firms*, in: *Brookings Papers on Economic Activity*, No.1, 1993, pp. 213-270.

²⁵ Poland's deficit was 4.1 per cent of GDP, down from nearly 7 per cent in 1992, while Hungary's deficit only fell from 7.5 per cent to just under 6 per cent. Note, however, that most Visegrad countries are progressing well in reducing their budget deficit to meet the EU target of 3 per cent of GDP. The Czech Republic had a budget surplus of 0.1 per cent of GDP. Cf. *The Economist*, July 2, 1994.

²⁶ Due to the economic recovery and reasonable political stability, an incredible surge in FDI could already be observed in the 9 months from June 1993 to March 1994, when the amount of FDI increased by \$ 1.2 billion, from approximately \$ 2.2 billion to \$ 3.4 billion.

²⁷ *The Economist*, March 19, 1994, p. 90.

²⁸ *Financial Times*, July 8, 1994.