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INTERNATIONAL CONFERENCE

on the 10-Year Review of Transitional Economies and Challenges in the Next Decade

Vienna, 30 November to 1 December 2000

FINAL REPORT

Discussion Record

UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION

economy environment employment

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and Challenges in the Next Decade

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UNITED NATIONS INDUSTRIAL DEVELOPMENT ORGANIZATION
Vienna, 2001

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PREFACE

INTERNATIONAL CONFERENCE ON THE 10-YEAR REVIEW OF TRANSITIONAL ECONOMIES AND CHALLENGES IN THE NEXT DECADE

BACKGROUND

Nearly ten years have passed since former communist countries embarked on their shift to a market economy. These countries have implemented various measures, such as liberalization, administrative reform, acceleration of privatization, promotion of domestic industries, and corporate management reform, on the advice of developed countries. During this limited period of ten years, the direction of their shift to market economies has been set and the change has achieved various results.

Notably, the shift to market economies has produced differences among the countries involved, and not all of them have gained significant benefits. In terms of per capita gross domestic product, their GDP levels are still far below the European average.

It was felt to be now an opportune time to evaluate the economic performance of former communist countries since the start of their shift to market economies, and analyse the factors that made their measures a success or failure, as well as explore the tasks these countries will face in the next decade.

OBJECTIVE

- The conference was to focus on international competitiveness, which is an essential element of the economic development in transitional economies. Because, given that similar conferences are executed by many organizations, we have made our conference particular in choosing a subject that had not been covered by other organizations. Second, we wanted to make the best use of the results in terms of formulating our cooperation toward the CEEC in the next decade.
- Subjects have covered not only a 10-year review but also future tasks. We have weighted the future prospects, given the objectives above mentioned.

SUBJECTS

Session 1 *Review of privatization from the viewpoint of corporate competitiveness, management, and development of technology and human resources*

Session 2 *Business infrastructure from the viewpoint of the private sector*

Session 3 *FDI policy, advantages and points at issue*

Session 4 *Promotion of SME*

Session 5 *Role of government, private sector and private organizations*

Session 6 *Evaluation of bilateral and multinational cooperation*

PARTICIPANTS

CEECs

Hungary, Poland, Czech Republic, Slovakia, Romania, and Bulgaria
Observers: Ukraine, Republic of Moldova, Bosnia and Herzegovina

International organizations

EBRD, OECD, UNIDO, World Bank

Businesses investing in CEECs

Austrian, German, and Japanese companies

Members from organizing and supporting institutions

ORGANIZING AND SUPPORTING INSTITUTIONS

Japan International Cooperation Agency (JICA)
Japan External Trade Organization (JETRO)
The Vienna Institute for International Economic Studies (WIIW)
Bank Austria
Intellectual Collaboration Group to Promote Market-Oriented Economies (Japan)

ORGANIZING COMMITTEE

The Organizing Committee was set to discuss the agenda, speakers, and members to be invited. The Committee works closely with WIIW and Bank Austria

Tsuneaki Sato	Prof. Emeritus of Economic Yokohama City University
Yoshiaki Nishimura	Prof. of Economics Institute of Economic Research Hitotsubashi University
Tetsuma Fujikawa	Senior Advisor The Sumitomo Trust & Banking Co, Ltd.
Noriyuki Yonemura	Senior Vice President Fuji Xerox
Masatake Wada	Prof. of Economics Teikyo University
Noboru Toyota	Director Overseas Investment Division Japan External Trade Organization (JETRO)

Masami Fuwa	Director Middle East and Europe Division Japan International Cooperation Agency (JICA)
Ivo Stanek	Director Senior Advisor to the Board
Peter Havlik	Deputy Director WIIW

AGENDA

Day 1 Thursday, 30 November

Co-Chairpersons: Noriyuki Yonemura and Ivo Stanek

13:30-15:00 *Opening Address* by Co-Chairpersons
Welcome Address by Japanese Ambassador, Akio Ijuin
Opening Remark by Shinji Fukukawa
Keynote Speeches
Tsuneaki Sato "A 10-year review of Transitional Economies"
Peter Havlik "Enterprise Competition in CEECs"

15:00-15:15 Coffee Break

15:15-17:00 Session 1. *Review and Future of Privatization from the Viewpoint of Corporate Competitiveness, Management, Development of Technology, and Human Resources*

Session Chairperson: Gabor Hunya (WIIW)

Presentation 1. Janusz Lewandowski (Poland)
Presentation 2. Ádám Török (Hungary)
Presentation 3. Kamil Janáček (Czech Republic)

Commentator: Yukihiro Nikaido (Japan)

Free Discussion

17:00-17:15 Coffee Break

17:15-18:45 Session 2. *Business Infrastructure from the Viewpoint of the Private Sector*

Session Chairperson: Marianne Kager (Bank Austria)

Presentation 1. Fumio Inoue (Matsushita Television Central Europe, Czech Republic)

	Presentation 2.	Mohammed Kaddoura (VAE Aktiengesellschaft, Austria)
	Presentation 3.	Christian Doerner (Siemens, Germany)
	Free Discussion	
19:00	Leave for Japanese Ambassador's Residence (by bus from Altes Rathaus)	
19:30-21:00	Reception hosted by Japanese Ambassador Akio Ijuin	
21:30	Return to Hotel	

DAY 2 Friday, 1 December

Co-Chairpersons: Noriyuki Yonemura and Ivo Stanek

8:30-10:30	Session 3. *FDI Policy, Advantages, and Points at Issue*	
	Session Chairperson: Peter Havlik (WIIW)	
	Presentation 1.	Miklós Szanyi (Hungary)
	Presentation 2.	Adam Pawalowicz (Poland)
	Presentation 3.	Vladimír Benáček (Czech Republic)
	Presentation 4.	Krassen Stanchev (Bulgaria)
	Presentation 5.	Florin Bonciu (Romania)
	Presentation 6.	Alan Sitar (Slovakia)
	Commentator Gábor Hunya (WIIW)	
	Free Discussion	
10:30-10:45	Coffee Break (Press interviews participants)	
10:45-12:45	Session 4. *Promotion of SMEs*	
	Session Chairperson: Noriyuki Yonemura (Intellectual Collaboration Group)	
	Presentation 1.	Iren Petrounova (Bulgaria)
	Presentation 2.	Ovidiu Nicolescu (Romania)
	Presentation 3.	Eva Hegedus (Hungary)
	Presentation 4.	Józef Chmiel (Poland)
	Commentator: Masayuki Kondo (Japan)	
	Free Discussion	
12:45-14:00	Lunch (Courtesy of Bank Austria)	
14:00-15:00	Session 5. *Roles of Government and Private Sector*	
	Session Chairperson: Shinji Fukukawa (Intellectual Collaboration Group)	
	Presentation 1.	Masatake Wada (Japan)
	Presentation 2.	Valentin Pavel (Romania)
	Free Discussion	
15:00-15:15	Coffee Break	

15:15-17:15	Session 6. *Evaluation of Bilateral and Multilateral Cooperation*	
	Session Chairperson: Jan Mládek (Czech Republic)	
	Presentation 1.	Rika Ishii (EBRD)
	Presentation 2.	André Barsony (OECD)
	Presentation 3.	Yo Maruno (UNIDO)
	Presentation 4.	Yasuo Izumi (IBRD)
	Presentation 5.	Yoshiaki Nishimura (Japan)
	Commentator:	Kamil Janáček (Czech Republic) Osamu Hayakawa (Japan)
	Free Discussion	
17:15-18:15	Wrap-Up Meeting	
18:15	End of Workshop	
18:30-19:30	Cocktail Party	

LIST OF PARTICIPANTS

CEEC Countries	Name	Title/Organization
Hungary	Ádám TÖRÖK	Dean and CEO, Professor of Economics IMC International School of Business, Budapest
Hungary	Miklós SZANYI	Senior Research Fellow Institute of Economics, Hungarian Academy of Sciences
Hungary	Eva HEGEDUS	Assistant State Secretary Ministry of Economic Affairs
Hungary	Attila TÖRÖK	Head of Department Ministry of Economic Affairs
Poland	Jánusz Auton LEWANDOWSKI	Vice-President, Gdansk Institute of Market Economics Member of Parliament, Former Minister of Privatization
Poland	Adam PAWALOWICZ	President Polish Agency for Foreign Investment
Poland	Jozef CHMIEL	Deputy Director Research Center for Statistical and Economic Analysis Central Statistical Office
Czech Republic	Kamil JANÁČEK	Chief Economist Komerční Banka
Czech Republic	Vladmír BENÁČEK	Associate Professor at the Faculty of Social Sciences Charles University; Head of the PhD (Economics) Programme
Czech Republic	Jan MLÁDEK	Deputy Minister of Finance
Bulgaria	Krassen STANCHEV	Executive Director Institute for Market Economics
Bulgaria	Iren PETROUNOVA	President SME Agency
Romania	Florin BONCIU	Director National Agency for Regional Development
Romania	Ovidiu NICOLESCU	President National Council of Romanian SME
Romania	Valentin PAVEL	Director of Asia and Oceania Division Ministry of Industry and Commerce
Slovakia	Alan SITAR	Advisor to the Prime Minister Office of the Government of Slovakia
Slovakia	Marek JAKOBY	Senior Economist Independent Center for Economic and Social Analysis
Rep. of Moldova	Iurii PINZARU	Economic Advisor to the President
Ukraine	Igor SHUMYLO	Deputy Minister, Ministry of Economy
Bosnia and Herzegovina	Dragoljub STOJANOV	Professor of Economics, University of Sarajevo

International organizations

EBRD	Rika ISHII	Economist, Office of the Chief Economist
OECD	André BARSONY	Deputy Director, Centre for Cooperation with non-member Countries
UNIDO	Yo MARUNO	Deputy Director General and Managing Director, Investment Promotion and Institutional Capacity-Building Division
World Bank	Yasuo IZUMI	Sector Manager, Private and Financial Sector Development, Europe and Central Asia, The World Bank

Companies operating in CEECs

Japan	Fumio INOUE	Managing Director, Matsushita Television Central Europe, s.r.o.
Austria	Mohammed KADDOURA	Director, VAE Aktiengesellshaft
Germany	Christian DOERNER	International Relations, Siemens

Cooperating companies

WIIW	Peter HAVLIK	Deputy Director
WIIW	Gábor HUNYA	Senior Economist
WIIW	Magdalena HÖLLHUBER	Managing Assistant
WIIW	Veronika JANYROVA	Assistant
Bank Austria	Ivo STANEK	Director, Senior Advisor to the Board
Bank Austria	Marianne KAGER	Chief Economist
IBD-BA	Friedrich EDLINGER	Deputy Managing Director, IBD-BA Consulting

Japan	Akio IJUIN	Ambassador to Austria
	Shinji FUKUKAWA	Chairman, Intellectual Collaboration Group to Promote Market-Oriented Economies
	Noriyuki YONEMURA	Senior Vice President, Fuji Xerox Co. Ltd.
	Tsuneaki SATO	Professor Emeritus of Economics, Yokohama City University
	Yoshiaki NISHIMURA	Professor, Institute of Economic Research, Hitotsubashi University
	Masatake WADA	Professor, Teikyo University School of Economics
	Masayuki KONDO	Professor, Kochi University of Technology
	Yukihiro NIKAIDO	Director, Technical Cooperation Division, Economic Cooperation Bureau, Ministry of Foreign Affairs
	Osamu HAYAKAWA	Deputy Director, Central and Eastern Europe Division, Ministry of Foreign Affairs
	Ikufumi TOMIMOTO	Resident Representative, JICA Austria Office
	Izumi TANAKA	Deputy Director, Middle East and Europe Division, JICA
	Shinichi OZEKI	General Director, JETRO Vienna
	Hiroshi KAZUI	Deputy Director General, JETRO Vienna
	Masakazu TACHIKAWA	Director, JETRO Vienna
	Dai UEDA	Director, JETRO Vienna
	Toshimasa TAKASHIMA	Resident Representative, JICA/JOCV Hungary Office
	Yoshio KOYAMA	JICA Expert in SME Promotion Policy, Hungary
	Masahiro NAKAI	Assistant Resident Representative, JICA Austria Office
	Akiko NANAMI	Assistant Resident Representative, JICA Austria Office
	Fumiko INOUE	Officer, JICA Austria Office
	Yasuaki AIHARA	Project Formulation Advisor, JICA Austria Office

Observers

Ukraine	Sophia MATEICHUK	Assistant to Deputy Minister, Ministry of Economy
Ukraine	Paul BRUNING (USA)	Treasury Advisor, Ministry of Economy
Japan	Hirohiko SEKIYA	Senior Consultant, Daiwa Institute of Research Ltd.
Japan	Hajimu WATANABE	Managing Director, Research Institute of Central Eastern Culture
Japan	Junichi HASEGAWA	Deputy Director General, Development Assistance Strategy Department, Japan Bank for International Cooperation
Japan	Hiroshi TOGO	Director, Development Assistant Department III, Japan Bank for International Cooperation
Japan	Isamu MOMOZUMI	Fellow, the German Institute for Economic Research in Berlin, Professor, Komzawa University

INTRODUCTION

Intellectual Collaboration Group to Promote Market-Oriented Economies
Noriyuki Yonemura, Japan

Intellectual Collaboration Group to Promote Market-Oriented Economies

Noriyuki Yonemura
Senior Vice President, Fuji Xerox Co. Ltd and Member of the Organizing Committee
Japan

INTELLECTUAL COLLABORATION GROUP TO PROMOTE MARKET-ORIENTED ECONOMIES

In the spring of 1996, several scholars, former government officials, executives of banks and trading houses, and manufacturing company personnel formed a volunteer group in Japan. Calling itself the "Intellectual Collaboration Group to Promote Market-Oriented Economies," this group pursues "intellectual collaboration" with members of former socialist economies seeking to move toward market-oriented economies and away from the disarray of their current economic systems.

From the fields of academia, government service and industry, we have invited those holding a strong interest in "intellectual collaboration" and having experience in the mechanisms of free market economics.

These individuals have abundant experience and have honed their expertise in their "primary occupation" such as university professors, government officials, executives of banks and trading houses, and manufacturing companies.

At this moment about 80 members are listed.

We plan to conduct the following activities:

ORGANIZE SPECIALISTS IN THE FIELD OF OPEN MARKET ECONOMICS
(Develop and use an advisor list.)

EXCHANGE INFORMATION BETWEEN ORGANIZATIONS WHICH IMPLEMENT "INTELLECTUAL COLLABORATION"
(Create and use a database of various programs of "intellectual collaboration" and others.)

EXCHANGE OPINIONS IN SPECIFIC AREAS WITH VISITING LEADERS FROM FORMER SOCIALIST COUNTRIES

COOPERATE IN TRAINING PROGRAMS FOR FORMER SOCIALIST COUNTRIES
(Upon request by organizations which implement this training, identify and introduce specialists in specific fields from our advisor list.)

COOPERATE WITH FORMER SOCIALIST COUNTRIES IN CONDUCTING THEIR RESEARCH
(Upon request by organizations which conduct research, identify and introduce specialists in specific fields from our advisor list.)

CONDUCT RESEARCH AND MAKE PROPOSALS REGARDING THE TRANSITION TO MARKET-ORIENTED ECONOMIES

EXCHANGE OPINIONS ON AN INTERNATIONAL LEVEL CONCERNING "INTELLECTUAL COLLABORATION"

OTHER
Sponsor regular meetings promoting member communication and enlightenment and others.

Our activities are part of the Japan Economic Foundation.

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OPENING REMARKS

Welcome Address
H.E. Akio Ijuin, Japan

Opening Remarks
Shinji Fukukawa, Japan

Welcome Address

H.E. Akio Ijuin
Embassy of Japan
Austria

Excellencies, Distinguished Participants from the Business and Academic Communities, Representatives of International Organizations, Ladies and Gentlemen,

It is a great honour for me to have the opportunity to welcome you to this conference today.

Since the fall of the Berlin Wall in 1989, the Central and Eastern European countries have been making strenuous efforts to consolidate market-oriented economies within a democratic framework. For this purpose, various measures have been implemented, such as market liberalization, administrative reform, acceleration of privatization, promotion of domestic industries, and corporate management reform. Japan has played a role in supporting the transition efforts in the region. Japanese direct investment in Central and Eastern Europe already amounted to about US$ 2.7 billion at the end of 1999 and it is expected to increase with the improvement of business conditions there. The Japan International Cooperation Agency (JICA) has invited more than three thousand trainees from Central and Eastern European countries and sent more than 600 experts there in the framework of official technical cooperation since 1988. In addition, the Japan External Trade Organization (JETRO) has organized a number of business seminars to promote investment in this region, and trade fairs to increase Central and Eastern European exports to Japan. JICA and JETRO are the co-organizers of today´s conference.

With the efforts in the Central and Eastern European countries supported by the international community, much has been done to promote the economies in transition. Most of the countries in this region now enjoy good rates of economic growth with inflation more or less under control. The consistently rapid growth seen in some countries is steadily closing the gap between eastern and western living standards. However, the processes and methods of transition differ from country to country. So, too, do the objectives involved and the measure of success achieved so far. Every country suffers to some extend from growing disparities between rich and poor, including the unemployed, the low-skilled and the elderly.

I believe that it is very important and useful to review the transition process in the past decade in order to utilize this experience for the next decade. For this reason, I am pleased that this conference is taking place in Vienna, the city most closely linked to the Central and Eastern European countries. The participants here today represent both the public and the private sectors, academic forums from the Central and Eastern European countries, and various international organizations and companies which have played a significant role in this region.

Ladies and gentlemen,

I am very grateful to the Vienna Institute for International Economic Studies (WIIW), which is one of the leading research institutions in this region, Bank Austria, which is very active in Central and Eastern Europe, and the Intellectual Collaboration Group to Promote Market Oriented Economies, all of which host today´s conference, together with the Japan International Cooperation Agency (JICA) and the Japan External Trade Organization (JETRO).

I hope that the fruitful discussions at this conference, which will surely draw international attention, will facilitate the process of transition in the next decade.

Thank you

Opening Remarks

Shinji Fukukawa
Chairman, Intellectual Collaboration Group to Promote Market-Oriented Economies
Japan

First of all, on behalf of co-sponsoring institutions and with the capacity of Chairman of Intellectual Collaboration Group to promote Market oriented Economy, I would like to thank all of you for attending this conference and sharing your expertise with other participants to this conference.

This conference is jointly sponsored by the Vienna International Economic Studies and Bank Austria which provided wide range of preparations as well as JICA and JETRO which extended significantly support and assistance. I would like to take the opportunity to express my deepest appreciation to these co-organizers.

Ten years have passed since former Communist countries embarked on their shift to a market economy. They implemented various measures necessary for settling market economy in view of achieving better economic performance.

However, the shift to a market economy has created differences among countries involved. Some of them have gained considerable benefit, but some of them are still suffering from an inactive economy. In terms of per capita GDP, generally speaking, their levels still remain lower that of West European countries.

I believe that now is an appropriate time to evaluate the economic performance of former communist countries moving toward a market economy, to analyse various factors which have made their policies a success or a failure and to evaluate the assistance provided by experienced countries and international institution. Those studies will certainly provide valuable tools for former communist countries to set up their strategies for challenging the next decade.

I personally visited Central and East Europe countries in September 1989 when changes in political and economic aspects started to emerge. I was strongly impressed by the increasing dynamism and enthusiasm to challenge the change of their system and the interchange with the West even at the time of Cold War. I notice that since the collapse of the Berlin Wall, a tide of globalization has been emerging in the world including CEE countries and it may develop to the main concept of a new world order.

Frankly, the Japanese government was not so positive in the beginning to extend assistance to CEE countries, because economic relationship remained weak. But gradually the

Government expanded its support to CEE countries in the field of policy implantation, export promotion and anti-pollution.

Japanese investment in this region has been behind other developed countries. However, recently, Japanese companies have become aware of the great potential and advantage in this region. For example, when it comes to green-field investment, Japan ranks third after Germany and the US in some transitional countries. Even smaller and medium-sized companies in Japan have begun to show interest in investing in this region. I heard that the commercial attachés of CEECs in Tokyo are extremely busy in responding to inquiries. This also signifies it is an opportune time to hold this conference.

I believe that the most important factor for sustainable economic growth of former communist countries depends on the dynamism of private enterprises. I think it quite significant to make clear whether private enterprises have grown to be fully competitive, and whether a sound economic environment has been created for stimulating the dynamism of private enterprises.

Considering that since similar 10-years review conferences are being held by many organizations and academics, we wanted to focus on "Creating a Competitive industry".

In close cooperation with Dr. Havlik, The Vienna Institute for International Economic Studies, we picked up the following six items for the agenda of the conference.

- Review of privatization from the viewpoint of corporate competitiveness, management, development of technology and human resources.
- Business infrastructure from the viewpoint of the economic performance of private companies.
- Implication of FDI and evaluation of FDI policy and related issues.
- Promotion of SME which may provide job opportunity and act as venture business.
- Role of government including macro economic management, competition policy, promotion of domestic industry and relations between the government and private sector.
- Evaluation of bilateral and multinational cooperation to CEES.

The results acquired here can be of use to the rest of the transitional economics to help them build their strategies.

This time we intend to analyse those issues mainly in six countries, namely Hungary, Poland, Czech Republic, Romania, Bulgaria and Slovakia. Fortunately, we have invited top class experts from governments, academia, think-tanks and industrial organization in those countries as well as related officials of EBRD, OECD, World Bank and UNIDO, and industrialists from Austria, Germany and Japan.

I strongly expect that a wide range of analysis will be provided and constructive exchange of views and ideas will be undertaken at the conference.

With the strong support of all who are participating in this conference, we are planning to publish a book comprising the papers presented, as well as the discussions held, with the hope that the achievements of the conference can contribute to create a future strategy of economic development in CEECs.

This is the very first trial for us to discuss the most relevant issues for further development of the transitional economies, where participants from government, academia and industry can exchange views openly and frankly in a very informal manner.

If you all regard this conference useful in the future, we would like to consider to continue to contribute this type of dialogue in one way or another.

I sincerely expect together with co-organizers, the Vienna International Economic Studies, Bank Austria, JICA and JETRO that the two days conference will obtain forward-looking results for helping CEECs catch up with the trend of globalization.

KEYNOTE SPEECHES

A 10-Year Review of Transitional Economies: Some Lessons
Tsuneaki Sato, *Japan*

Competitiveness of CEEC's Industry
Peter Havlik, *Austria*

A 10-Year Review of Transitional Economies: Some Lessons

Tsuneaki Sato
Em. Professor of Economics,
Yokohama City University
Japan

INTRODUCTION

Just a decade ago Central East European countries (hereafter CEECs) (not to speak of the former Soviet Union/FSU/) were in a big and deep turmoil. At that time an era was coming to an end, an era that involved the fate of several generations, and with it the greatest political, social and economic experiment in the twentieth century saw a tragic end. The concept of a radical transition to a market economy won support (at least theoretically) in a new political environment. Quite contrary to several decades ago, this time "vulgar Marxism",[1] as Kornai named it, took over. They tried to do just the opposite of what their predecessors had done especially in changing ownership forms as fast as possible.

Kornai in the same paper writes: "Vulgar Marxism in this context means a simplified formula: the change of not just a necessary condition of capitalism, but a sufficient one.[2] Capitalist property relations form the base that goes on to create its own superstructure: the institutions, political organisation and ideology required to operate the capitalist base.

The real course of history showed earlier and the post-socialist transition confirmed that the relation of base and superstructure is far more complicated than that. The mere existence of capitalist property relations is not a sufficient condition for the consolidation of capitalism. If a drastic reform of ownership should happen, to proceed the transformation of political, legal and cultural institutions, the latter may follow very slowly and

[1]Janos Kornai, "Ten Years After 'The Road to A Free Economy': The Author's Self-Evaluation", World Bank ABCDE/*Annual Bank Conference on Development Economics/paper*, April 18-20, 2000. He reiterated this paper at the lecture he gave at the 6th EACES Conference in Barcelona, September 7-9, 2000. He even added *orally*, "I think ownership reforms in China are following the Strategy A ("strategy of organic development" in privatizing SOEs-T.S.)", which he had been advocating from the outset of transformation.

[2]This coincides with Sato's notion of "ownership obsession" which was more extensively discussed in Sato, T., "How Extensive Has the 'Transition to a Market Economy' Been?", *Moct=Most* , No.1, 1995.

painfully, at grave social cost.[3] So, even if it is feasible under certain conditions, it is not certain that having a rapid and drastic ownership reform before the transformation of the auxiliary institutions is the most beneficial sequence."

Optimistic (and not very rational) expectations prevailed and people were ready to suffer for a while expecting prosperity after a certain period. The political pendulum moved to the "right". In this, relatively favourable, social atmosphere the economic transition started in 1990-1991. It turned out, however, people had to await the expected "prosperity" still for a long time to come.

As Kornai rightly noted in the same paper, "I am convinced that speed, while important, is *not* the primary measure of success... Excessive emphasis on speed leads to impatience, aggressiveness and arrogance... the expression "mass privatization", used a synonym for give-away and voucher schemes, is the inverse of the 'mass collectivization" familiar from the history of Stalinism... I do not want to exaggerate the comparison... Nonetheless, there were similarities: the subordination of the ownership reform to political and power purposes, the horror of gradual change, the impatience, and the obsession with speed."

Though the latest EBRD "Transition Report 2000" proclaimed the completion of the "recovery period" and we see in most countries of the region the resumption of economic growth, it now seems high time to look back at the trodden path to draw lessons from the first decade of transformation and to look forward to the challenges ahead in the coming new decade. Leaning from mistakes committed here might be more important than self-complacency with hard-won achievements.

MISSING LINK 1: SYSTEMIC TRANSFORMATION vs. ECONOMIC GROWTH

Now it has become perfectly clear that systemic transformation itself does not ensure economic growth. But this problem has to be seen in a broader historical perspective. From a very broad historical perspective, ever since 1989, this author has considered it as the "resumption" of "interrupted" capitalist development. Countries of Central-Eastern Europe (CEECs), not to speak already of former Soviet Union, belonged more or less to the group of "late-comers" of capitalist development, and had been pursuing modernization cum industrialization after the capitalist model, floating between the "West" and the "East".[4] But

[3]The most comprehensive analysis of the costs of transformation is given in a remarkable paper by Michael Ellman " The Social Costs and Consequences of Transformation Process", Paper presented at the UN/ECE Spring Seminar "From Plan to Market: the Transition Process after Ten Years", 2 May 2000, Geneva. Also see; Laszlo Szamuely "The Social Costs of Transformation in Central and Eastern Europe", *Working Papers*, No. 31, Department East European Studies, University of Uppsala, Jan. 1997. In this sense transition path to a market economy in CEECs and FSU could be called a "high cost" one, while the Chinese path a "less costly" one. The "high cost" was brought about both the quick liberalization cum stabilization policies, which could not be discussed in this paper more extensively. Only Sato wishes to agree with Bruno Dallago who writes in this respect: "the costs of transformation proved to be much higher than anticipated, the processes much longer, and the economic system that came out of transformation is generally less, sometimes much less desirable than envisaged a decade ago. There are different reasons for this outcome. Certainly, one crucial reason is that—in large part because of drastic macroeconomic stabilization and swift privatization of SOEs—destruction was not followed—nor could it have been—by sufficient creation, both in quantities and particularly in quality." (Bruno Dallago, "The Sate and the Transformation of Economic Systems", Paper presented at the International Workshop on Transitional Economies, 24-25 Nov. 2000, Budapest.

[4]Ivan Berend, citing the early twentieth century Hungarian poet-prophet, Endre Ady, writes, "The region is, in the middle of Europe,—like a ferry-boat,—sails from the East to the West, but more likely back to the East.", Ivan Berend, "The Future Enlargement of the European Union in a Historical Perspective", paper presented at the International Symposium in commemoration of the 120th Anniversary of the Hosei University, 3 October, 2000, Tokyo.

this process of development was "interrupted" in the case of Russia in 1917 and in the case of CEECs around 1948 after World War II.

However, what these countries tried to seek after within the framework called "socialism" was not so much different as the continued pursuit of modernization-cum-industrialization in a different framework: catching up with the developed capitalist countries. Since the new "framework", which was heavily politicised, had collapsed, it is not strange at all that the "interrupted" historical development has been "resumed", which in any sense did not mean the "reversal" of historical development. It should be noted, however, that while the "interruption" was relatively easy, the "resumption" was not so easy as was expected at the outset of transformation, once a peculiar system had been formed.

In the context of the aforementioned, the author wishes to stress that these transition countries are faced with *dual tasks*: systemic transformation and the unsolved task of "catching up"; the latter task having become more serious than before, since, as a result of "transformational depression" (not "recession"), the economic gap between CEECs and the advanced Western countries has widened enormously.

Transition countries badly need both systemic transformation and economic development. In this respect the difference between CEECs and East Asian countries, China first of all, which started its transition from a less developed country situation, is not so much of a "qualitative" nature as a problem of degree. So, the argument, sometimes raised by some experts[5] that the aim of reform is different between China and CEECs, the former aiming at faster economic growth, while the latter aiming at systemic transformation itself, is quite misleading. It is a sheer simplification. Even leaving other factors aside, this factor alone suggests that CEECs need a more "active" state than in developed countries in the West with mature market economies. This may also concern the discussion of when the "transition" will be completed even for CEECs.[6]

MISSING LINK 2: SEQUENCING OF LIBERALIZATION

Probably, with no small benefits of hindsight, most people would agree that liberalization should have been conducted consistently but more gradually, with great prudence. In most countries, however, liberalization of trade, including foreign trade, of prices, currency transactions were done overnight, in one stroke, and subsidies to firms were abolished or phased out, almost all kinds of private activities were permitted without relevant legal framework and regulation. Liberalization should have been preceded by the establishment of the

[5]See for example, Pomfret, Richard," Growth and Transition: Why has China's Performance been so different?", *Journal of Comparative Economics*, vol. 25, No. 3, 1997, pp. 25-44.

[6]See, for instance, Ivan Berend, "From Plan to Market, From Regime Change to Sustainable Growth in Central and Eastern Europe", UN/ECE Spring Seminar, 2 May, 2000., Geneve. Berend argues, citing Tsuneo Morita ("The Hidden Growth Potential of EU Candidates", in: *World Bank Newsletter,Transition*, Vol. 10, No. 5, October 1999), that "if they (transition countries-T.S.) achieve a growth rate of in the range of 4.5 to 6.0 per cent annually against an assumed 3 per cent growth in the low-income countries of EU, it may take, in the best possible scenario, about 30 years. The Czech Republic may reach that level in 10-15 years, Hungary, Poland and Slovenia in 20-25 years." In the same context, G. Kolodko rightly refers to the "necessity of equitable growth" as the missing link in "Transition Orthodoxy". Grzegorz Kolodko, "Ten Years of Post-socialist Transition: the Lessons for Policy Reforms", The World Bank, Development Research Group, *Working Papers*, No. 2095, April 1999. Also see: the same author, "Globalization and Catching-Up: From Recession to Growth in Transition Economies", *IMF Working Paper*, NO. 100, June 2000.

relevant institutions, the development and regulation of capital markets and accompanied by the strengthening of the state control and enforcement capability in a developing market environment. Liberalization of external economic relations, in particular, went too far and too fast, which should have proceeded prudently, since excessive external shocks are counterproductive for firms that were weak in terms of market response capabilities.

That was the special case with the unprecedented abolition of import barriers or with introducing excessive import competition on the domestic market. The fact that afterwards some excessive liberalization measures had to be withdrawn in many countries in a case-by-case manner clearly testifies to the unsustainability of this policy. A clear tendency towards "primitivization" of industrial structure, which we see in many countries flooded with imported goods, is only an outcome of this policy. Again this depends largely on the ability of the state to implement a credible liberalization policy that is progressive through time and possibly differentiated among different activities and branches.

This problem was hotly debated after the Asian financial crisis of 1997. It was even asserted that the crisis has been "created" by the IMF, as Milton Friedman said in an interview he gave to the Hamburger Abendblatt (Oct. 3-4, 1998). He says while the crisis in Japan is a home-made (hausgemacht) one, "on the contrary, in Malaysia, Thailand and Indonesia the crisis was created first of all by the IMF" ("In Malaysia, Thailand und Indonesien wurde dagegen die Krise durch den Internationallen Waehrungsfonde (IWF) erst geschaffen"). In a sense speaking for Asian countries, where criticism had been mounting that the Fund itself had contributed heavily to the outbreak of the crisis, since it encouraged governments in this region to open their markets to foreign capital, even short-term one, and then—when the capital rushed out—imposed excessively severe belt-tightening policies for loan package, thereby inviting further downturn in the economy of the affected countries, the then Japanese delegate at the Interim Committee Meeting of the Board of Governors of the IMF, on Oct. 4 in Washington, made the following critical statement, which was quite illustrative of the Japanese perspective:

"What one can draw from this experience is that the Fund's traditional prescription which combines fiscal balance improvement with tightening of monetary policy is no longer appropriate in every instance.—The Fund should recognize that the modality of the market economy can be diverse, reflecting the history and culture of each country as well as its stage of economic development. In this context, the Fund should perhaps reflect on what it has done—."[7]

The statement also called for an appropriate regulation over the international capital flows, short-term capital (hot money) in particular, and for more attention to be paid to the appropriate sequencing in capital account liberalization in emerging market economies.

MISSING LINK 3: SOME NEGLECTED ASPECTS OF "PRIVATIZATION"

That swift and massive privatization has not seemingly brought about expected beneficial results has already been acknowledged by most experts. Ever since these countries embarked on systemic transformation, that is, their capitalist makeover, the issue of privatization of gigantic state-owned enterprises has been a central focus along with liberalization

[7]Interim Committee Meeting of the Board of Governors of the IMF, on Oct. 4, 1998, in Washington, MOF Homepage.

and macroeconomic stabilization. Together, these three objectives form the pillars of the Washington Consensus ("the Holy Trinity", I would say). But the scenario in this part of the world has unfolded differently from the privatization pattern seen in Japan and other advanced capitalist countries in the 1980s. In those economies, the integration of a handful of inefficient public corporations took place in the context of an already existing market-economy infrastructure dominated by a dynamic private business sector.

By contrast, the former socialist states must rein in a sprawling state-run sector minus the existence of any market-economy infrastructure. Despite beginning from completely different circumstances, these states are in the grip of what could be termed an "obsession with ownership" which was legally understood. Consequently, their approach has regarded conversion to private ownership as a panacea while giving short shrift to the most crucial aspect of privatization: the establishment of a management framework for assuming risk and responsibility. Coupon privatization—and its failure—offers a typical example, resulting in most cases in "Potemkin's Villages".

Privatization is usually considered to lead to improved performance of divested companies and that privately owned firms outperform state-owned enterprises. This seems to have also been conclusively proved in industrialized countries where a small number of publicly-owned enterprises were turned into private hands in the 1980s and 1990s. Usually this is taken to mean that privatization is badly needed in post-socialist countries and should prove to yield the same desired results. The first part of this understanding is quite right, since an effective economy is not conceivable at all under conditions that a small sector of private enterprises is encircled by dominant state-owned ones, so the situation should be reversed so that public enterprises, even when they continue to exist, be encircled by dominant sector of dynamically developing private companies, thereby creating the most important competitive environment for the remaining public enterprises. The latter part of this conventional interpretation, however, often ignores the different conditions under which privatization is carried out in advanced capitalist countries and in former socialist, transition countries. As this writer wrote several years ago:

"It (privatization in post-socialist countries) is quite different from privatization seen during the 1980s in some of the developed capitalist countries, in which only a limited number of inefficient and often deficit-ridden public enterprises were affected; this at a time when a dominant part of the national economy was represented by more or less efficient and dynamic private sector accompanied by a well-established market infrastructure. To use an analogy: in the case of capitalist privatization only a small number of public enterprises have needed to be put into a "ready-made" stage-setting; in the post-socialist case "stage" itself has to be created from scratch onto which a colossal amount of state-owned assets is supposed to be brought. Obviously, the latter is quite another story and requires a different approach than the former."[8]

Also this writer has warned from the outset of transformation against the "ownership obsession" (a term coined by this author himself) which was repeated in the same paper as follows: "The first stage of transformation was characterized by a strong "ownership obsession", under which most efforts were devoted to how to change the property rights while little attention was paid to the "management" aspects of privatization, namely, how

[8]This coincides with Sato's notion of "ownership obsession" which was more extensively discussed in Sato, T., "How Extensive Has the 'Transition to a Market Economy' Been?", *Moct=Most*, No.1, 1995.

to establish a rational model of management at the enterprise level capable of taking both risks and responsibilities. And he sees its typical case in so-called "voucher (mass) privatization". In the first phase of transformation, it was regarded that, formally, privatization process was most advanced in the Czech Republic (and in Russia!) with Poland and Slovenia in-between, while Hungary, which was regarded as taking a gradual approach and for that reason often "unsuccessful" in the transition performance. After the financial crisis of May 1997, the assessment turned to the opposite.

Kornai in the same paper on "Ten Years After", referring to the difference in labour productivity growth, confirmed that his Strategy A, that of "organic development", has proved viable. But, ten years ago, as he rightly writes, "it was certainly a small minority of Western academic economists who supported a strategy of organic development of the private sector."

A decade after, it has been established, regrettably with "high costs", that a well-designed and carefully guided privatization process, which naturally takes a lot of time, ensures the creation of the much-hoped-for efficient ownership cum management structures in privatized firms, which, in turn, would promote the transformation of the remaining SOEs in a more transparent way.

MISSING LINK 4: THE ROLE OF THE STATE

The first phase of transformation was characterized by the "desertion" or "retreat" of the State.[9] During the first stage of transformation, symptoms indicating rejection of the role of the state were commonly seen throughout CEECs and FSU. These were an understandable, but not entirely justifiable, reaction to the excessive level of state intervention in the economic life of these countries in the past. Even industrial policies, which proved quite effective in the post-war reconstruction and development of Japan, and later in NIEs were identified with central planning in former socialist economies. By the mid-1990s, however, the more realistically-minded experts in the region and in the West have already realized that simply undertaking the opposite of past practice was also not a proper policy. Active industrial and trade policies have then been put on the agenda.[10] Needless to say, institutional reforms are perhaps at least equally important as a formal privatization. No "invisible hand" itself can automatically guarantee a smooth functioning of a market economy.

A more active state involvement and more or less targeted developmental policy approach might perhaps be required. Some transition countries are very proud of the number of their "mushrooming" small private firms. But most of them are found in service sectors. So far, few countries seem to have succeeded in accommodating the appropriate mechanism, through which domestic savings are channelled into industrial investment to

[9]"Desertion" of the state was one of the major factors responsible for the much-longer-and-much deeper than anticipated "transformational depression". In this respect Grzegorz Kolodko rightly refers to the "policy failure which almost negated the intermediate control mechanism which was to be applied to the enormous state sector in turn increasing the uncertainty at the enterprise level, leading to further decline in production", which is unconceivable without an active state involvement. See: "From Output Collapse to Sustainable Growth in Transition Economies", *Institute of Finance Working Papers*, No. 35, 1993.

[10]See for instance: Michael Landesmann's pioneering paper, "Industrial Policy and the Transition in East-Central Europe", *Forschungsberichte*, No. 156, WIIW, Wien, 1993.

accelerate modernization process. This too, however, is unconceivable without the state playing the active role. Today, after ten years of transformation, the role of the state seems to acquire new dimensions. In view of the widened inequality between the "winners" and "losers" of transitional societies, and also widened gap in development between the regions of the countries concerned, the state has a lot to do in diffusing the possible tensions in the society. Social security reforms, now hotly debated not only in the West but also in countries of transition, are the special case in point.

MISSING LINK 5: FAST EU EASTWARD ENLARGEMENT IS RATHER UNLIKELY

The Eastward Enlargement of the European Union has been on the agenda for more than a decade by now, seemingly too long. However, if we consider that the longest accession period, the British case, lasted twelve years, while the target date of 2002 has had to be abandoned even by the most ambitious candidate countries, it is obvious that the process is, and will be, extremely protracted. On the one hand since the Luxembourg Council of December 1997 at the latest, the fact of Enlargement seems to have become a settled issue in theory. Meanwhile practical accommodation of this process proved to be harder to elaborate than most analysts would have anticipated. For the time being official optimism puts 2003-2004, expert opinion estimates 2005-2006 as the earliest point of time when the *first* front-runner country may actually join the EU. This author is of the opinion, to use an "analogy" of 007, first actual accession would not come earlier 2007. At least it is rather clear: timing is uncertain.

On both sides of the Enlargement, initial euphoria or enthusiasm with the European Integration has subsided, and the Enlargement itself has come across the hardest pass where contradictions, rather than accord, came to the forefront. Accommodation of the interests between industries on the sectoral and regional dimensions is also a hard task, as we see in the case of Polish agriculture, closely related to the CAP reforms. Moreover, it seems to the present writer that the EU has watered down the actual Enlargement process by inviting so many "potential" candidates onto the negotiation table, a move apparently motivated by political factors.

Sometimes candidate countries blame the EU side for its loss of enthusiasm and bureaucratic procedures in the negotiation, but it is not the whole story. As Laszlo Csaba writes, even in the case of Hungary, usually considered one of the top candidates, "the country is likely to forego the SAPARD pre-accession fund, since the agency administering the use of money could not be set up in due time and equipped with the appropriate competences. This is telling for the future in so far as the administrative capacity of the most advanced transition country has proved inadequate to capitalize already available EU funds. Thus in the future the gap between allocated and actually drawn funds is likely to grow, the farther east we go, the more so."[11]

This writer thinks Csaba is quite right when he refers to the "absorption capacity" even of a frontrunner country—real convergence does not matter when it is relevant to the disbursing of structural funds, and nominal convergence matters in fact though not a

[11]Laszlo Csaba, "Ostpolitik and the Enlargement of the EU: The Challenge of the Millennium", Mimeo, October 2000.

condition of accession. The EU had better to tackle no less than three countries first to push the actual Enlargement process forward.

So, CEECs might be better prepared for a longer time when they had to wait in the entrance hall of the house of EU in order to be better prepared for the accession, while making further efforts on the way of institutional reforms.

MISSING LINK 6: THE NEGLECT OF "MORAL" ASPECT WAS COSTLY: NO ECONOMIC SYSTEM CAN BE BASED ON SELF-INTEREST ONLY

The "idol" of rationality, very narrowly understood as instrumental, the conviction that economic behaviour is motivated exclusively by intentional self-interest and its causality, has shaped in most cases the strategy of transition. This was kind of an extreme reaction to the practice under state socialism, where hypocritical doctrine prevailed that everything was determined by common, public interest. But a concrete form of market order cannot emerge without an accompanying development of belief and value structures of market participants, which are in turn shaped by a long process of learning by doing in the development of modern capitalist economy. The neglect of the belief and value structures, indispensable for the proper functioning of modern market economy, only leads to the emergence of "vulgar liberalism", a new materialistic way of thinking about the market and the society in general. The reconstruction of an institutional framework, necessary for the proper functioning of the modern market economy, concerns thus a wider context of social order, i.e. the moral order too.

The most harmful impact on the "emerging" market economy was caused by wild-West forms of privatization, fraudulent practices of stripping assets and "tunnelling" of state, quasi-state and even privatized firms. Some would-be reformers, faced with the unprecedented task of mass privatization, argued in favour of "revolutionary" social ethics, reminiscent of old Bolsheviks. In the Czech case, within the narrow group of major privatization architects, the conviction prevailed that "standard" business ethics are "a kind of skating on the cake" that they cannot afford, at least not at the present time. There was no room for building institutions for the common good, mutual trust and the spirit of cooperation.

Unfortunately, even the temporary use of "revolutionary" ethics causes long-term damage to the social fabric, weakens the spirit of trust, and brings disorder to the whole society. For this transition societies paid a very high price.

MISSING LINK 7: SOUTH EASTERN EUROPE

So far, little attention has been paid to the specific problems of South-East European transition countries, which are apparently falling behind Central European countries during the past decade, as most people were attracted by the political turmoil unfolded there. Now that there is some hope for improvement, we should be prepared to fill the blank in our transition economics. Here "transition orthodoxy", the "Holy Trinity" (liberalization, stabilization, privatization) does not seem to give a workable recipe. In a well-known lecture

Joseph Stiglitz referred to the "failure"[12] of reforms in Russia, but to a lesser extent it might be true of South Eastern Europe where, to quote the statement by Daniel Daianu, formerly Minister of Finance of Romania, "People no longer understand the transition as a regime change to a miraculous state of market economy. Mistakes had been made, and—What is now evident is the need to catch up and to grow."[13] Catch up and grow, yes, but "how?"—we do not have a ready-made answer. It might become the trial ground for the Economics of Transition, if there are any.

A TENTATIVE CONCLUSION: "TRANSITION IS NOT OVER"

In 1996, the then prime minister Vaclav Klaus claimed that transition was almost over and that the Czech Republic had entered a "post-transformation" stage. At that time most macroeconomic indicators seemed to support this argument. The currency crisis of May 1997, however, gave a severe blow to this challenging view. Immediately following this crisis, the tone of the world press turned to the other negative extreme.[14] Since then, the Czech economy has been in recession in contrast to 4-5% annual expansion in most CEECs, Poland and Hungary in the first place. In 1998 alone GDP contracted by more than 2.5 %, and only from the second quarter of 1999, the decline has hit the bottom to make a modest upturn. There are many reasons for the slide, but much of the blame is placed on the way privatization was carried out. An OECD Report (1998) states that the Czech voucher approach to privatization produced ownership structures that "impeded efficient corporate governance and restructuring."

The author wanted to recall the above story, already fading away in our old memory, because first, he thinks that the West should share due responsibilities for it,[15] giving arrogant "credits" on the performance of "their pupils", and second, now some experts from

[12]Joseph Stiglitz, "Whither Reform? Ten Years of the Transition", Keynote Address, World Bank *ABCDE/Annual Bank Conference on Development Economics/*, April 28-30, 1999. Quite recently, Jeffrey Sachs, Wing Thye Woo and Xiaokai Yang in their joint paper "Economic Reforms and Constitutional Transition" (CID/Center for International Development at Harvard University/*Working Paper* No.43, April 2000) argue, "There are two patterns of transition. One is adopted by Eastern Europe and Russia, in which market-oriented reforms are just a small part (sic!—T.S.) of the transition of constitutional rules. The other is adopted by China and Viet Nam, in which market-oriented reforms are implemented under communist game rules (i.e., a communist monopoly of political power)." Though, of course, this writer is not at all against the constitutional development, he is against such a shift of argument which does not seem to justify the failure in the "small part of transition" in Russia. It is the less convincing, as the "constitutional development" itself in Russia under an authoritarian president is open to question, to put it mildly.

[13]UN/ECE informal seminar on "The Economic Regeneration of South-East Europe", 3 May, 2000, Geneva.

[14]Interestingly enough, most "cold-hearted" in this regard were those mass media which had been praising the Czech model of privatization as the top "honor student" among transition countries. For instance, Financial Times, 14 May, 1997, wrote; "The slowdown is blamed on weak voucher privatization which failed to encourage the industrial restructuring necessary to enable Czech companies to compete abroad." It should be noted that Karel Kouba, a noted Czech economist, had been already stressing in 1995 the "weak microeconomic foundation of macroeconomic stabilization". See: Karel Kouba "Macro-economic Trends in the Czech Republic", in: *Reevaluating Economic Reforms in Central and Eastern Europe since 1989*, published jointly by NIRA and Kopint-Datorg, 1996, Budapest.

[15]See, for instance, Janine Wedel's book for which she was awarded Grawemeyer World Order Award. To quote Web Site: http://update.unu.edu/issue6_2.htm, "Prof. Wedel received the US$ 200,000 award for her 1998 book *Collision and Collusion: The Strange Case of Western Aid to Eastern Europe 1989-98* (St. Martin's) in which she argues that the American government helped wreak economic and social disaster in Russia by providing inappropriate policy advice and aid to corrupt policy brokers. A raft of fly-in, fly-out consultants and reforms financed by Western taxpayers did little to help Russia and former Soviet block nations build themselves as democratic, free-market states."

CEECs have begun to repeat the same statement.[16] This is not a place to give judgement whether it is right or not, but the author entertains some concern about the "recurrence" of such a statement, as it might lead to the underestimation of the "dual tasks" he referred to earlier in this paper.

This author has to recall that the biggest concern among CEECs reformers towards the end of 1980s was that if things went on the same way, CEECs might be reduced to the "peripheral" position of the world economy, not to speak of Europe. Since 1989 and from the mid-1990s in particular, the trend has shown a favourable turn-around, but still the post-1989 experience has also shown that systemic changes alone could not solve the historic challenge of "catching-up" with the West. "Transition" will be over when CEECs succeed to make a big stride in this direction, not a few steps of recovery from the "bottom" of the first half of 1990s. Together we should like to look forward to the further success of CEECs on the way of tackling with not so easy tasks ahead.

[16]Quite recently 31 October, 2000, Jeno Koltay, Director of Economic Institute, MTA, gave a paper at a seminar in Tokyo, organized by the Institute of Economic Research, Hitotsubashi University, in which he referred to the "completion of Transition " in Hungary, while reserving that "social transition" had yet to be completed.

Competitiveness of CEE's Industry

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RE-SHAPING OF CEEC INDUSTRY

Central and East European countries (CEECs) have inherited a huge industrial sector from the previous period of central planning. But, because of large structural distortions and production inefficiencies, this high degree of industrialization has initially turned out to be a drawback rather than an advantage. Industry suffered over-proportionally from the 'transformational recession' at the beginning of transition. Industry, and especially its manufacturing part, declined in both absolute and relative terms owing to a number of factors such as the loss of traditional export markets, excessive liberalization, restrictive macroeconomic policies and insufficient restructuring. In the more advanced CEECs, industry was able to recover at least part of its previous position thanks to active restructuring efforts. Nevertheless, only Hungary and Poland now produce more industrial goods than in 1990. In contrast, Bulgarian and Romanian industry shrank by half during the last decade, while in the remaining CEECs the drop was still around 20% (we shall turn to the related structural changes below).[1]

As a result of combined changes in the manufacturing industry and GDP, only two CEECs could restore (Czech Republic) or even increase (Hungary) the initial shares of manufacturing value added in GDP by 1999 (figure I). The process of industrial downsizing is still underway elsewhere but manufacturing still contributes a significant part (between 15% in Bulgaria to nearly 33% in the Czech Republic) to the GDP.

Manufacturing industry employment underwent even more dramatic developments. These changes reflect general developments in CEEC labour markets: declining overall employment, shifts from industry to the service sector and, last but not least, the emergence of open unemployment.[2] Poland has been the only CEEC where manufacturing employment increased a bit in the second phase of transition (after 1993) and then stabilized at about 75%

*The author wishes to thank Boriana Assenova and Renate Prasch, WIIW for statistical assistance.

[1]Unless otherwise stated, the WIIW Annual Database Eastern Europe and WIIW Industrial Database are used as the main source of data.

[2]For more details on labour market developments see H. Vidovic, "Recent labour market developments in CEECs", *The Vienna Institute Monthly Report*, No. 4, March 2000.

of the 1990 level. Employment adjustments occurred with a certain time lag due to delayed lay-offs and hardly any expansion of manufacturing jobs afterwards (again in both absolute and relative terms). In fact, losses in manufacturing employment between 1990 and 1999 amounted to 25% in Poland, 40% in the Czech Republic, Hungary and Slovenia, and to more than 60% in Bulgaria. As far as the importance of manufacturing industry as a job provider is concerned, the only exception is again Hungary which not only managed to increase the share of manufacturing employment to the initial level from 1990 (25% of the total), but even recorded a slight growth of manufacturing jobs after 1997. In the majority of remaining CEECs, the number of manufacturing jobs stabilized at around 60% of the initial (1990) level. In Bulgaria the manufacturing industry continues to decline (it dropped below 40% of the initial level last year). But manufacturing industry is still an important job provider in all CEECs; the highest employment shares in manufacturing industry are nowadays in the Czech Republic and in Slovenia (around 30% of the total—see figure II).

Figure I. Manufacturing value added in percentage of GDP

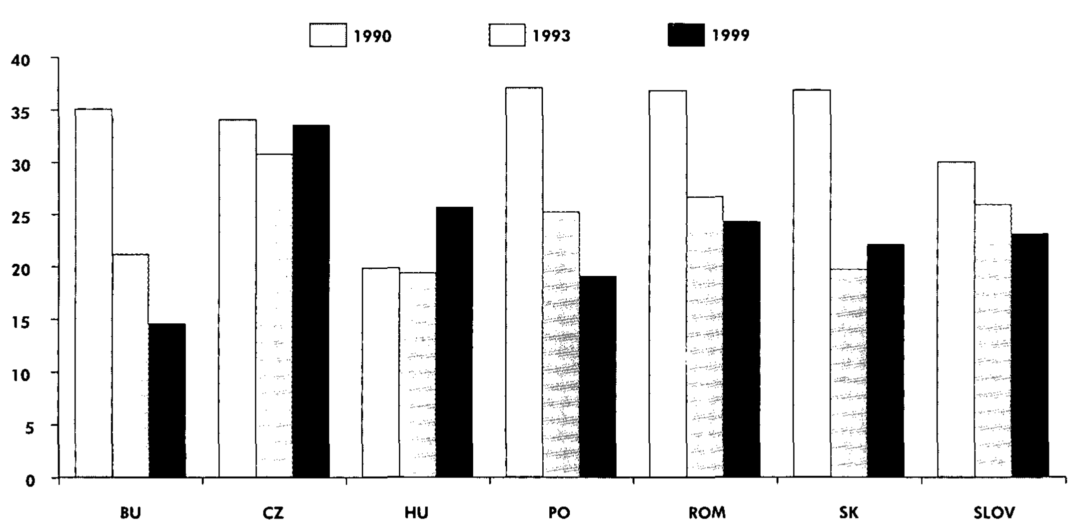
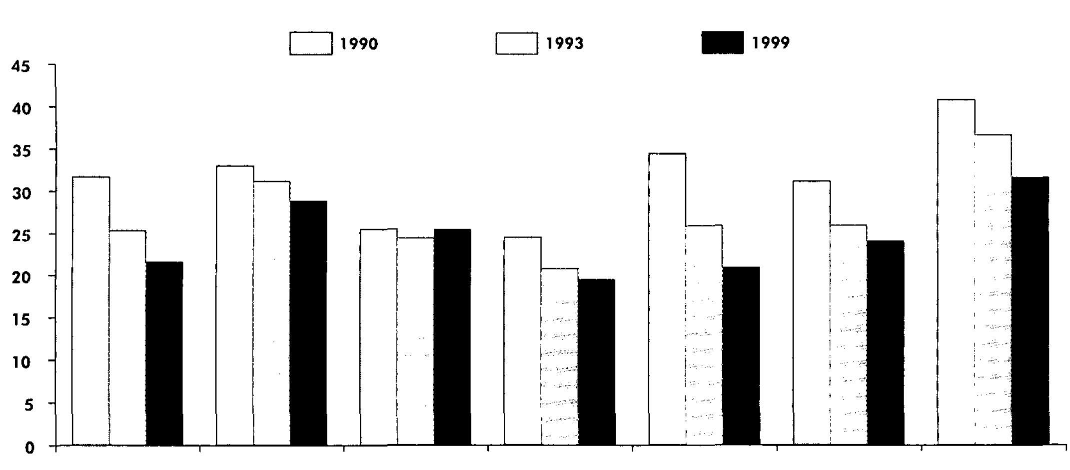


Figure II. Manufacturing employment in percentage of total



CEEC's MANUFACTURING INDUSTRY IN THE EUROPEAN CONTEXT

After nearly a whole decade of downsizing and re-shaping, the structure of CEEC manufacturing industry production now fits fairly closely into the European pattern (figure III). Compared to the EU average industry structure, according to Eurostat data, there are now (year 1998) somewhat higher production shares of food and beverages (DA), coke and refined petroleum (DF) and basic metals (DJ) industries in some CEECs. Lower shares are observed in machinery and equipment (DK) and—with a notable exception of Hungary—electrical and optical equipment (DL). Nevertheless, the overall structural differences vis-à-vis the EU are not so great, at least for the more advanced CEECs (that is, except Bulgaria and Romania—figure IV). The structure of Czech, Slovak and Slovene manufacturing industry is fairly similar to that of Austria (though, not so much to that of Germany). In fact, the structure of manufacturing industry output in the more advanced CEECs nowadays shows a greater similarity with the EU average structure than does Austria.

PRODUCTIVITY RECOVERY AND CATCHING UP AT BRANCH LEVEL

The varying growth rates of production and employment translate into different gains (or losses) in labour productivity (estimated as gross production per employed person in manufacturing industry). During the first period of transition (passive restructuring, until about 1993/94—see Urban, 2000), an initial productivity drop (due to declining output and delayed lay-offs) occurred nearly in all CEECs (except Poland). However, an impressive productivity recovery started in most CEECs afterwards (only in Bulgaria labour productivity continued to decline). Hungary's performance stands out again: its labour productivity in manufacturing industry is now twice as high as in 1993. The cumulative Polish productivity improvement during the period 1993-99 exceeded 50%, somewhat more than in the Czech and Slovak Republics as well as in Slovenia (all between 40% to 50%). Productivity gains have been much lower in Romania (figure V).

Figure III. CEEC manufacturing industry in the EU context, 1998
(branch shares in total manufacturing output)

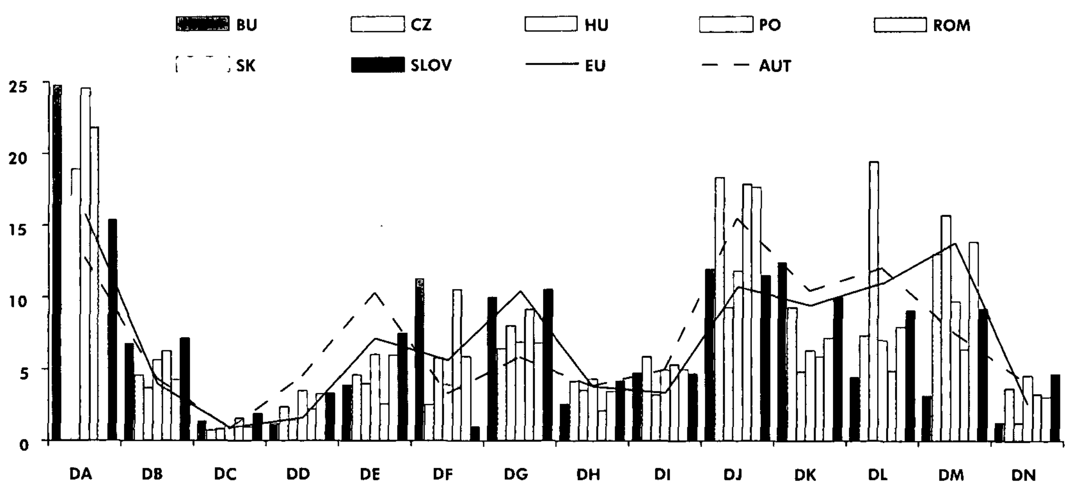
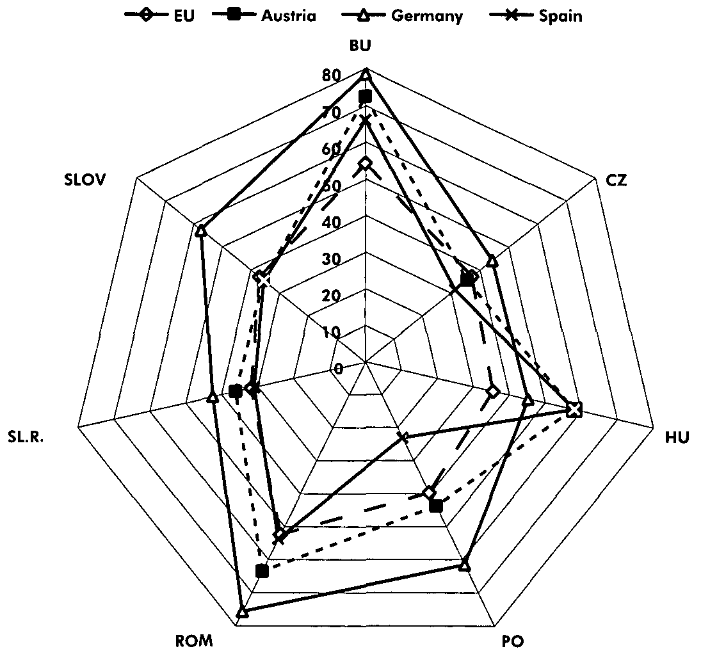
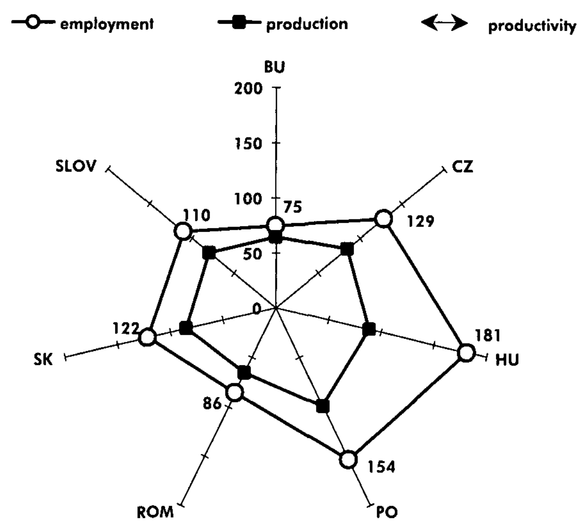


Figure IV. Deviations of CEEC manufacturing output structures, 1998



Note: Square roots of quadratic deviations in corresponding NACE 2 digit branch output shares (see Urban, 2000).

Figure V. Manufacturing labour productivity, 1999
(1993 = 100)



MANUFACTURING LABOUR PRODUCTIVITY IN INTERNATIONAL COMPARISON

The main difficulty in productivity comparisons form the internationally comparable productivity estimates, in particular the conversion of the national output data to a common currency. The use of market exchange rates is not appropriate for this purpose (especially for the CEECs, mainly due to their grossly undervalued currencies and fluctuating exchange rates). Alternative proxy converters are either purchasing power parities (PPP), or – much better – branch-specific unit value ratios (UVR) which compare aggregate prices of representative products. Preliminary results for the Czech Republic, Hungary and Poland from an ongoing research project, jointly conducted by the WIIW and the University of Groningen, show a broad correspondence of estimated productivities obtained with UVR and PPP for gross capital formation.[3]

Indeed, a comparison with Austria using PPP for gross capital formation (PPPCAP) and German-based bilateral UVR as converters gives fairly close results (figure VI).[4] The estimated Czech and Hungarian manufacturing industry labour productivity was about 35% of the Austrian level in 1996, the respective Polish-Austrian relation was 32% after the conversion with PPP for gross capital formation.[5] The corresponding results for UVR-based productivity comparison were 37%, 41% and 34%, respectively.

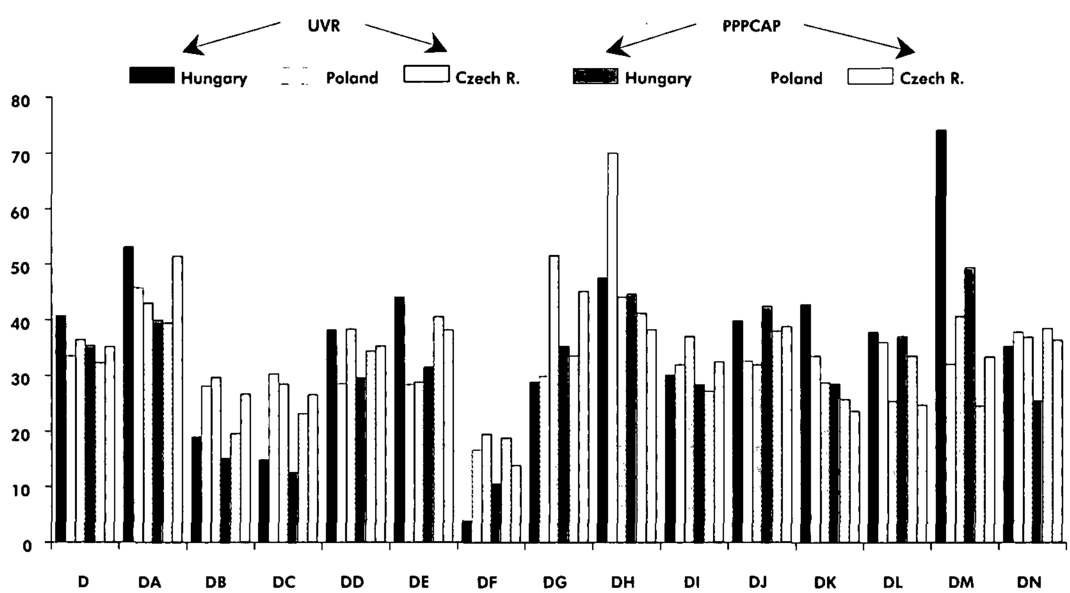
A closer look at individual branches, using the conversion with branch-specific UVRs, shows that relatively smaller productivity gaps were observed especially in manufacturing of food, beverages and tobacco, rubber and plastic products, transport equipment (Hungary); food, beverages and tobacco and other manufacturing sectors (Poland), food, beverages and

[3]Using the UVRs conversion, the relative level of labour productivity in Hungarian manufacturing was about 39% of that in Germany in the year 1996, the Czech-German productivity relation was 35% and the Polish-German relation was 25%—see E. Monnikhof and B. van Ark, "New estimates of labour productivity in the manufacturing sectors of Czech Republic, Hungary and Poland, 1996", Groningen Growth and Development Centre, University of Groningen & The Conference Board, Second Report for the WIIW Countdown Project, June 2000.

[4]PPPCAP for 1996 was taken from Eurostat-OECD "Benchmark Results of the 1996 Eurostat-OECD Comparison by Analytical Categories", OECD, Paris, 1999. We assume that Austrian-German UVRs are proportional to ATS/DM exchange rate. Austrian manufacturing labour productivity was in 1996 slightly (-3.3%) lower than in Germany—see Guger, A., "Verbesserung der relativen Lohnstückkostenposition durch Euro-Kursrückgang". WIFO Monatsberichte, 9/2000, pp. 541-546.

[5]See P. Havlik, "Trade and Cost Competitiveness of the Czech Republic, Hungary, Poland and Slovenia", World Bank Working Paper, Washington D.C. (forthcoming).

Figure VI. Manufacturing labour productivity, 1996
(Austria = 100)



tobacco, chemicals, rubber and plastics (Czech Republic) in 1996. Hungarian labour productivity in transport equipment industry was 74% of the Austrian level in 1996 (60% of German level), the Czech productivity in chemicals was 52% of the Austrian level (54% of German level), Polish productivity in rubber and plastic products was 70% of the Austrian level (60% of German level). On the other hand, productivity gaps in textiles and leather manufacturing (as well as in refined petroleum products) were in all three countries especially large. Taking into account recent impressive productivity improvements (+40% in Hungary, +20% in the Czech Republic, +30% in Poland between 1996 and 1999), all three countries must have by now caught up further with productivity levels in the EU.[6] The extrapolated relative productivity levels presented in figure VII (extrapolated with branch-specific productivity changes from UVR-based estimates for 1996 presented in table 6) suggest that Hungary (and especially its electrical and transport equipment industries) moved closer to Austrian productivity levels.

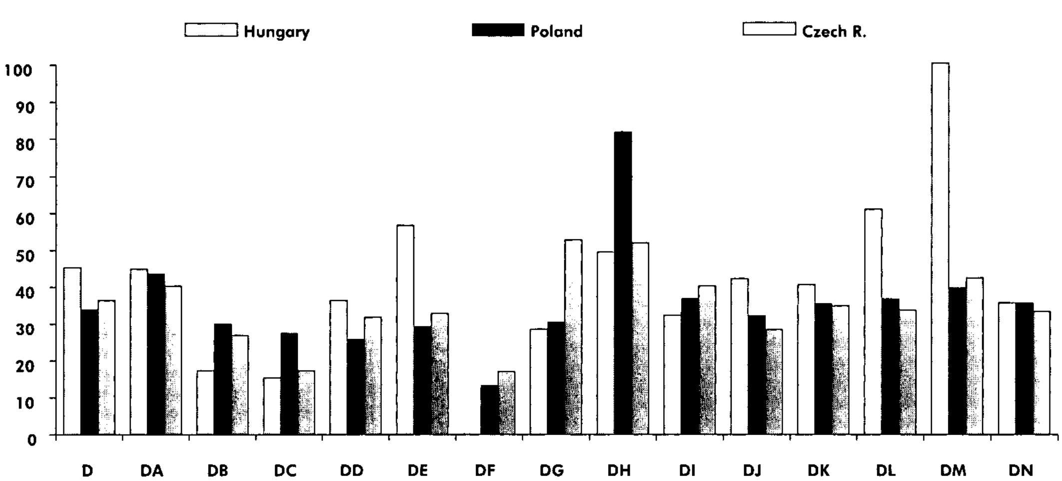
EMERGING WINNER AND LOSER BRANCHES

Overall developments mask substantial structural changes within manufacturing industry, reflecting inter alia different speed of restructuring and resulting efficiency gains or losses of individual branches. These structural changes again vary across individual CEECs and over time; the time differences partly reflect the uneven progress of industrial restructuring. Compared to the initial phase of transition, we find a new pattern of winner and loser branches emerging recently—frequently quite opposite to that from the period of passive restructuring during the early 1990s.[7]

[6]Taking into account that (nominal) productivity in the EU has been growing by 4.3% per year during 1988-98 (in Austria by 8.8%, in Germany by 5.2%)—see "The competitiveness of European industry. 1999 Report", Working document of the services of the European Commission, COM (1999) 465, Luxembourg, 1999, p. x. Guger (op. cit. P. 543) gives an estimate for hourly productivity growth between 4-5% per year in both Germany and Austria during 1995-1999.

[7]See W. Urban, "Patterns of Structural Change in CEECs Manufacturing", *WIIW Structural Report* 1999.

Figure VII. Manufacturing labour productivity (UVR-based), 1998
(Austria = 100)

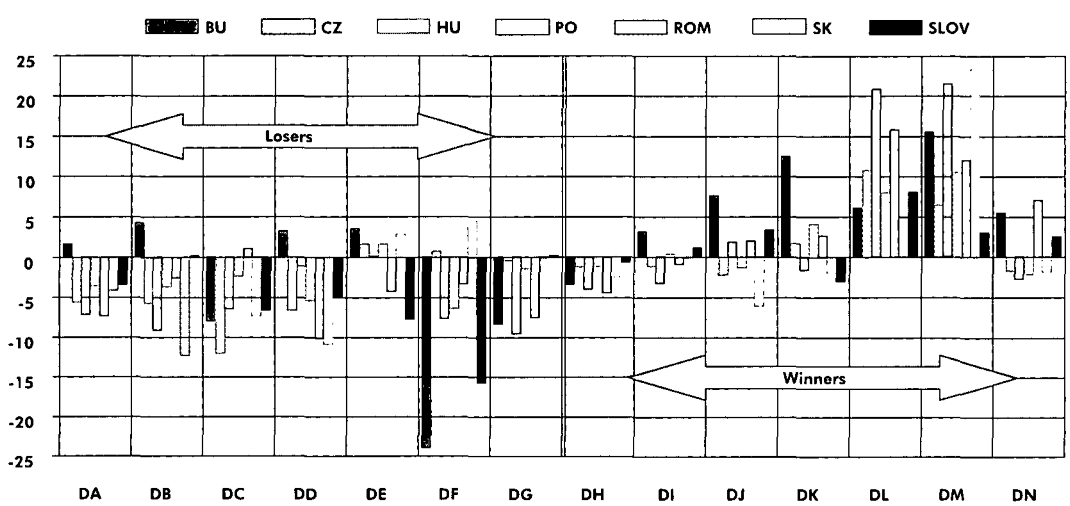


Looking at the relative labour productivity changes in the period 1993-98 by individual branches (relative to the manufacturing industry average), one can distinguish two distinct groups of industries (figure VIII). Roughly speaking, among the winners (branches with above-average productivity gains during the period 1993-98) are in most CEECs only a few of the following industries: machinery and equipment (DK), electrical and optical equipment (DL) and transport equipment (DM) as well as (less clearly) other manufacturing (DN). Manufacturing of electrical, optical and transport equipment has been a clear productivity winner in all CEECs. In Hungary, productivity in these branches has been growing by more than 20% per year; in the Czech Republic, Poland, Romania and in Slovakia by double digit annual rates as well. On the other hand, the loser branches are frequently the manufacturing of food, beverages and tobacco (DA), textiles (DB), leather (DC), wood products (DD), coke and refined petroleum (DF) and chemicals (DG). In some cases, productivity even declined in absolute terms: apart from most manufacturing branches in Bulgaria (here productivity declined everywhere except for machinery and equipment n.e.c. and transport equipment), this happened e.g. in leather industry in the Czech Republic and in Slovenia, in the wood industry in Romania and Slovakia, etc.

COMPETITIVE STRENGTHS AND WEAKNESSES: EVIDENCE FOR SELECTED BRANCHES

We shall now look more closely at some aspects of selected winning and losing branches in order to find out where their particular strengths and weaknesses might come from. First of all, we know that wages are still generally low in all CEECs, and this is true for all sectors of the economy. Even in "high wage" Slovenia the average gross wage (EUR 900 per month in 1999) was only some 40% of either the Austrian or German level (at current exchange rates). Czech, Hungarian or Polish average wages range between EUR 300-400 per month (15-18% of either the German level or Austrian level) and wages are even much lower in the remaining CEECs. East-West gaps in total labour costs are even slightly bigger since direct

Figure VIII. Relative productivity gains
(annual averages, 1993-1998)



wage costs in the CEECs usually account for a greater share of total labour costs than in most EU countries.[8]

A cross-industry comparison of relative wages shows that wages in the above identified winner branches are usually higher than the manufacturing industry average, whereas in loser branches wages are much lower than average. The relative wage level thus seem to be positively associated with the varying sectoral productivity performance: "successful" branches can afford to pay higher wages. A more important indicator of the cost competitiveness is unit labour costs (ULC). These are defined as a ratio of wage costs (gross wages, including indirect wage costs, in EUR at current exchange rates) and labour productivity levels (defined as gross output per employed person. Sectoral differences in ULC are affected mostly by varying labour productivity, as wages display less pronounced sectoral variation. Productivity differences, in turn, partly result from different capital intensity of individual industries, which we disregard here due to the lack of reliable data on the capital stock (we shall briefly return to this issue below).

A comparison across manufacturing industry branches, within each CEEC, shows that the winner branches tend to have lower (or at least not too high) ULC than the manufacturing industry average (table 1). On the other hand, ULC in most of the loser branches are considerably higher than manufacturing industry average. This is largely because of (by definition) the relatively high productivity gains, shown above, achieved by winner branches and the corresponding productivity losses of losers. Moreover, these productivity losses have not been compensated by appropriate wage adjustments (despite below average wage increases in loser industries). The winner branches thus managed to keep (or even to increase) their comparative ULC advantage, despite (or perhaps because of) the fact that they offer above-average wages. On the other hand, the loser branches have high ULC despite low wages—especially due to their low productivity. Besides, they are also overproportionally labour intensive.

Table 1. Unit Labour Costs, year 1998
Manufacturing = 100

		Czech Republic	*Hungary*	*Poland*	*Romania*	*Slovakia*	*Slovenia*	*Bulgaria*
D	Manufacturing total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
DA	Food products; beverages. tobacco	69.3	100.9	72.7	56.0	72.2	66.8	69.4
DB	Textiles and textile products	161.2	284.9	166.9	260.5	259.4	153.9	171.3
DC	Leather and leather products	230.4	271.8	158.7	154.0	245.8	149.9	165.0
DD	Wood and wood products	182.3	111.5	99.9	134.3	250.3	143.5	100.6
DE	Pulp, paper & paper prod., printing	82.1	104.8	86.5	149.2	97.8	136.1	91.0
DF	Coke, refined petroleum products	12.9	83.6	40.4	33.9	21.2	45.5	44.2
DG	Chemicals, chemical products, fibres	55.1	122.0	97.9	86.5	70.3	74.9	87.1
DH	Rubber and plastic products	121.3	108.8	87.9	106.4	99.5	103.5	108.6
DI	Other non-metallic mineral products	128.4	160.1	126.0	125.1	136.2	94.7	125.8
DJ	Basic metals and fabricated metals	120.6	101.7	109.0	71.4	107.6	126.6	75.0
DK	Machinery and equipment n.e.c.	157.8	181.2	155.1	260.1	189.4	117.3	164.9
DL	Electrical and optical equipment	103.6	63.2	102.8	97.3	157.3	132.0	148.4
DM	Transport equipment	69.5	49.6	83.7	97.9	35.9	40.3	131.5
DN	Manufacturing n.e.c.	149.6	176.2	115.0	165.1	186.0	92.3	123.3

[8]Direct wage costs account for 60% to 75% of total labour costs in CEECs as compared with 50% to 60% in the majority of EU countries—see Havlik, P., op.cit.

Tables 2a and 2b contain two sets of ULC estimates which provide ranges for a cross-country level comparison. The first data set results from national productivity figures converted into common currency with purchasing power parities for the whole GDP (PPP96). This conversion leads to higher productivity estimates and therefore to lower relative ULC levels for CEECs. The second data set uses as a convertor PPP for gross fixed capital formation which lead to lower productivity estimates and therefore to higher relative ULC. Given the above shown (figure VI) close correspondence of the latter productivity estimates to the theoretically superior UVR-based productivity data, and assuming that a similar correspondence exists for other CEECs as well, one can reckon that ULC figures from the table 2b are probably closer to reality—at least for the manufacturing industry as a whole.

But even when using the upper boundary range for ULC, the gaps—that is CEECs' cost advantages—behind Western Europe (here represented by Austria or Germany) are quite large: more than 30% in case of Slovenia (though some branches such as textiles, leather, wood and coke industries—may have higher ULC than in Western Europe). In general, CEEC wage gaps are much bigger than productivity gaps and this is valid especially for the more advanced CEECs and for the winner branches: Hungary's ULC in electrical, optical and transport equipment industries were less than one fifth of Austrian level, and about one third of that level in the Czech Republic, Poland and Slovakia—see table 2b. We shall present some evidence that the winner branches may have even enjoy increasing competitive advantage below.

Table 2a. International comparison of ULCs in the manufacturing industry
(year 1998, PPP96 for GDP, Austria 1998 = 100)

		Bulgaria	*Czech Republic*	*Hungary*	*Poland*	*Romania*	*Slovakia*	*Slovenia*
D	Manufacturing total	17.1	30.3	21.1	28.6	19.7	25.9	68.4
DA	Food products; beverages and tobacco	15.4	27.3	24.1	27.1	12.9	24.3	59.5
DB	Textiles and textile products	24.7	41.1	45.9	40.2	37.5	56.5	88.6
DC	Leather and leather products	29.7	73.5	59.6	47.8	34.2	67.0	108.0
DD	Wood and wood products	18.6	59.9	24.4	31.0	28.1	70.2	106.4
DE	Pulp, paper & paper products; publishing	15.9	25.4	23.6	25.3	30.6	25.9	95.2
DF	Coke, refined petroleum products & nucl.	33.0	17.1	71.3	50.5	26.9	24.0	135.7
DG	Chemicals, chemical products and fibres	17.3	19.4	25.0	32.5	21.5	21.1	59.4
DH	Rubber and plastic products	15.7	31.0	17.5	21.2	17.9	21.7	59.7
DI	Other non-metallic mineral products	16.8	30.4	25.3	28.2	19.0	27.6	50.7
DJ	Basic metals and fabricated metal prod.	11.2	31.9	18.6	27.2	13.3	24.3	75.6
DK	Machinery and equipment n.e.c.	21.2	35.9	27.9	33.3	36.6	36.8	60.3
DL	Electrical and optical equipment	22.8	28.2	14.3	26.4	16.0	36.6	81.1
DM	Transport equipment	30.5	28.6	15.0	32.5	28.2	12.6	37.4
DN	Manufacturing n.e.c.	17.7	38.1	31.9	27.7	26.4	40.5	53.1

Table 2b. International comparison of ULCs in the manufacturing industry
(year 1998, PPP96 for gross capital formation, Austria 1998 = 100)

		Bulgaria	*Czech Republic*	*Hungary*	*Poland*	*Romania*	*Slovakia*	*Slovenia*
D	Manufacturing total	41.7	45.6	34.0	38.5	46.9	40.4	80.4
DA	Food products; beverages and tobacco	37.7	41.2	38.7	36.4	30.7	38.0	69.9
DB	Textiles and textile products	60.2	62.0	73.7	54.1	89.5	88.2	104.2
DC	Leather and leather products	72.5	110.8	95.8	64.4	81.5	104.5	127.0
DD	Wood and wood products	45.5	90.3	39.1	41.7	67.0	109.6	125.1
DE	Pulp, paper & paper products; publishing	38.9	38.4	38.0	34.1	73.0	40.4	111.9
DF	Coke, refined petroleum products & nucl.	80.5	25.7	114.6	68.0	64.2	37.4	159.6
DG	Chemicals, chemical products and fibres	42.1	29.2	40.2	43.7	51.2	32.9	69.8
DH	Rubber and plastic products	38.2	46.8	28.2	28.6	42.7	33.9	70.2
DI	Other non-metallic mineral products	41.1	45.9	40.7	38.0	45.4	43.0	59.6
DJ	Basic metals and fabricated metal prod.	27.3	48.0	29.9	36.6	31.7	37.9	88.8
DK	Machinery and equipment n.e.c.	51.7	54.1	44.9	44.8	87.3	57.4	70.9
DL	Electrical and optical equipment	55.6	42.5	22.9	35.6	38.1	57.1	95.4
DM	Transport equipment	74.5	43.1	24.0	43.8	67.3	19.7	44.0
DN	Manufacturing n.e.c.	43.3	57.4	51.2	37.2	63.0	63.1	62.4

Sources: WIIW estimates based on national statistics, OECD, EUROSTAT and UNIDO.

In a dynamic perspective, ULC can improve (that is, to decline, assuming constant capital intensity) if wages are growing slower than labour productivity. Moreover, in the international context, wage costs can be curbed also by "competitive devaluation" (currency appreciation has the opposite effect).[9] In the Czech Republic, for example, the 'winner' branches are characterized by modest ULC increases (or even by their decline in manufacturing of electrical and optical equipment). On the other hand, 'loser' branches have suffered from a huge deterioration of labour cost competitiveness, especially in leather and leather products manufacturing. In Hungary, on the other hand, both winner and loser branches have enjoyed impressive ULC improvements, but the winner branches have still fared much better than the losers.

REVEALED COMPARATIVE ADVANTAGE (RCA) OF MANUFACTURING INDUSTRY

We shall now look briefly at the trade performance of manufacturing industry branches. Can we find a distinct pattern in the revealed comparative advantage in CEEC trade with the EU?[10] There were only a few CEEC industries with clearly positive RCA in 1998: textiles (DB), leather (DC) and especially wood (DD), as also minerals (DI) and basic metals (DJ)—see

[9]Since the exchange rate changes affect all branches uniformly (at least as far as wage developments are concerned) we do not show this effect separately. The wage data refer to wages in international currency (euro).

[10]Revealed comparative advantage is defined as RCA = ln [(Exit/Imit)/(Ex/Im)]*100.

figure VIII. Most of these branches with positive RCA belong to productivity losers, and several of the winner branches in terms of productivity improvements have clearly negative RCA in most CEECs (electrical, optical and transport equipment in Hungary are the most important exceptions). There seems to be no clear productivity-related RCA pattern. Looking at changes in RCA during the last couple of years,[11] one can see that only a few industries in some CEECs have recently experienced RCA improvements: food industry (DA) in Poland, leather (DC) in Slovakia, again the electrical, optical and transport equipment (DL, DM) in Hungary, as well as transport equipment (DM) in the Czech Republic and Slovakia (figure IX). Again, there seems to be no straightforward relation with productivity improvements: even the winner industries frequently suffered (with some of the important exceptions mentioned above) from a deteriorating RCA. This may be related to the largely incomplete industrial restructuring as branches with improving productivity still import more than they are able to export.

EFFECTS OF FDI ON PRODUCTIVITY, ULC AND RCA IMPROVEMENTS

The recent UNCTAD study has identified a strong relationship between inward FDI and manufactured exports performance for a number of developed and developing countries.[12] The impact of FDI rises with the technology intensity of exports, especially in the case of developing countries: a one per cent rise in FDI per capita leads to 0.78% increase in high technology exports. In countries with strong national innovation systems and exports led by national enterprises (still the case in many CEECs), the question is how to cope with the pace of technical change and make inroads into markets held by more advanced countries (that is, to catch-up). Moreover, when the evolution of dynamic comparative advantage is

[11]Average RCA during the period 1996-1998 over the RCA average during 1993-1995.

[12]See *World Investment Report. 1999 Foreign Direct Investment and the Challenge of Development,*. UN, New York and Geneva, 1999, pp. 244-255.

Figure IX. Revealed comparative advantage (RCA), 1998

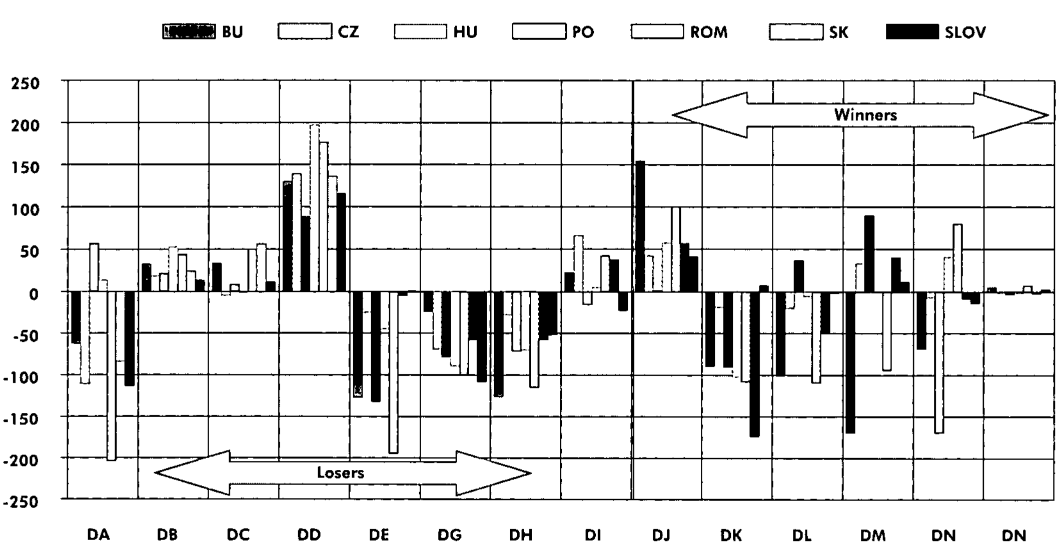
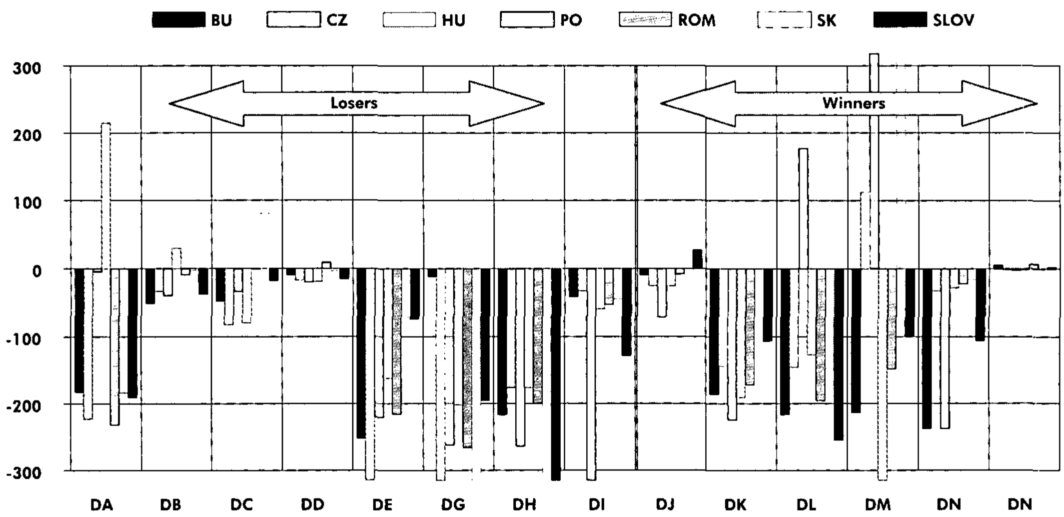


Figure X. RCA improvements
(percentage change, average 1996-1998 over 1993-1995)



assisted by FDI there is a problem of sustainability and upgrading, especially as wages rise and cheaper competitors appear. Last but not least, the question of spill-overs between foreign-owned and domestic sectors has to be tackled in order to avoid that isolated pockets of advancement develop while the rest of the economy falls behind.

We have investigated branch specific relationships between inward FDI stock, productivity, ULC and RCA performance for selected CEECs.[13] First we note that the FDI penetration is highly uneven across individual manufacturing industry branches (figure X). On average, manufacturing industry FDI stock per employed person amounted in 1998 to over US$ 5,000 (except for Slovakia), but pulp and paper (DE), chemicals (DG), other non-metallic minerals (DI) and transport equipment (DM) industries have attracted much more FDI in most CEEC.

Generally, there is an impression that winner branches (in terms of relative productivity gains) are generally more penetrated by FDI, while there is very little FDI in most loser branches (except for food, beverages and tobacco). However, just as for RCA, there is hardly any significant statistical relationship across all five CEECs and across all branches, between FDI stock per employee and either productivity or ULC improvements in a branch.[14] But in countries with higher FDI penetration (the Czech Republic, Hungary, Poland and Slovenia), there is a statistically significant and positive relationship between the FDI stock per employee and the productivity performance of the winner and loser branches: a one per cent increase of FDI per employee is associated with a nine per cent productivity improvement (figure XI). There is also a significant relationship between the FDI stock per employee and ULC improvements: higher FDI is associated with declining ULC (figure XII). Foreign direct investments thus clearly contribute to efficiency improvements in CEEC manufacturing, but do not (still) necessarily show up as a factor explaining the revealed comparative advantage of CEEC manufacturing in trade with the EU.

[13]Branch-specific FDI data are available only for the Czech Republic, Hungary, Poland, Slovakia and Slovenia.

[14]A similar conclusion was reached by Barrel and Holland who use a more sophisticated model with data for the Czech Republic, Hungary and Poland—see Barrel, R., Holland, D., "Foreign direct investment and enterprise restructuring in Central Europe". The Economics of Transition, Vol. 8, No. 2, 2000, pp. 477-504.

Figure XI. FDI stock per employee, 1998
(In US dollars)

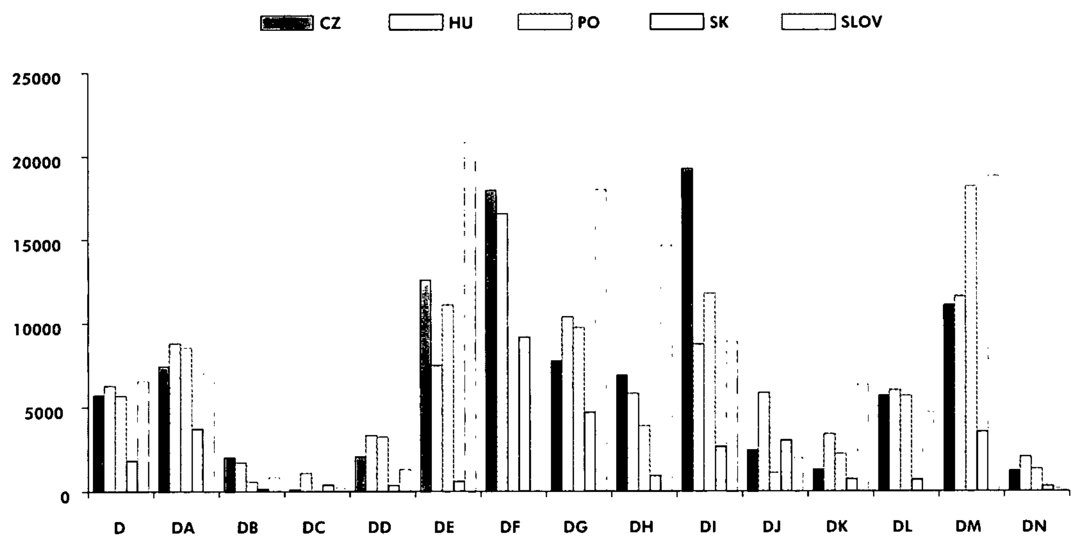


Figure XII. Productivity improvements and FDI per employee

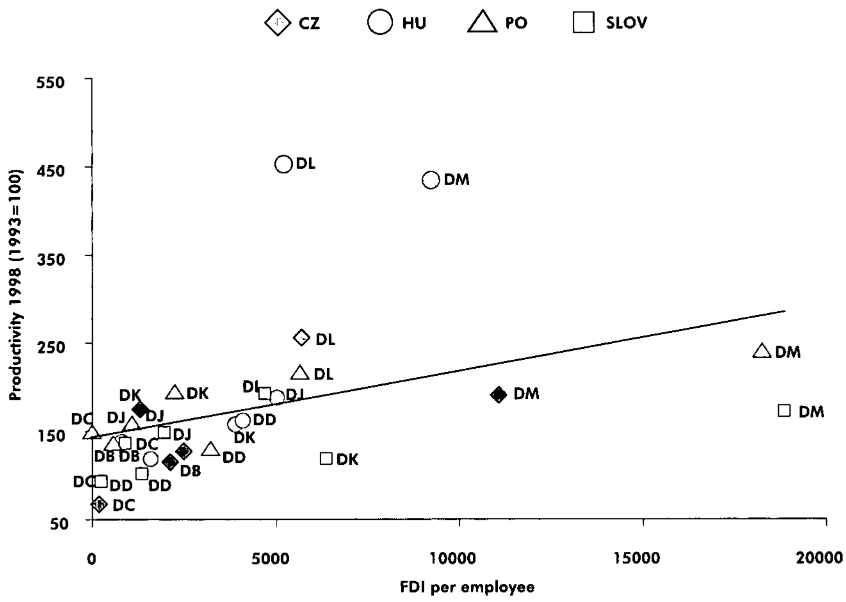
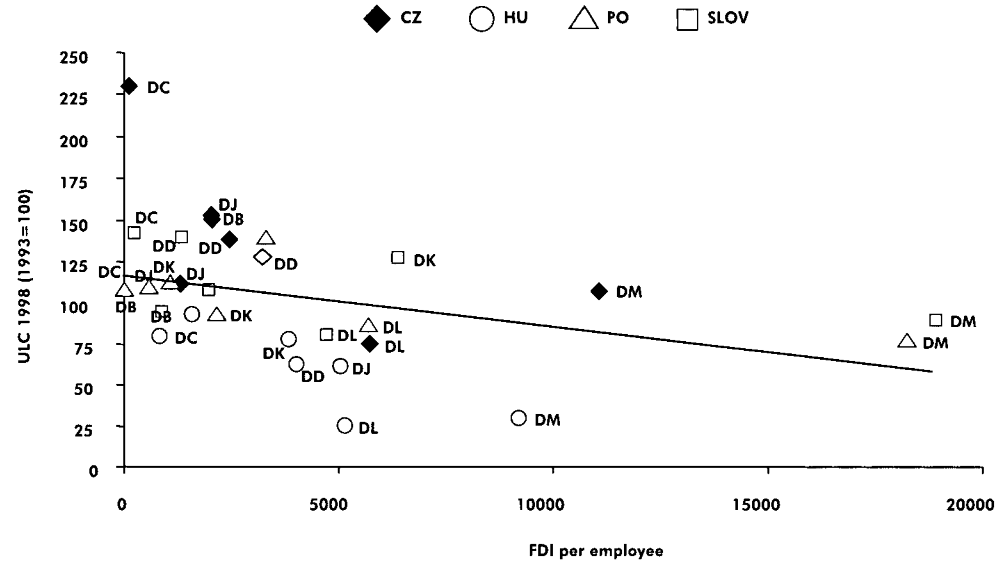


Figure XIII. ULC improvements and FDI per employee



SESSION 1

REVIEW AND FUTURE OF PRIVATIZATION FROM THE VIEWPOINT OF CORPORATE COMPETITIVENESS, MANAGEMENT, DEVELOPMENT OF TECHNOLOGY AND HUMAN RESOURCES

Review of Privatization from the Viewpoint of Corporate Governance and Macroeconomic Impact: Poland's Experience

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This paper is designed to present the experience of ten years of privatization in Poland, with particular view to the emerging corporate governance structures, as well as its impact upon modernization of economic potential.

WHAT IS SPECIFIC ABOUT THE POST-COMMUNIST EUROPE PRIVATIZATION?

Although privatization is now a world-wide tendency, it acquires additional dimensions in Poland and in other post-communist countries of Central and East Europe. It is part of a much wider, historical task of the reconstruction of a market economy from the ruins of central planning system. It has to be accompanied by the macroeconomic deregulation and stabilization, decentralization of the state (i.e. in Poland, delegating powers and a part of public property to 2,500 local communes), demonopolization of the foreign trade, promotion of the bottom-up private enterprise, restitution of confiscated property, initiating the capital market and overall re-shaping of the legal and institutional framework. Normally, these are simultaneous efforts, undertaken under the pressure of time and people's expectations. The scale of the ownership transfers in the post-communist Europe is also different.

It covers 80-90% of the economy, including agriculture, financial sector, military complex built for the sake of the Warsaw Pact and municipal privatization. Additional major differences consist in the shortage of capital in the Central/Eastern Europe countries as well as lack of the disposable income in their population, initial shortage of privatization skills and inherited, weak administration.

Privatization throughout former communist countries shares several characteristics in terms of starting point, scale, typical barriers and social constraints. However, in each country there are several distinctive features. Poland's specific traits include:

- A relatively large margin of private business. The predominantly privately-owned agricultural sector was a unique phenomenon among COMECON countries. The non-farm private sector in 1989 accounted for 10.3 of industrial production and 14% of non-agricultural labour force;
- A strong trade union tradition of solidarity and a generally influential labour force;
- Rapid "small privatization" of some 2,500 enterprises in retail, construction and service industry.

What is, in turn, common and important, is the strong politicization of ownership changes, due to the scale of transfers and therefore huge re-distribution of economic and political power. This is amounting to social revolution, affecting almost everyone. As such, privatization is seen as the most destabilizing and potentially conflicting factor in this time of painful transition. Apart from the other interesting aspects, ownership transfers in former totalitarian states provides a special case-study of the interplay between politics and economics—unfortunately, not properly seen and largely underestimated in the early stages of our transformation.

POLAND'S APPROACH: THE INSTITUTIONAL FRAMEWORK, METHODS AND ACHIEVEMENTS

FRAMEWORK

The state sector in Poland encompassed some 8,500 enterprises in 1989, generating 73% of the GDP. It was heavily concentrated and monopolized. Privatization is the responsibility of the Ministry of Ownership Changes (nowadays renamed the Ministry of Treasury), its Privatization Agency dealing with more routine job and 13 regional offices of the Ministry. Large-scale privatization was initiated in late 1990, when a great optimism prevailed as to the progress and social acceptance of ownership changes. It was reflected in the first programme, assuming that in the years 1991-1993 some 50% of all SOEs would be privatized—not a realistic assumption, as has been revealed in the course of action. On the other hand, from the very beginning, it was recognized that, given the scale and complex nature of the challenge, any analogies to privatization in the West or in developing countries would be misleading. A truly innovative strategy was necessary, as reflected in the multi-track approach, and the concept of mass privatization. No one particular sector of the Polish economy has been explicitly excluded from privatization. A number of companies of strategic importance require the approval of the Council of Ministers before their transformation. Traditionally, annual targets for the Ministry and the other privatization agencies are set by parliamentary decision, voted on as a supplement to the annual budget.

METHODS

Poland's approach may be summarized as follows:

- A multi-track approach, allowing for flexible adjustment of the applied techniques to particular privatization cases (taking into account size of the enterprise, actual and projected financial performance, competitive position and interest expressed by Polish or foreign investors);

- Decentralization of the procedures;
- "Insider's" initiative (managers and workers leveraged buy-outs);
- Employee shareholding (up to 15%);
- Limited and delayed Mass Privatization Programme;
- Bank conciliatory procedures (debt-equity swaps);
- Still unsolved problem of restitution and compensation for confiscated property.

Over the past ten years, several basic techniques for privatizing SOEs have been defined. The evolution of the diverse variants illustrates the process of adaptation to changing economic, political and social conditions. The law allows for the two fundamental, alternative methods of privatization:

- Transformation of SOEs into a State Treasury corporation, either as a joint-stock or limited liability company ("corporatization" of SOEs), the shares are then sold to private investors via trade sale, initial public offering or mixed methods.
- Direct privatization through formal liquidation of SOEs with subsequent sale, transfer of the assets into an existing company, or its lease in part or as a whole.

Poland's variant of mass privatization—the National Investment Funds Programme was conceptually mature by mid-1991, but voted in parliament in not earlier than 1993 and implemented with delay, in 1995. The programme contained 512 enterprises, mainly medium-size and large, more than 50% of them loss making, accounting for 8.5% of the overall industrial production—a relatively modest programme in relation to the MPPs adopted in the other former COMECON countries. Every adult Pole had a possibility to purchase one voucher, to be converted into shares of the 15 specially formed investment funds. Ninety-five per cent of people reacted positively, purchasing vouchers, but the majority of them confirmed "preference for liquidity" rule of the Central/Eastern Europe—selling vouchers and participating in the subsequent stages of the programme.

PRIVATIZATION RESULTS TO DATE

The actual privatization appears to be slower and more politically controversial than assumed in early 1990s. Between 1990 and 31 December, 1999 privatization covered: 1,454 firms via corporatization of SOEs; 1,727 firms via direct privatization. Additionally: 1,641 firms were liquidated due to economic reasons or declared bankrupt. Therefore, taking also into account initiated privatization procedures, at the end of 1999: 2,599 firms were still in the public register.

The strength of organized labour, as well as the vital role of management in SOEs, is reflected in the privatization statistics. The insiders—managers and employees—clearly dominate Polish property transfers in small and medium scale companies, while foreign investors prevail in large enterprises. Nowadays, Poland's transformation in general and privatization in particular, has entered the stage of the "second generation transition issues". Privatization of so called "natural monopolies" dominates the Treasury Ministry's agenda since 1999, including former telecommunication monopoly (Telekomunikacja Polska S.A.—sold), banks and insurance (almost finished), energy system, Polish airlines (LOT—first stage accomplished) and transport infrastructure. Our privatization agenda tends to be strongly correlated with the European Union calendar of liberalization and deregulation.

CORPORATE GOVERNANCE AND MACROECONOMIC IMPACT OF PRIVATIZATION

CORPORATE GOVERNANCE MECHANISM

The question of emerging corporate governance structures was largely underestimated in the early stages of the post-communist transition. The prevailing mood of thinking favoured speed of property transfers and standard procedures, delegating restructuring task to the future private owners. Mass and rapid privatization was widely considered as an optimal solution to the post-communist etatistic challenge. How else could one divest, in a short time, the thousands of companies and break the links between the economy and the state? Apart from this prevailing dogma, several East and Central European countries—Poland among them—were dominated (as mentioned above) by the managerial/workers buy-outs, shaping the corporate mechanism in small and medium size sphere. It is quite acceptable, of course, that the insiders be given an initial share in the ownership. However, there also risks of excessive managerial/workers power. There is namely, a danger of producing self-interested decisions and avoiding inconvenience such as painful restructuring, wages controls and labour reductions. As for employee substantial stakes, there is a special risk that they would be able to induce the managers to award them short-time gains at the expense of the long-term profitability of the enterprise. Further, with limited outsider controls over managers, private suppliers of equity finance tend to demand a premium in the cost of capital they supply, the same applying for the suppliers of debt finance. The weaker the degree of outsider control over an enterprise, the higher the cost of capital or credit can be expected. Generally speaking, the inherited structure of excessive insiders controls, strengthened in the process of privatization, is not favourable to deep restructuring, so much needed in our transition economies. Mass privatization schemes are also not conducive to rapid performance improvement. Privatization to diffuse owners, with poorly regulated voucher funds doesn't create pressure to improve economic performance. These observations were strongly verified in numerous transition countries, including Poland. Consequently, in the second half of 1990s, the quality of privatization and the resulting corporate governance patterns have attracted more attention. The quality of the transaction and its impact upon microeconomic performance appears as important as the statistics of the privatized companies. The key issue now is what new governance mechanism will be most conducive to the necessary restructuring and improvement of the competitive position of the privatized company. Thus, on our "trial and error" path, we have learned to accept that the efficient corporate governance and the proper institutional framework as the crucial issues and expected output of privatization, enhancing the results of the formal property rights transfers.

MACROECONOMIC IMPACT

Poland's economy was rising at the 5% average annual growth rate in the decade of 1990s. Privatization is rightly seen as one of the decisive factors behind the impressive growth. On the other hand, the dynamic growth of grassroots private business—more than 2 million new undertakings since 1989—plus the increasing tendency among foreign investors to seek a "greenfield" solution, gain in importance in the further expansion of the private economy in Poland.

The relation between privatization and overall economic performance depends upon mood of the divestiture. From the purely economic standpoint, trade sales involving foreign strategic investors are much more efficient. They entail substantial investments in the form of modernization, restructuring and ecological improvements. They also generate essential budgetary revenue. Companies controlled by foreign investors contribute positively to Poland's export potential. Fiat, Philips, Thomson, International Paper, GM are among the major exporters. On the other hand, this path of privatization appears more politically conflicting. In turn, privatization involving employee/managerial LBOs is politically more accepted but the economic results of this path—as mentioned above—are dubious and much delayed. These procedures, involving insiders appeared to be 10 times as numerous as IPOs and trade sales involing real capital input. Only with time, through the consolidation of property rights and growing financial credibility, the companies privatized by LBOs improve and contribute to the modernization of Poland's economy. There is therefore, a clear trade-off between efficiency and political acceptance of various privatization methods.

The Polish example proves that the ownership transformation is very much a social process. People's perception plays a significant role. It is easier to develop conceptual schemes of privatization than to sustain them politically. Given the scale of remaining "work in progress" in Poland, both the qualitative and social aspects of privatization should be incorporated into the economic strategy—here is an important lesson which can be drawn from our case for the benefit of other transition countries.

Privatization, Foreign Direct Investment and Economic Performance in Hungary, 1990-1999

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The Hungarian economy faced a critical situation in 1990 when the first freely elected government took office. Hungary belonged to the most indebted economies of the world with a per capita gross foreign debt of US$ 3,000, it was stuck in a lasting growth crisis, inflation measured on a CPI basis approached 25% per year and, last but not least, the economy struggled with immense structural problems. The sudden loss of traditional export markets in the COMECON trading block of Eastern Europe was aggravated by shrinking domestic demand and the sweeping first consequences of import liberalization for a string of domestic producers. A not insignificant number of reputed experts expressed fears that the Hungarian economy was close to collapse.

The picture is very different a decade later. Hungary cannot be regarded as a case of economic crisis. It is referred to by the European Union as the leading candidate for accession, its debt problem has more than halved if the level of per capita gross foreign state debt is considered the appropriate measure, and it has been on a steady path of economic growth since 1996. Moreover, the obsolete export structure of 1990 has been replaced by a sound new one in which the relative share of high-tech goods is above 25%. The country's export capacity in terms of US dollars went up from 10 billion to almost 25, one half of GDP. Unemployment is in the range of 7 to 8% as opposed to figures above 13% in the worst years of the early nineties.

A very good indicator of the extent to which the Hungarian economy has improved its performance during the nineties is the change of its position in the international competitiveness ranking list of the World Economic Forum. Hungary started from very low on this list: it ranked 47th ahead only of the Russian Federation and Venezuela in 1994 when it first figured on the list. Hungary's latest position was 26th in 1999, the highest in Central Eastern Europe and well ahead a couple of EU countries including Italy, Greece and Portugal. In other words, the poor competitiveness performer became a player in the Champions League of the global competitiveness game.

The obvious question is how such a dramatic change could take place within a time span of less than ten years. Good economic policies can, of course, be praised for such positive developments, but their impact would have been meagre without the contribution of economic actors. Are these the same in the year 2000 as the ones clearly very much underperforming ten years ago? Or has structural change meant that a great number of new players adapted to much higher competitiveness standards appeared in the Hungarian economy?

This working paper explores the assumption that besides the rules of the game also a significant part of the players has changed. This assumption means much more than just far-reaching privatization, since privatization as such changes the names and maybe the outfits of the players but they remain basically the same. In addition to privatization, greenfield foreign direct investment is really the force that generates new market players.

WHO HAVE BEEN THE PLAYERS?

The number of market players has shown an incredible increase since 1990 in general. There were 660,139 private enterprises in Hungary at the end of 1999 as opposed to 393,450 in late 1990. The figure for 1999 is somewhat misleading since it included about 312 thousand self-employing entrepreneurs, i.e. family businesses.

Still, it is telling to which extent the formerly dominant forms of "socialist entrepreneurship" yielded the ground to modern corporate structures based on private ownership. Amongst these structures, Hungarian entrepreneurs' priorities showed a clear bias towards simpler corporate structures requiring less investment but more personal liability as in the case of corporate entities with higher degrees of financial and lower levels of legal exposures of the owners.

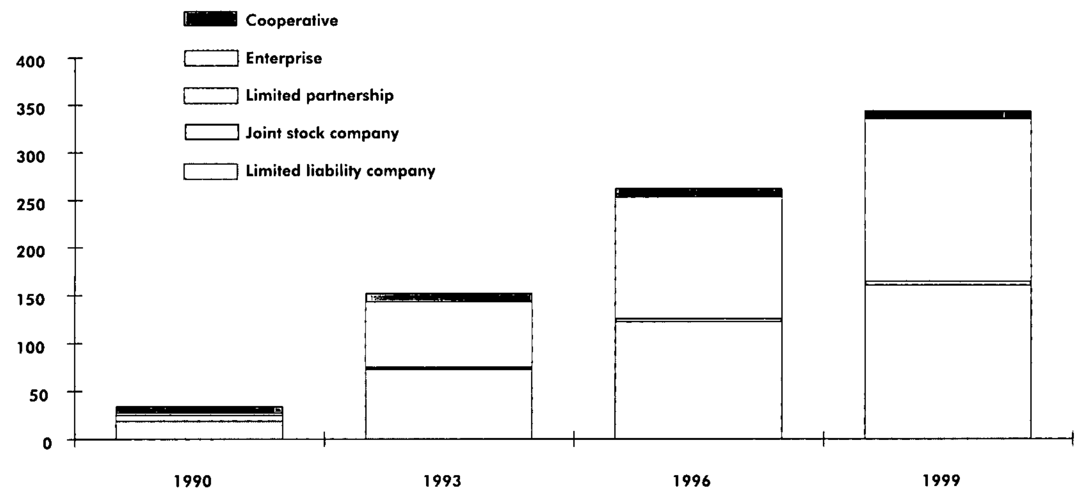
Figure I shows the development of the density of five main forms of entrepreneurship in Hungary. "*Enterprise*" which meant mainly, but not exclusively state-owned "socialist" enterprise in the pre-1990 past was the only category which has been slowly phased out. The sole form of non-state ownership officially encouraged before 1990, cooperatives, showed stagnation.

The other three forms expanded in a spectacular manner. Due to the differences in the amounts to be invested to set up one or the other, *limited partnerships* usually are small firms, *limited liability companies* tend to be medium-size, and joint stock companies may be really important in terms of output and employment.

The spectacular increase in the number of firms with corporate structures and mainly private owners has to be noted for one particular reason. It substantiates the development of what may be called (borrowing the term "*tissu industriel*" frequently used by French industrial economists) "entrepreneurial fabric" of the Hungarian economy. Even if most newly created firms are local market players without any presence on national markets to speak of, this explosion in the numbers of market players shows that competition has really gained ground in Hungarian market structures.

Overall quantitative data are not available on previous and current numbers of players in diverse market niches. One example from a strongly competitive sector sheltered from import competition might show how underdeveloped the "industrial fabric" had been if monopolistic competition is considered the dominant market structure.

Figure I. Number of business organizations in Hungary, 1990-1999
(in thousands)



Source: National Bank of Hungary (NBH) Annual Report 1999. 192.

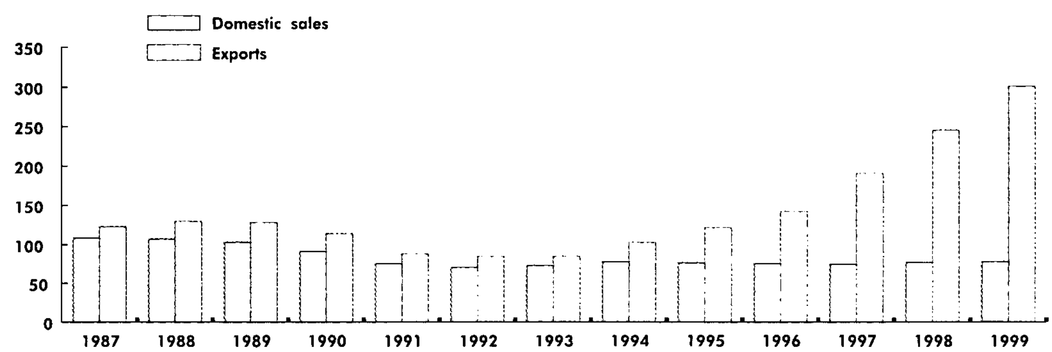
The merger of two national hotel chains was decided in 1996. Since both of them more or less covered the entire map of the country the extent to which their merger might or might not constrain competition was determined on the basis of the model of relevant markets. Two dimensions of this model were used: the geographical and the product structure dimension. The national market of hotel services was split up in 20 regional market niches (the 19 counties plus Budapest) and 5 quality categories (one to five stars). The result of the analysis of the national market of hotel services was more than surprising: *there was only one market niche* (Budapest, three star hotels) *in which the two partners envisaging the merger were competitors*. They were not simultaneously present in any of the other 99 market niches. This means they enjoyed strong local monopolies in a number of market niches before 1990 when no other major hotel firm existed in the country.

Hungarian market structures showed a spectacular development as a result of the interaction of several factors. The following list of these factors can be but tentative based on more of a speculative than an analytical background:

Import liberalization: taking place between 1989 and 1991, this successful effort of eliminating import licensing made customs duties the practically exclusive tool of trade policy. While imports took substantial market shares from a string of domestic producers many of the latter did not collapse but converted themselves into trading firms. The disappearance or the shrinking of several manufacturing firms gave way to the emergence of smaller, specialized service firms as spinoffs of the former local giants. This is how one state enterprise could have a significant number of successors, in the first place in the light or the electronics industry.

A mirror process of import liberalization, Hungarian manufacturing became increasingly export-oriented during the nineties. Figure II shows the astonishing speed of this trend after 1993, or three years of a crisis of export competitiveness owing to the loss of traditional export markets in Eastern Europe.

Figure II. Volume changes in the domestic sales and exports of Hungarian industry, 1987-1999 (1980 = 100)



Source: National Bank of Hungary (NBH) Annual Report 1999. 193.

Exports increased more than fourfold as compared to domestic sales when the entire time series is considered. This gives, however, a wrong impression since pre-1991 exports included non-competing (and mainly non-competitive) exports to COMECON member countries. The figure shows three different trends.

The *first* one is the deterioration of sales performances on all markets, testifying of the lasting crisis of the competitiveness of Hungarian industry before transition. The *second* trend is an overall sales slump between 1990 and 1993 in exports and, very tellingly, from 1990 through 1999 in domestic sales. 1993 was the year when the third trend, an increasingly fast improvement of export performance took its start and started to develop independently.

A comparison of the three trends in sales developments helps draw a snapshot picture of Hungarian industrial restructuring. The pre-1990 years were the ones when old structures started crumbling with entire sectors including mining, an important part of footwear, iron and steel, motor vehicles (mainly buses) and agricultural machinery industries. Most of their capacities disappeared and this is why it would be misleading to think that the very slow recovery of domestic sales after 1995-1996 re-created former structures of production. In fact, under the titles of old industries completely new ones were born, mainly under the control of foreign investors:

Table 1. An overview of the development of diverse Hungarian manufacturing sectors, 1992-1997

Sector	*Output growth (1992-1997, per cent, constant prices)*	*Former players*	*New players*
Textile, shoes, leather	-6.9	Budaprint, Panyova, Tisza Cipo, Mino, BBV	Graboplast, export-oriented subcontracting firms
Iron and steel	46.4	Dunaferr, Csepel, LKM, Ózd, MAT	Dunaferr, Alcoa
Engineering	213	IKARUS, Rába, Videoton, Ganz, MGM	Opel, Suzuki, Ford, IBM, Siemens, Daewoo

Source: A gazdasági fejlodés és a foglalkoztatottság a 90-es években. ECOSTAT, Budapest, 1999. 74.

The above table shows the divergence in sectoral developments on the example of just three sectors. Even an incomplete sample shows the extent to which almost all major players in the three sectors were replaced by new ones, most of them multinational firms. Most of the latter have been real newcomers in the engineering sector, entering the market through greenfield investments. Their appearance in Hungary has greatly contributed to the fact that the relative share of engineering in the gross output of Hungarian industry increased from 14.6% in 1990 to 35.2% in 1998 (*ECOSTAT*, 1999b. 46.).

A special case has been that of the pharmaceutical industry, too little to be included in the table above. This industry has kept all of its major players and plants, but the companies were renamed after their privatization. Six out of the seven leading domestic firms in this industry were acquired by multinationals from France, the United States and Israel, and one (Richter) went public on the Budapest stock exchange. This one got back its old, pre-war name, while all the others now bear the names of their foreign mother firms.

Privatization: many state-owned firms were privatized in a multiplicative way. Specialized units of former industrial complexes became independent firms even if their only market remained their mother firm. But many of these spin offs were later forced to enter open competition and survived under such circumstances.

Hungarian privatization seems in 2000, that is in retrospect, a process important first of all for its political and social implications, but not so much for its direct structural impacts on the economy. Only a few strong and competitive Hungarian-owned firms emerged from privatization, and even when this occurred (cf. the Dunaferr case), the way privatization had been carried out raised very loud and politically motivated questions. The really competitive part of the Hungarian private sector was created mainly through foreign direct investment, and the main channel of the latter was not privatization.

Restrictive fiscal policies: high levels of personal income tax and social security payments have kept the cost of labour outrageously high as compared to incomes from employment. Even after a recent series of reductions in tax and social security burdens of employees and employers only about one third of the cost of the employee to the employer can be pocketed by the employee. The implications of this situation for fiscal policy cannot be discussed here, but it has had quite special consequences for entrepreneurship development.

The result has been called "forced entrepreneurship" by several Hungarian authors. It means the transformation of employment into subcontracting at a number of firms or even government authorities.[1] The employee hoping for a higher net income gives up his job but keeps his desk in his former office. He creates a small firm (preferably a limited partnership with modest accounting and auditing obligations) and this firm bills his former employee for the same services now rendered in a form disguised in subcontracting.

Such practices are widespread and not illegal as such even if not always tolerated by the taxman or the labour authorities. If more fiscal transparency is envisaged, employment and subcontracting is combined for the same service: the employee keeps his job for a minimum wage and bills the employer on a subcontracting basis for the rest.

The game described above is one of the reasons why entrepreneurship has so spectacularly flourished in Hungary. The fact that the number of limited partnerships increased

[1]There have been government offices in recent years where about 10% of *de facto* employees were *de jure* subcontractors. This situation was, however, less attributable to a conserted attempt at tax avoidance than to the repeated obligation of reducing employment in the public sector.

from 5,789 in 1990 to 170,762 in 1999 (MNB, 1999. 192.) can partly be explained by the massive transformation of employment into subcontracting.

Such developments also offer a partial explanation of the fact established in several analyses of the Hungarian labour market.[2] Namely, that the employment level of the active population has declined in Hungary to a critically low level in an international comparison. Many family firms are not even self-employers: their owners get only dividends and try to have part of their living costs covered by the family firm. Such small firms have no employees at all and this is why it has been possible that the loss of jobs at larger firms and in the government sector was not offset by job creation in the SME world.

So far we have mainly assessed some such critical or not completely transparent areas of the Hungarian economy in which sometimes spectacular development did not always yield really important results in terms of macroeconomic growth and competitiveness performance. However, neither structural changes in the nationally-owned part of the economy nor privatization as such could prove to be massive and long-term engines of growth. Nearly all analyses coincide that mainly the spectacular development of foreign direct investment (FDI) helped transform both the outward appearance and the real performance of the Hungarian economy.

FOREIGN DIRECT INVESTMENT AND ECONOMIC PERSPECTIVES

The massive inflow of FDI into the Hungarian economy during the nineties has completely transformed the economic landscape of the country. Suffice to mention that about two thirds of Hungarian exports are generated by multinational firms (MNCs) present in the country and about 40 of the 50 largest corporations in the world have subsidiaries in Hungary. Two preliminary conclusions seem appropriate before more in-depth analysis:

- Massive structural changes and considerable improvements in competitiveness took place in the Hungarian economy owing to the inflow of FDI. Many MNCs present in the country have tied their Hungarian subsidiaries into their worldwide, and especially European supply networks. This has meant rapid micro-integration between Hungary and the European Union in several industries such as engineering, chemistry, light industry, electronics and food. Micro-integration has been going well ahead of Hungary's official process of accession to the EU. Technologies, labour relations, employee skills and corporate cultures have undergone great improvements in all the sectors doing business within or with the MNCs.
- Dynamic developments in the Hungarian economy were, to a great extent, limited to both the structural and the geographical segments of the economy where MNCs have been strongly present. This has lead to a certain "*dualization*" of the economy which, in a regional approach, can also be called "*italianization*". Smoothing out the structural and the regional tensions of the economy is not an easy task at all since it should take place in a very cautious way, with the highest possible degree of freedom from short-sighted political influences, and without endangering the already existing growth base of the economy.

[2] Cf/ [ECPSTAT. 1999a. 107.].

Our subsequent analysis will focus on the development of FDI in Hungary in an international comparison, while a section on its own will be devoted to regional economic developments due to the increasing importance of the problem. Figure III shows Hungary as one of the most important FDI receiver countries of the region, second only to Poland with almost fourfold GDP and population sizes and in a close competition with the higher developed Czech economy.

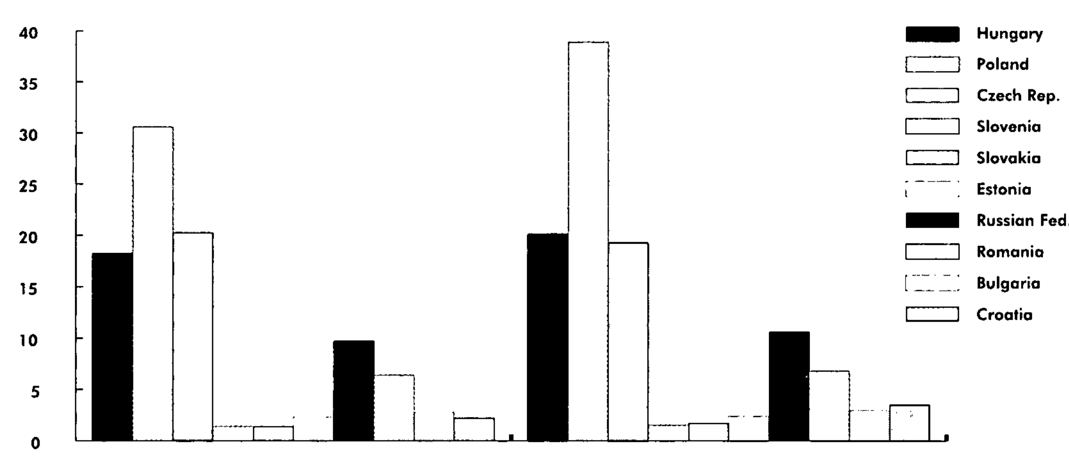
The considerable size differences between the economies shown on Figure III could make it worthwhile to show FDI stock on a per capita basis. In such a comparison, Hungary would also fare much better than when absolute indicators of FDI stock are used. Such an approach would be, however, questionable from a methodological point of view. Global competition including regional competition for FDI takes place irrespective of per capita indicators. What matters is in the first place economic performance by country regardless of how a given country has been able to overcome its competitive disadvantages linked to its smaller size.

The inflow of FDI in the Hungarian economy took a head start in the early nineties. Up till 1994, the stock of FDI in Hungary made out more than 50% of all FDI stock in the 12 comparable countries of the region.[3] The corresponding figure for 1999 is significantly lower, about 18%. The reason for this substantial decrease is twofold: on the one hand, FDI inflow in Hungary has slowed down as will be documented below. On the other hand, the "reform lags" in the other CEECs have started to disappear as the possibility of EU accession came within reach and transition gained speed almost everywhere in the region. Economic stabilization policies and reform packages were positively received by MNCs and they started to set foot in most other CEECs.

The time series based analysis of FDI inflow in Hungary makes it possible to link these trends to overall economic performance as well as changes in different locational

[3]Countries listed in figure III plus Latvia and Lithuania.

Figure III. FDI stock in selected CEEs, 1998-1999
(billions of US dollar)



Source: Business Central Europe September 2000. 69.

advantages making Hungary a more or less attractive investment target during the nineties. We will use GDP volume growth as background data visualizing investment climate.[4]

The cyclical picture shown by figure IV seems to be somewhat confusing. FDI inflow has been more or less constant during the nineties. It peaked in 1995 due to the massive privatization of utilities in December of that year. If trends of FDI inflow and GDP growth are compared striking divergences arise: the lasting slump of the early nineties did not prevent foreign investors from appearing massively in Hungary. In the same time, accelerated GDP growth in the late nineties did not increase the attractiveness of the economy for foreign investors.

These apparent contradictions might have to do with a somewhat narrow perception of the relationship between FDI inflow and macroeconomic performance. Not only FDI might prefer to flow into high-growth economies but growth also accelerates in economies where FDI stock is strong enough to support competitiveness increase.

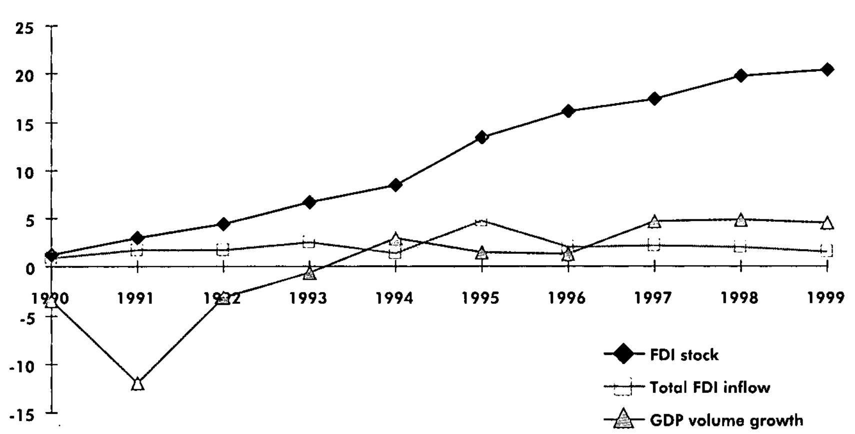
If any parallel should be sought in figure IV between FDI developments and GDP growth then trends of FDI stock and GDP growth have shown a certain convergence. In fact, the nineties have been the decade of massive revival of the Hungarian economy's export base due to the fast increase in FDI stock: Hungary's exports measured in US dollars and sold on competitive markets increased from 10 billion to 25 billion in less than ten years. Interestingly, non-FDI based exports have more or less stagnated between 1990 and 1999 and basically all the incremental part of Hungarian exports was generated by inflowing FDI.

The slowdown of FDI inflow to Hungary in the late nineties can also be tracked to two further factors:

Structural exposure. International comparisons speak of a quite tight relationship between levels of economic development and the capacity of FDI absorption. In fact, Hungary

[4]We are aware of the fact, of course, that GDP growth as such is largely insufficient to depict changes in investment climate. Still, at least in the Hungarian case, it has been a quite good indicator of cyclical developments during the nineties given the fact that the economy had suffered from a lasting growth crisis between 1979 and the late eighties

Figure IV. Hungary FDI stock and inflow (billions of US dollars) and GDP (percentage)



Source: for GDP data MNB 1999., 188.; for FDI data the homepage of the Ministry of the Economy (http://www.gm.hu/economy/capital/capi-01.htm) is one of the few countries of the world where a medium level of development is accompanied by a well above average weight of FDI in the economy. According to UNCTAD, four countries of CEE had very high ratios of inward FDI stock by international standards in 1997: Hungary (35%), Estonia (25%) and both Latvia and the Czech Republic with 23% each (*UNCTAD*, 1999. 71.). The world average for the same year was 11.7%, the average of the developed countries 10.5%, and the EU average 15.2% (*UNCTAD*, 1999. 513.). Only very highly developed and traditionally very open developed economies had ratios higher than Hungary: Belgium/Luxembourg 55.1%, New Zealand 48.1% and the Netherlands 35.3%. From the less developed world and besides about twenty city-states and tiny Third World economies including a number of Pacific and Caribbean islands only Chile had a ratio comparable to that of Hungary in 1997 (33.1%).

Both Chile and Hungary are countries in the second tier of world economic development which have followed liberal and export-oriented economic policies during the nineties. It may well be possible that they both become Dutch or Belgian-type financial and trading hubs later in their history. Still, a significant difference between them and the two Benelux economies is that the two latter have been traditionally very important exporters of FDI which cannot be said of Chile and Hungary.

Another important sign of Hungary possibly approaching an upper limit of its FDI absorption capacity is provided by the international comparison of *FDI inflows measured in terms of gross fixed capital formation*. In this respect Hungary almost tops the CEEC field: only Latvia came ahead of Hungary in 1997 with 40%. Hungary was second with 30% and Poland, Bulgaria and Estonia were tied with 15% each (*UNCTAD*, 1999. 71.).

If worldwide data are used Hungary's high structural exposure to FDI becomes even more striking. World, OECD and EU averages are all between 7 and 9%. Within the developed world only Sweden stood out with 35% in 1997 (but all the same its outward FDI flow came to 40% as compared to gross fixed capital formation in 1997) and, besides Latvia, still Colombia and Venezuela had indicators higher than Hungary (*UNCTAD*, 1999. 501-512.). Any other country with higher indicators had so small economies that basically one or two major investment projects could send the ratio easily above 30%.

The very high relative data of inward FDI flows in Hungary do not necessarily speak of a major risk to the country's economic development since most foreign-owned capacities have become organically integrated with the domestic economy. The problem is rather that the government does not seem to understand that a turning point vis-a-vis FDI is approaching: if nothing is done FDI inflow might very well go down in an asymptotical manner since an absorption capacity problem could appear in a macroeconomic and structural approach.

It has to be decided rather sooner than later whether Hungary would like to become a small and very open trading nation such as Belgium or the Netherlands, very probably in a pioneer role among the CEECs. If this is not decided and declared fast enough, the economy's current FDI absorption capacity would determine further inflows in which case further falls in FDI inflow could be predicted.

Regional saturation. The regions of the country receptive to FDI and acceptable for foreign investors might have become saturated which is shown by labour shortages in industrial locations (Gyor, Székesfehérvár, Komárom, Tatabánya) with high FDI stock concentration. Any further acceleration of FDI inflow would suppose an intense development of both physical infrastructure and human resources in less developed Eastern and Northeastern regions.

Whatever has been said in the previous paragraphs on the country's overall FDI absorption capacity now it turns out that *everything* regarding Hungary's high exposure to FDI is valid for only a few regions of the country. FDI is rather scarce in a couple of regions. Regional imbalances therefore play a major role in how Hungary could benefit from eventually continuing FDI inflow during later stages of its economic development.

THE REGIONAL PICTURE OF GROWTH, DEVELOPMENT AND FDI

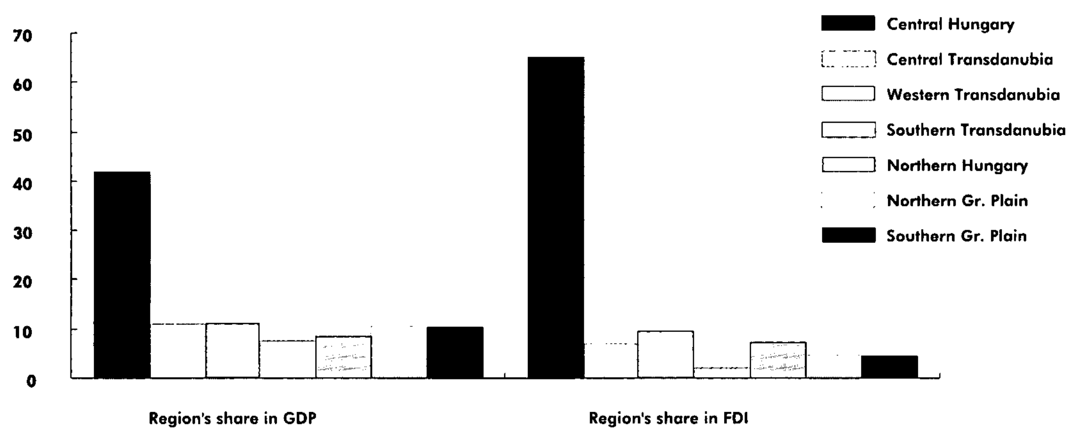
Hungary consists of seven so-called planning-statistical regions according to the EU methodology used for the distribution of regional subsidies. The regions are as follows:

- Central Hungary (around Budapest);
- Central Transdanubia (including Székesfehérvár and Veszprém);
- Western Transdanubia (including Gyor and Szombathely);
- Southern Transdanubia (including Pécs);
- Northern Hungary (including Miskolc);
- Northern Great Plain (including Debrecen and Nyiregyháza);
- Southern Great Plain (including Szeged).

These regions have about equal geographical sizes but greatly different population numbers and they also show a great diversity of economic structures and potentials. As a rule valid also in historical retrospect the Western part of the country has been more integrated with the Western part of Europe and has been usually ahead of the Eastern half of the country. The reasons for these lasting development gaps include the much higher exposure of Eastern Hungary to Turkish occupation in the 16th and 17th centuries resulting in a devastated economy and traditionally poor infrastructures in the East of the country.

Figure V shows regional differences within the Hungarian economy from two aspects: the regional breakdown of GDP and the regional breakdown of FDI.

Figure V. Hungary: regions share of GDP and FDI, 1998
(percentage)



Source: A magyar régiók zsebkönyve'99. KSH, Budapest, 2000. 15, 22.

The dominance of Central Hungary, and within it Budapest is astonishingly strong in both respects, especially in FDI. It seems from the graph that the presence of FDI in the central region is even stronger than it could be expected from its share in GDP. The unexpectedly great regional disparities make it clear that the absorption problem can be valid only for one region or two, but certainly not for the Eastern half of the country.

The unemployment situation seems to confirm this assessment. Regional rates of unemployment measured in late 1999 ranged from 4% in the central region to 17.1% in Northern Hungary (KSH, 2000. 11.), with a national average of 9.6%. Meanwhile, the three central and Western regions had rates of unemployment below 9% each, whereas the remaining four regions had indicators above 10%.

There seems to be a positive loop in the "winning" and a negative one in the "losing" regions. The positive loop is self-asserting in the sense that higher economic development attracts more FDI which, in turn, creates jobs, generates additional exports and growth which, again, make the region even more interesting for investors from abroad. This loop seems to be, though, approaching its end in those regions where very low rates of unemployment seem to indicate a certain depletion of factors for growth.

The negative loop is still alive and well. This loop is also self-asserting because FDI avoids low-growth regions where the availability and the quality of resources for growth are much below optimal levels. Therefore growth in those regions can be supported only by local resources which are unable to generate significant additional exports. As has been seen in the previous section, the carrier of Hungarian industrial growth has been its export to an ever increasing extent during the 1990s. The transformation of Hungary into an export economy has taken place, however, mainly in the "winner" regions only.

The location of the "winner" regions also has some explanatory power. If business contacts of smaller local firms are surveyed it becomes clear that natural contacts for Western Hungarian firms are German, Austrian or Italian businesses[5], while Eastern Hungary's smaller businesses tend to cooperate with their Yugoslav, Romanian or Ukrainian counterparts. These differences in trading patterns are very likely to be reflected in diverging developments of business cultures in the different regions of Hungary as well.

This regional approach to the recent development of the Hungarian economy makes it clear that the average indicators of macroeconomic performance and structural change give a somewhat misleading picture. It was explained earlier in this paper that the engineering industry has been the engine of growth of industrial output and exports. It turns out from regional data that 24.5% of the employees of the engineering industry were based in Central Hungary in 1999 (KSH, 2000. 32.). If this region and Central Transdanubia (including the town of Székesfehérvár with IBM, Philips, Siemens and the Videoton Holding ranking, respectively, 2nd, 3rd, 8th and 15th on the list of top Hungarian engineering firms in 1999[6]) are considered together, their joint percentage share in Hungarian engineering employment is above 46%. Western Transdanubia is added and it can be shown that about two thirds of engineering employment are in the three "winning regions".

In any event, the industrial strip Budapest-Székesfehérvár-Gyor has been the main stakeholder of recent Hungarian industrial expansion, and most of the benefits including

[5]Large multinational corporations including most United States and Japanese firms present in Hungary have a tendency towards preferring the central region but their choices of partners depend much more on global than on regional considerations.

[6]Figyelö, 2000.73.

growth in investment and employment went also to this part of the country. The success story is there, but it is still an open question whether this success story would really cover the entire Hungarian economic space or not.

DIFFERENT PERFORMANCE BY A DIFFERENT ECONOMY

A brief summary of Hungarian economic development in the 1990s should very likely contain the statement "redefinition of the economic space" and its explanation. This redefinition has meant much more than just a structural shift from or a growing regional imbalance between the East and the West of the country. The content of the Hungarian economic space has undergone very significant changes, players and capacities representing completely new levels of quality have appeared in the economy. This transformation has had, of course, a strong regional component but also extremely important other ones.

The main reason why we now see the Hungarian economy different from what it was about ten years ago is the massive appearance of new, competitive players in the economy. It is very telling to see the list of the leading Hungarian firms in 1999 broken down in three groups:

Pre-1990 market players, unchanged. This lack of change does not refer to ownership since ownership change has been general in the Hungarian economy. It rather reflects the changing "boundaries of the firm", i.e. those companies are considered here which offered basically the same product/services mix in 1999 as back in 1989. In other words, they remained players on the same markets;

Pre-1990 market players, transformed. Transformation does not mean legal transformation (the creation of corporate legal structures) here, because it was again the rule among Hungarian firms in the 1990s. These firms either substantially enlarged or narrowed down their product/services mix in recent years but their core activities remained the same. They continued to compete on the same markets as before but they entered some new ones and/or exited some of their former ones;

New players. Before 1990, these company names were present in Hungary only linked to imports, if any, but not at all related to domestic production.

The company structure shown by the table is remarkably symmetrical: both about 40% of the companies listed are either unchanged or new, and only 20% of them belong to the "transformed" ones. This first observation seems to suggest that the company picture of the Hungarian economy (judged from the largest firms) has a dualistic character in the sense that old firms coexist with new ones, but relatively few companies have undergone a really deep and adaptative transformation.

This argument is, however, somewhat misleading from a market structure based point of view: out of the 17 firms "unchanged", no less than 11 are utilities, other natural monopolies or national "flagship" firms (cf. the national airlines). As opposed to this, 16 out of the 19 "new" firms are players in really open and competitive markets. The exceptions are Panrusgaz, an exclusive importer of natural gas from the Russian Federation, and the two GSM firms competing with each other but sheltered from new entries by a concessions-based regulatory system. Regarding the smallest group, that of the "transformed" firms, 3 out of the 8 are at least partly concessions-based or natural monopolies (oil, telecom, gambling).

Table 2. Old, transformed and new players in Hungary (1999), based on the Top-200 list (first 50 firms, company name plus ranking)

Players unchanged from before 1990	*Players transformed since 1989*	*New players*
1. MVM (Hungarian Electricity), 6.	1. MOL, 1.	1. Audi Hungaria, 2.
2. Dunaferr Group, 7.	2. MATAV—Hungarian Telecom, 5.	2. IBM Storage Products, 3.
3. Hungarian Railways, 10.	3. Shell Hungary, 17.	3. Philips Group, 4.
4. Budapest Electricity Works, 12.	4. Hungaropharma Ltd., 34.	4. Opel Manufacturing Hungary, 8.
5. GE Lighting Tungsram, 13.	5. Siemens Hungary, 35.	5. Metro Holding, 9.
6. TVK Ltd., 19.	6. Electrolux-Lehel, 44.	6. Panrusgaz, 11.
7. MALEV Hung.Airlines, 20.	7. Hungarian Tobacco Trading Ltd., 46.	7. Flextronics Int'l., 14.,
8. Hungarian Mail, 21.	8. Szerencsejatek (Gambling) Ltd., 50.	8. Westel 900 GSM, 15.
9. Northern Transdanubia Electricity Co., 22.		9. Hungarotabak, 16.
10. Paks Nuclear Power Station, 24.		10. Suzuki Hungary, 18.
11. Alcoa Kofem, 28.		11. Opel Southeast Europe, 23.
12. Borsodchem, 31.		12. Philip Morris Hungary, 25.
13. Tigaz Ltd., 32.		13. OMV Hungaria, 26.
14. Dunamenti Power Station, 38.		14. Pannon GSM, 27.
15. Budapest Gas Works, 45.		15. Porsche Hungary, 33.
16. Northern Hungary Electricity Works, 48.		16. Tesco-Global, 36.
17. Gedeon Richter Chemicals (Pharma) Ltd., 49.		17. Fintage Ltd., 37.
		18. Visteon Ltd., 40.
		19. Spar Hungary, 41.

Note: Six company names are missing from the source, but their positions were left blank on the original list.
Source: Figyelo Top-200, 2000. 20.

All this means that about *two-thirds of the largest Hungarian firms under steady short-term competitive pressure are new entrants to the domestic market.* The competitive sphere of the Hungarian economy was much more different in 1999 from its 1989 edition than it was the case for the whole economy.

The findings of this paper can be summarized based on the above observation. While macroeconomic data speak of an impressive performance improvement in the Hungarian economy, we feel the really important changes took place in the Hungarian corporate world. The new economic landscape also means increased regional differences but, in the first place, an overwhelming majority of large new players as compared to large incumbents in the competitive field.

If there is any real possibility for the country of a catching up with the West, it is based on the strikingly great number of new competitive firms that have appeared in Hungary since 1989. This is only partly due to privatization, but its role in launching the deep transformation process of the Hungarian "microeconomy" can hardly be exaggerated.

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Privatization in the Czech Republic: Results, Problems and Open Issues

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THE EXTENT OF THE PROBLEM

In none of the other smaller European communist countries was the elimination of private property as complete as in the former Czechoslovakia. Poland had private farming; in Hungary there was always some private sector, and its role increased in the Eighties. Even East Germany retained some forms of private business. This was not the case in Czechoslovakia.

Here, though only the largest companies and banks were nationalized in October 1945, all the remaining industrial firms were seized by the new communist regime after 1948 and turned into state-owned enterprises. In the 50s, 99% of private farms were massed together into cooperatives in which private property rights were disregarded; the same happened to small businesses in retail trade and services. Since then, for 30 years, no private enterprise practically existed in Czechoslovakia.

Elimination of private entrepreneurial activity was one of the reasons why the country was lagging more and more behind in its economic performance. Complete "socialist" ownership formed a firm base for a full-fledged command economy, with highly monopolized production structures. The absence of private activities enabled complete central price fixing, with the result that prices, in the end, lost any role for efficient allocation of resources.

In state-owned enterprises or formal cooperatives, individual initiative and responsibility was largely lost, as was entrepreneurial know-how. Collective irresponsibility arose. In the social sphere, people became accustomed to relying on a paternalistic state in every respect.

Centralization of enterprise profits in the state budget led to huge redistributions—profits were taken away from efficient producers, and used to subsidize loss-making ones.

Productivity growth within the economy had been slowing down since the 1960s, and by the end of the 1980s, productivity actually began to fall. Czechoslovakia was lagging behind in the technical level and quality of its products, losing ground in international competition, and becoming more and more dependent on the "soft" Soviet and other COMECON markets.

In 1989 in the Czech Republic, 98.5% of GDP was produced in the state-owned sector, private sector having only a tiny 1.5% share. For comparison, the share of private sector on GDP in the former East Germany was 8.5%, it was 14% in Hungary, and 26% in Poland. This shows the huge extent of the privatization task in the Czech economy at the start of transition, even compared to the above mentioned neighbour countries.

THE STRIFE FOR FAST PRIVATIZATION

Rapid privatization of state-owned enterprises was seen as one of the main pillars of transformation. Other pillars were the freeing of prices after 40 years of central price control, and the opening of the economy—i.e. freeing of exports and imports, and introducing convertibility of the currency for external trade. All the transformation steps however were preceded by a year of preparation and macroeconomic stabilization in 1990—so that the transformation programme really started as of January 1991.

The privatization programme went along three, or better to say four, lines: restitution, small-scale, and large-scale privatization of existing enterprises (compare the annex for statistical data)—and the emergence of new private businesses as soon as private business activities were legalized.

- Restitution, to natural persons, of property nationalized after February 1948 started in 1991 and concerned mainly real estate and retail businesses. It was the first step to create a new basis for small private enterprise, and till 1995, roughly a hundred thousand persons got their former property back. Restitution to natural persons was accompanied by partial restitution of church property—mainly to the Catholic Church—while another part of church property restitution remains unresolved owing to lack of political consensus up to now.
- Small-scale (or "small") privatization concerned small state-owned businesses, mainly in retail trade and services, which were sold by auction. Small privatization started in 1991 and was completed in 1993. More than 22 thousand of small businesses were auctioned, in a total book value of about CZK 30 billion.
- Large-scale ("large") privatization was the key, and most difficult, part of the privatization programme. It involved almost all large industrial enterprises that were in state hands—with the exception of some public utilities.

The combined book value of enterprises going into the programme of large privatization greatly exceeded the financial possibilities of the Czechoslovak citizens; consequently, public tender or direct sale to domestic and foreign buyers were combined with a give-away transfer of part of the property to Czech and Slovak citizens—the so-called voucher privatization.

Privatization projects were prepared by the management, while any natural or legal person could submit a competing privatization project: on average, four competing projects were submitted for each enterprise (including projects submitted by potential foreign buyers). The winning project was chosen by the respective (Czech or Slovak) Ministry for Privatization. This meant that the ministry (or, in conflicting cases, the Government) decided on the actual breakdown of the different privatization methods to be used.

The process actually began in 1991 with the direct sale of some large enterprises to foreign investors, the liquidation of some non-viable units and by turning state-owned enterprises into the legal form of joint-stock companies. But mass-scale large privatization started with the first round of voucher privatization opened in May 1992. As of January 1993 however, Czechoslovakia was divided into two states—the Czech Republic and the Slovak Republic—and this paper, from here on, will follow the progress and results of privatization in the Czech Republic only. The Czech government introduced a second round of voucher privatization in 1993.

In large strategic enterprises (and banks), the most usual privatization procedure was to transform the state-owned enterprise into a joint-stock company, and to offer its stock partly for sale, partly for distribution through vouchers—a small part remaining aside for restitution (in a Restitution Investment Fund, RIF), and another part being retained in the hands of the state represented by the Fund of National Property.

THE PROS AND CONS OF FAST PRIVATIZATION

From the very start of the transformation programme, it was seen as vital not only to privatize, but to privatize quickly. The motto was to "privatize as much as possible, as fast as possible".

Ministerial officials were unable to play the role of effective owners for thousands of enterprises. After the collapse of central planning, they also had very few effective instruments to control the behaviour of firms. The economy could no more subsidize the increasing numbers of state-owned enterprises that actually were value subtractors—the value of their output was lower than the cost of the inputs which they absorbed. So-called "production for production" was increasing, with little effect for the final consumer. External conditions also changed for the small and highly open Czechoslovak economy as the traditional "soft" markets were breaking down and trade had to be re-oriented.

Former Czechoslovakia had ample experience with reform attempts that failed to increase the efficiency of the economy based fully on state ownership. Fast privatization was seen as the only viable solution—but it faced a fundamental problem: there was no domestic capital capable to buy such a vast volume of property.

Selling it all to foreign investors was politically unfeasible. It was also practically impossible, as it would have required to attract, within two to three years, US$ 40 bill. of foreign investment. Moreover, foreign capital would not have been interested in the whole range of privatized firms. If confronted with actual figures on the cumulative foreign direct investment inflow during the whole 1990s (approximately US$ 16 billion), the idea of mass privatization by foreign capital is clearly unrealistic.

The political feasibility was no less important at the time when decisions on the form and speed of privatization were taken. In the years 1991 to 1993, the entrepreneurs' interest groups, the trade unions, and most of the general public supported the slogan "Czech firms into Czech hands". Even some very liberal economists backed the idea that the so-called family silver must remain in the hands of Czech capital. In this prevailing social climate, it was a success that the government pushed through the principle of equal access for everybody—that is, no discrimination of, but no big advantages for, foreign capital.

Only practical experience gained during privatization could change this prevailing attitude. Several years later, with the visible economic success of most foreign-owned firms, it became clear that foreign owners bring not only capital but know-how, managerial experience, access to markets, and employment opportunities. Yet, in spite of that, it would be a heroic and naive abstraction to think that the bulk of privatization could have been based on foreign capital.

The solution that was found, as shown above, was a combination of voucher privatization of almost half of the property, direct sale (financed predominantly by privatization credits granted by Czech banks) for another part, and with a third part being privatized by foreign investors. This solution had the benefit of being fast. It prevented huge potential losses of trying to run a state-owned economy for another decade, or, rather, decades.

Of course, there are seldom benefits without some costs. The main problems are presently seen, first, in the lack of effective corporate governance, and second, in the two-sided position of banks as creditors and owners. Let us discuss both problems briefly.

CORPORATE GOVERNANCE

Voucher privatization was not best suited to bring effective owners immediately into the privatized firms. It formed only a basis on which effective corporate governance could evolve gradually. A major role in voucher privatization was played by the so-called investment privatization funds (IPFs). The IPFs were originally proposed by the government with the idea of assisting voucher holders, and limiting the dispersion of ownership. Actually, the funds succeeded in concentrating in their hands the bulk of the property privatized by vouchers, and became very important owners. That opened the way for a large role of investment funds in the ownership structure.

Nevertheless, the concept of IPFs had some serious weaknesses from the very origin. Legally, they were inspired by European Union and United States legislation, suitable for funds as a tool of collective investment. For this reason, the IPFs' maximum stake in one company was limited by law to 20% of the shares, and simultaneously, the fund was not allowed to invest more than 10% of its assets in the equity of one issuer. After the IPFs became the main owners emerging from large privatization (according to some estimates, in 1996 they owned more than two-thirds of assets privatized by vouchers), economists realized that there was no one but the IPFs who could act as agent of corporate governance. In fact however, only the largest IPFs formed by banks were capable of playing this role, as the banks delegated experts to the supervisory boards of companies in which their IPFs had large stakes. But due to legally limited stakes, their influence was undercut, leaving the real control in the hands of managers.

The still underdeveloped capital markets with low liquidity, on the one hand, and the ambiguous position of investment funds toward playing the role of effective owners on the other, opened the problem of effective corporate governance in the Czech economy. The country thus was positioned somewhere between the American model of corporate governance, and the German, or European, model.

The usefulness of the 20% ownership limit was widely discussed, with OECD even proposing to decrease the limit. But for effective corporate governance, IPFs needed larger stakes. A radical solution found at the start of 1996 was the transformation of IPFs into joint stock companies, in the form of holdings, to which no ownership restrictions are applied. Thus, the holdings escaped the change in law which came into effect in 1998, when, following the recommendation of the OECD; the limit for IPFs was decreased to 11%. A concentration of ownership followed the transformation into holdings, and opened the potential for a better corporate governance. Subsequently, it could be observed that the restructuring of companies, especially the large "mastodonts" inherited from the past, speeded up substantially.

On the other hand, the transformation of IPFs into holdings opened another serious problem—that of inadequate legal protection of minority shareholders, whose interests the holdings often neglected. This problem was alleviated only in 1999 by the amendment of law, forcing the majority shareholders (with more than 50% of equity) to buy out the shares of minority shareholders, at a price representing a six-month average of the Prague Stock Exchange price.

DOUBLE ROLE OF BANKS

Some of the largest investment privatization funds (now called investment funds) are owned by large Czech banks which, in turn, were till the end of the 1990s partly state-owned. That opened the way for criticism that privatization was only formal. In fact however, the state had little possibility to control businesses via the banks directly. More important was the line of control of companies by bank credits, where the state had only limited possibilities of involvement. Nevertheless, both public opinion and the government often indirectly pushed banks to continue the financing of ailing companies, to avoid mass unemployment and social unrest. This pressure however proved short-sighted and counter-productive, enhancing the bad loan problem in the portfolios of banks, which the government is presently forced to resolve. That is why the government is now pushing for finalizing the privatization of the state stakes in the banking sector.

Banks that indirectly, via the investment funds, own large amounts of industrial property are in a double position as owners and creditors. In the last two years, additional legal measures to strengthen the "Chinese wall" between banks and their investment funds were taken, to alleviate possible problems of conflict of interest and to bring the respective Czech law fully in accordance with European Union legislation.

The present position of the Czech banking sector is still largely defined by the role which the banks played during privatization, as creditors. The part of small and large privatization that went by sale into domestic hands was almost fully financed by credits by Czech banks. In addition, Czech banks also financed the newly emerged private firms that mushroomed in the first years of transformation: between 1990 and 1993, the total number of firms in the Czech Republic increased 50 times (from 18,800 to 1,119,000). The result was an enormous increase of demand for bank credit, and bank services generally. Credit activities in this period, of course, involved an unusually high degree of risk. By taking the burden of this risk, the Czech banking system made privatization and economic transformation possible.

The privatized firms also carried a high burden—that of large past debts from the communist era, debts which reflected the decreasing efficiency of the "command economy". Enterprise debts in the Czech Republic were not written off by the government, so that the firms were privatized with all their liabilities. Unlike in Poland in Hungary where double- or triple-digit inflation effectively wrote-off the old debts of companies, in the Czech Republic inflation was successfully kept at low levels. That was a remarkable success on the one hand. It preserved, for households, most of the purchasing power of their savings. But, on the other hand, it meant that Czech firms entered the phase of micro-economic restructuring with a substantial burden of past debts. Via the ownership relations, as well as via bad loans (due to enterprise insolvency), this burden has to a large part been transferred to Czech banks. This is a problem with which the Czech economy is struggling till today, and it will preoccupy us for several years to come.

The Government and the Czech National Bank later helped to relieve part of this burden by programmes of recapitalization and consolidation of small banks. Despite all the efforts, 15 small banks collapsed and were either closed down or taken over by large banks, in 1995-2000. As to large banks, the government has in 1999 and 2000 transferred a part of their bad loans to a special institution, the Konsolidační banka (basically, a bad-asset management agency). The aim is that with cleaned portfolios, the large banks can function normally, and be privatized in a standard way by strategic foreign partners.

WAS PRIVATIZATION TOO HASTY?

Both among Czech economists and in international circles, a dispute exists on privatization. Privatization was one of the main pillars of transformation. Was it correct to privatize fast, and to start privatization before a standard institutional framework of the market economy was established? Lately, it was Joseph Stiglitz, Chief Economist of the World Bank, who cast doubt on one of the pillars of the so-called Washington Consensus (the basic IMF and World Bank recommendations to the post-communist transition economies, stating that transition toward a market economy must include macroeconomic stabilization, liberalization of prices, trade, and capital movements, as well as mass privatization). The critics—with the benefit of hindsight—now argue that the transforming economies should have concentrated their effort, first, on building and strengthening the basic institutions of the market economy and the legal system. Only afterwards, mass (and fast) privatization was to be started. The slogan is "Regulation and institutions prior to privatization".

Let us leave aside the problem whether it is at all possible (except in the virtual reality of a theoretical concept) to start building a market economy without its main constituting element, i.e. private property, or privately-owned firms. In the light of this problem, the only realistic view is to discuss the adequate speed of privatization in the transition from a centrally-planned system toward a market economy.

However, even here, the critics of the adopted way of privatization can find no strong evidence. Two recently published studies[1] have come to two fundamental conclusions:

- in spite of all problems, privatization in transition economies can be seen as a success. Countries that did a fast and massive privatization (e.g. Poland, Hungary, Czech Republic, Slovenia, Estonia) have substantially better macroeconomic figures than whose who hesitate to privatize, hoping that the state-owned firms can survive (e.g. Ukraine, Belarus, the Russian Federation);

[1]Nellis, John: Time to Rethink Privatization in Transition Economies? IFC Discussion Paper No. 38, 1999. Hawrylshyn, Oleg—McGettigan, Donal: Privatization in Transition Countries: A Sampling of the Literature. IMF Working Paper WP/99/6.

- any privatization is better than none, because in general, private firms are much more efficient, more profitable, they export more, and restructure faster.

It is of course true that there has been a weak point—the problem of efficient management, and effective corporate governance in general. Discussing the Czech way of fast privatization, the voucher method which helped to solve the problem of lack of capital at the start of privatization (and helped to gain support of most citizens for radical economic transformation), suffers from this weak point. Insufficient or wrong enforcement of ownership rights then can, in some cases, lead to inefficient functioning of firms, and to non-ethical or illegal behaviour of the owners. However, the social and economic costs of waiting for a well-established institutional market framework would have been much higher than the costs of fast privatization—as experience of some other countries in the last decade shows.

PRIVATIZATION AND ECONOMIC EFFICIENCY

Opinions on the effect of privatization on efficiency of the Czech economy differ significantly among Czech economists. One stream argues that at least one part—the voucher privatization—led to substantial loss of efficiency. In their view, only in companies privatized by standard methods, and mainly by foreign capital, can one observe productivity growth and visible gains in efficiency.

This view however is not substantiated by facts, as both Czech and foreign analyses show (see, inter alia, Pohl at al., 1997). Empirical evidence, rather, indicates that companies which had sound management, good prospects on domestic and foreign markets, and started early with restructuring, show significant increases of productivity and profitability, without respect to their ownership structure. Of course, there is a high share of foreign-owned companies among them, as these had easier access to foreign financing, know-how, and could restructure earlier and faster.

Indirectly, one can prove that the micro-efficiency has improved during the last decade, by some macro-data. At the end of the Eighties, the (then) Czechoslovak foreign trade was primarily oriented on soft COMECON markets, their share reaching 70%. Within the last ten years, we succeeded not only to shift trade to advanced, mainly European Union markets (EU now represents 71% of Czech exports), but also to increase the share of higher-value-added goods in exports. In 1993, the share of SITC groups 7 and 8 (machinery, technological equipment and industrial consumer goods) represented 38% of Czech exports. The respective figure for September 2000 is 64%. This inevitably reflects a substantial increase of efficiency, not only in a few large companies. Almost 50% of exports in these commodity groups are exports by small and medium-sized companies, largely owned by Czech capital. The importance of these figures is underlined by the high degree of openness of the Czech economy (combined share of exports and imports on GDP exceeding 135%) which means that exporting companies form the bulk of the economy and their results are thus highly representative.

WHAT TO DO NEXT?

Evaluating ten years of economic transformation in the Czech Republic, we can conclude that the privatization programme has created a private corporate structure, separating the state from most of the property which was formerly state-owned. It has also been an important step toward a functioning capital market. At the same time, some weaknesses, as analysed above, still prevail. The weaknesses are mainly rooted in the institutional and legal framework.

Creating and improving the institutional framework of market economy is a permanent, unending task. Implementing the laws takes time and requires numbers of competent experts. This process can be speeded up in some aspects, but it cannot be "solved" in a short horizon (and once for ever). Yet it has to be said that in this sphere, more could have been done to the benefit of private enterprise—by making the activities of some government institutions more efficient and transparent, and providing more support to small and medium-sized firms. I do not mean financial support —which exists since several years— but consultancy on legal procedures, on accounting, on preparing entrepreneurial projects, etc. In this respect, experience from some EU countries remained untapped. In general, convergence to the European Union and the necessity to adopt the "acquis communautaire" is a factor speeding up the process of institutional change toward a full-fledged market economy in the Czech Republic.

The main problem of effective corporate governance lies in the former IPFs, which, as holdings, often still have a fuzzy and non-transparent, or weak-defined incentive structure. As a result, they lack a strong long-term strategy and a strife for long-lasting success. More important than sanctions for improper behaviour, in the longer perspective, is a pressure for acquiring the standards of proper corporate governance, good corporate citizenship, vision, awareness of the need to live in a globalized economy. Here, education and exchange of experience with the help of entrepreneurs'organizations (chambers of commerce and other interest groups as the Business Leaders Forum in the case of the Czech Republic) is as important as the improvement of the legal framework.

ANNEX

Restitutions

Legal Framework:

Law No. 403/1990 (On Relieving the Consequences of Some Property Injustice), October 1990
Law No. 87/1991 (On Extra-court Rehabilitations), March 1991

Property Concerned:

only property nationalized after February 25, 1948

originally only Czech citizens eligible (later changed by the Constitutional Court)

concerned mostly real estate and retail businesses

until 1995 over 100,000 cases; the majority was real estate

retail: 17,000-20,000 cases

Restitution of Church Property:

first round based on the Law No. 298/1990 (On Regulation of Property Relations of Religious Orders and Congregations and the Olomouc Archdiocese; amended by Law No. 338/1991)

around 250 properties returned to the Catholic Church (out of 800; the remaining roughly 550 properties were not demanded by the Church)

restitution of the remaining property (land, forests etc.) is still unresolved and currently represents a major political problem

Small privatization

Legal Framework:

Law No. 427/1990 (On the Transfer of State Ownership of Certain Properties to Other Legal or Physical Bodies), October 1990

no preferences to employees

Property Concerned:

The small privatization went on between January 1991 and December 1993; the number and value of items sold was the following:

Table 1. Small Privatization in the Czech Republic

	Number of Units Sold	Value (in CZK billion)
1991	15,291	18.3
1992	6,411	11.1
1993	640	0.8
Total	22,342	30.2

Source: Fund of National Property

The sectoral composition of privatized property was as follows (the group "others" refers to cars, trucks, garages, warehouses, production plants, factories, houses, offices and cultural centres):

Table 2. Sectoral Structure of Units in Small Privatization

	Number of Units	Average Final Price
Shops	13,042	1,194,000
Restaurants	1,861	1,790,000
Services	4,007	1,491,000
Others	3,435	2,185,000
Total	22,345	1,665,000

Source: Fund of National Property

Large privatization

Legal Framework:

Law No. 92/1991 ("The Transition Law"), February 1991 (+ several amendments, the most important one is Law No. 222/1993, July 1993)

Privatization Process:

there were competing privatization projects (the basic project was prepared by the management of companies); the winning project was selected by the government

the privatization projects have been implemented by the Fund of National Property (FNP)

3% of each company went into the Restitution Investment Fund (RIF)

Time Schedule:

2 privatization waves (1st wave: 1991-mid 1993, 2nd wave: mid 1993-1994)

since 1995 privatization has taken standard forms (sales on secondary market, direct sales etc.)

Table 3. Time Schedule of Large Privatization

	Projects submitted to the FNP	*Property (in CZK billion)*	*Completed projects*	*Property (in CZK billion)*
1991-94	4,227	869.2	2,329	840.1
1995	1,050	23.5	1,212	20.3
1996	714	11.7	1,211	21.9
Total*	5,991	904.4	4,752	882.3

Source: Fund of National Property
*As of December 31, 1996

Privatization Methods

a variety of privatization methods was used in the Czech large privatization. The property of former state companies was either sold directly, or a joint-stock company was formed and its shares were then privatized.

Table 4. Completed Property Sales and Restitutions (as of July 31, 1997)

	Projects submitted	*Property (om CZK billion)*
Public auction	1,016	7.6
Public tender	1,077	28.6
Direct sale	5,686	61.7
Free transfer, restitution etc	4,600	48.5
Total	12,379	146.3

Source: Fund of National Property

voucher privatization was the main, but not the only, method of joint-stock company privatization (see table 5)

Table 5. Joint-Stock Companies Privatization (as of 31 December, 1996)

	Property (in CZK billion)	*In % of the total*
Public offer	12.6	1.8
Direct sale	35.3	5.0
Employee shares	2.2	0.3
Public tenders	17.8	2.5
Voucher method	341.4	48.0
Free transfers	52.3	7.3
Restitution or shares for RIF	21.4	3.0
RIF shares	6.1	0.9
Others	13.0	1.8
Strategic holdings by the FNP	170.1	23.9
Other holdings by the FNP	38.8	5.5
Total	711.7	100.0

Source: Fund of National Property

Voucher Privatization:

all shares had the nominal value of CZK 1000 and were dematerialized

every Czech citizen over 18 living in the Czech Republic was eligible to buy a "voucher book" for CZK 1000 in each wave

the shares were allocated for vouchers in several rounds of auctions

Table 6. Voucher Privatization—basic facts

	1st Wave	*2nd Wave*	*Total*
Number of companies	988	861	1,664
Number of shares offered (million)	212.5	155.0	359.5
Number of shares sold (million)	198.0	149.3	347.3
Eligible citizens (million)	7.2	7.2	—
Number of participants (million)	5.95	6.16	—
Number of shares per one participant	35.1	25.2	60.3
Number of IPFs	265	194	326
Percentage of vouchers invested by individuals	73.3	63.5	—
Percentage of vouchers invested through IPFs	26.7	36.5	—

Source: Fund of National Property

Table 7. Inflow of foreign direct investment (1991-30 June 2000)

Country of origin	*million US$*	*% of total*
Germany	4,253.2	24.3
Netherlands	2,958.0	16.9
Belgium	2,528.1	14.4
United States	1,924.8	11.0
Austria	1,562.2	8.9
Switzerland	1,359.5	7.8
France	877.1	5.0
Others	2,062.3	11.7
Total	17,525.0	100.0

Source: Czech National Bank

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SESSION 2

BUSINESS INFRASTRUCTURE FROM THE VIEWPOINT OF THE PRIVATE SECTOR

The Operation in the Czech Republic
Fumio Inoue, Japan

VAE in Central Europe
Mohammed Kaddoura, Austria

Business Infrastructure from the Viewpoint of the Private Sector
Christian Dörner, Germany

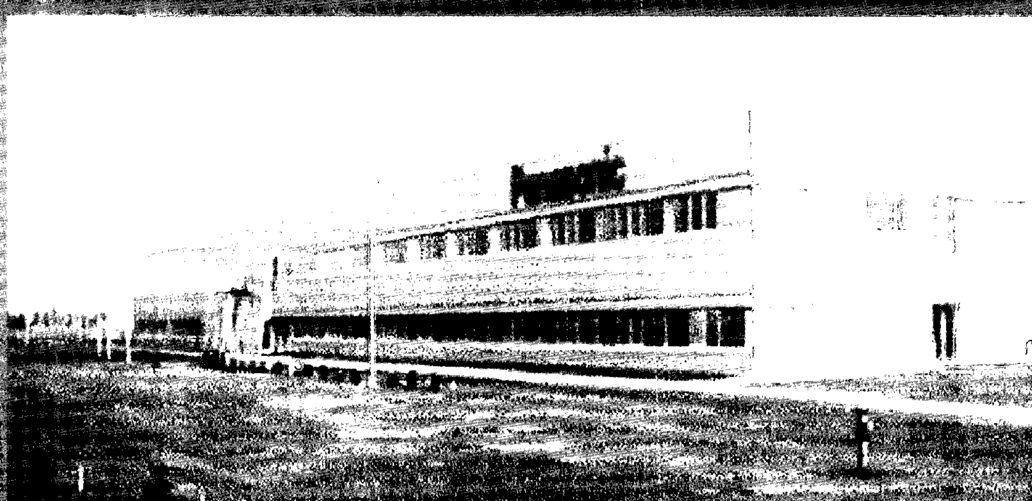
The Operation in the Czech Republic

Fumio Inoue
Officer, JICA Austria Office
Japan

CONTENTS

1. Company Introduction
2. Reasons of Investment in Czech Republic.
3. Guidelines for Global Management, Business Principles
4. Start Up Operation
5. Problems and Actions of Setting Up
6. Challenge for the Future
7. Goals of Matsushita

PREMISES



1. COMPANY PROFILE

Name:	MatsushitaTelevision CE
Capital:	CZK 2.7 bn (77 mil. EUR)
Product:	Colour TV
Place:	Pilsen, Czech Republic
Established:	March 13, 1996
Product. Start:	April 1, 1997
Employees:	1 500 / October 2000
Land:	166 000 m^2
Building:	47 000 m^2

2. REASONS OF INVESTMENT

1. Cancellation of import duty to EU (if EUR)
2. Political and economical stability was better than in Poland and Hungary
3. Localisation of Logistics
4. Forward looking of the CR government concerning search for foreign investor
5. Forward looking of City of Pilsen by the Mayor
6. Human resources

3. GUIDELINES FOR MANAGEMENT

1. Good Corporate Citizenship
2. Mutual Respect & Understanding with the Host Country
3. Product Competitiveness in Quality, Cost & Performance
4. Transfer of Technology under a Worldwide R&D System
5. Autonomous & Responsible Management
6. Management Localisation & Employee Skills Development

3. MTE BUSINESS PRINCIPLES

1. Through the Most Competitive Products Contribute to Prestige and Progress of the Czech Republic
2. Maximum Customer Satisfaction
3. Development of Individuals & Groups with Strong Belief in High Productivity & Positive Involvement
4. Business Expansion & Market Share Increase

4. START UP OPERATION

a) PRODUCTION & SALES

Cumulative:	1 mil.:	Oct '99
	2 mil.:	Oct 2000
Destinations		30 Countries

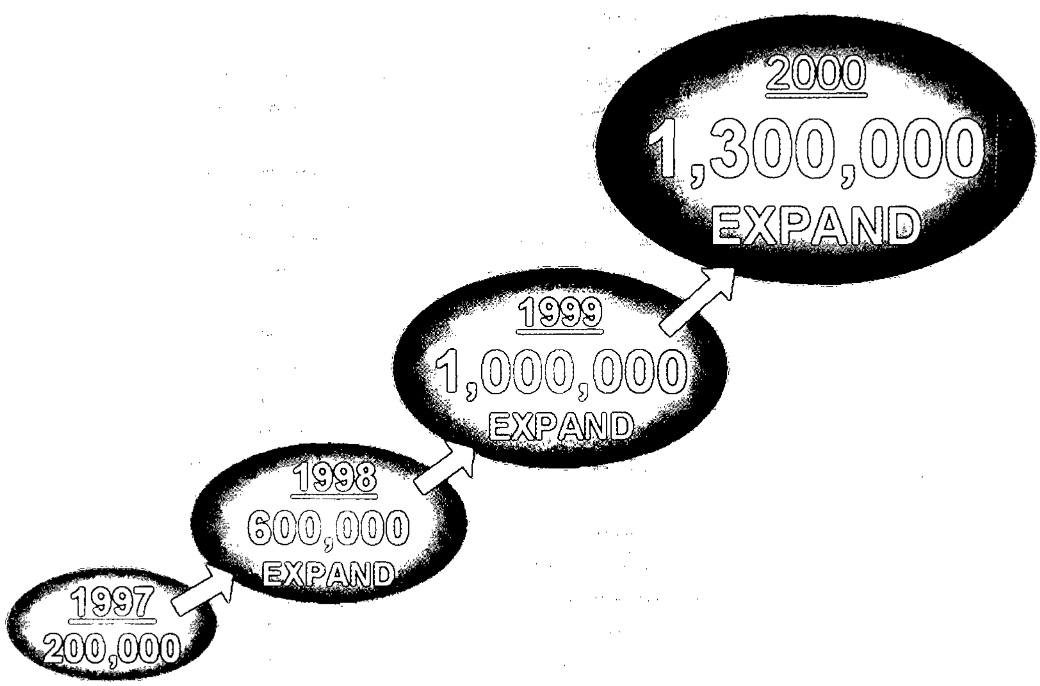
b) QUALITY

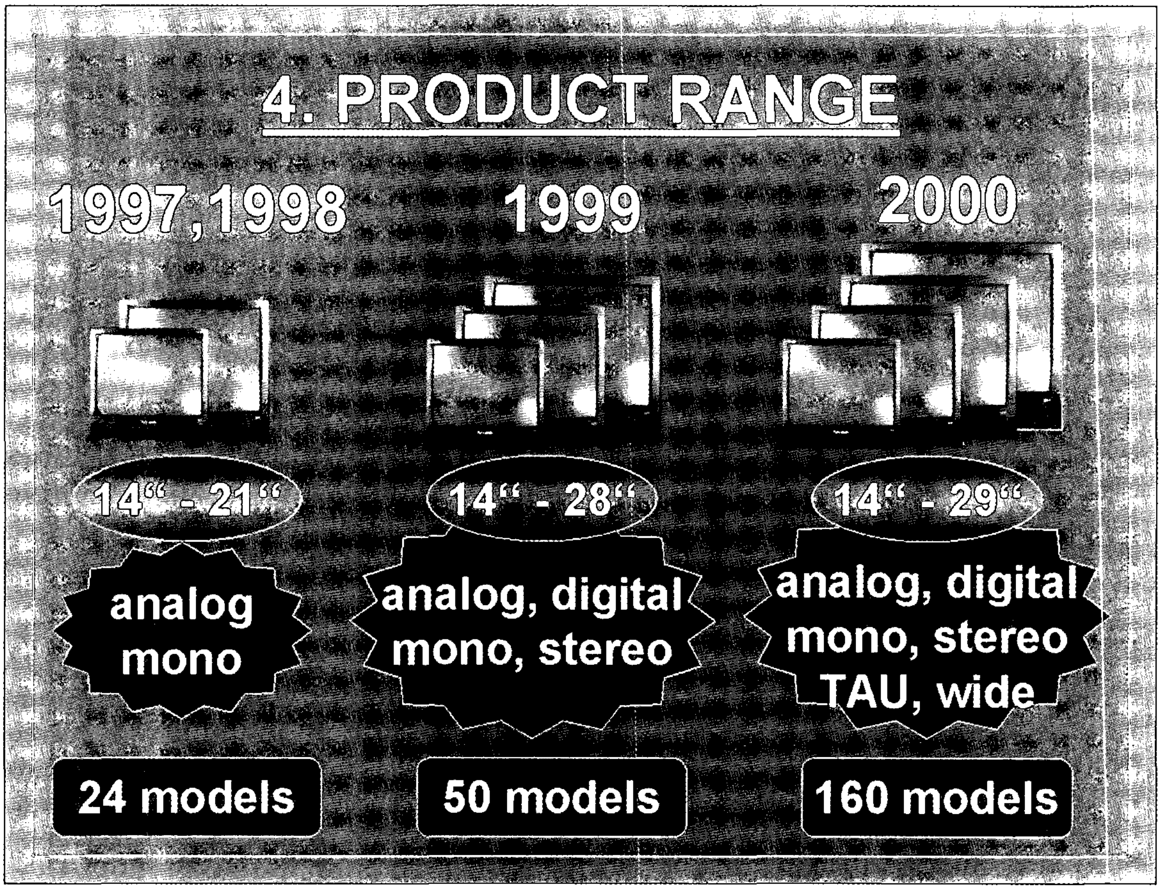
Market Approval	30 Countries
The target was achieved	

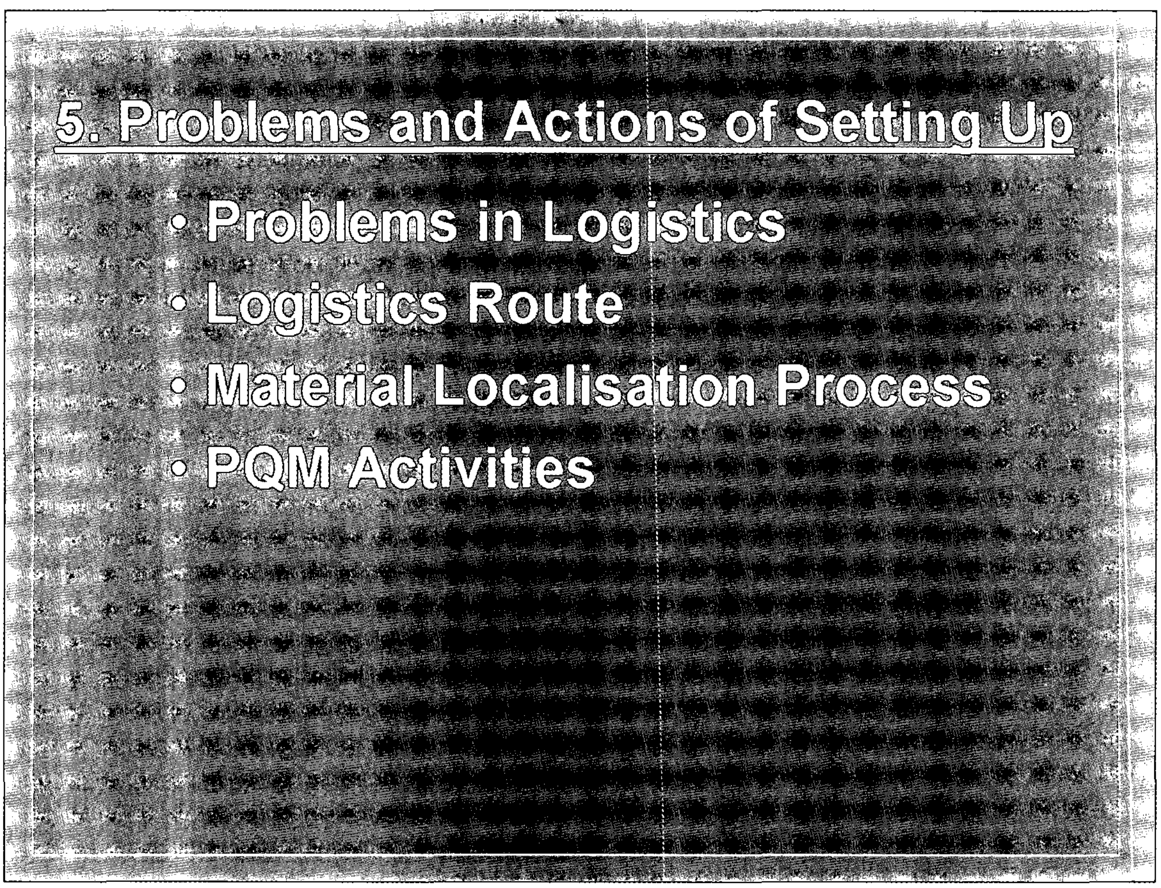
c) CERTIFICATIONS

BEAB	July 1997
ISO 9002	March 1998
ISO 14001	December 1998

4. PRODUCTION & SALES




4. PRODUCT RANGE
1997,1998
1999
2000
14" - 21"
14" - 28"
14" - 29"
analog
mono
analog, digital
mono, stereo
analog, digital
mono, stereo
TAU, wide
24 models
50 models
160 models


5. Problems and Actions of Setting Up
• Problems in Logistics
• Logistics Route
• Material Localisation Process
• PQM Activities

5. PROBLEM IN LOGISTICS

1. Customs conditions

- Customs clearance depends heavily on human factors
- Outdated customs clearance controls & procedures

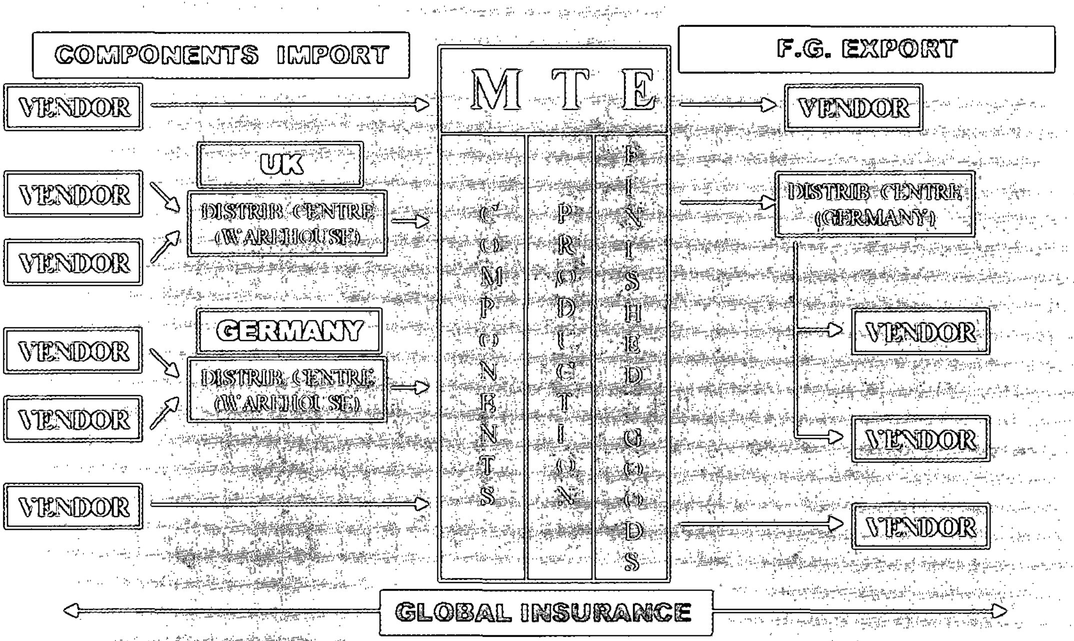
2. Transport conditions

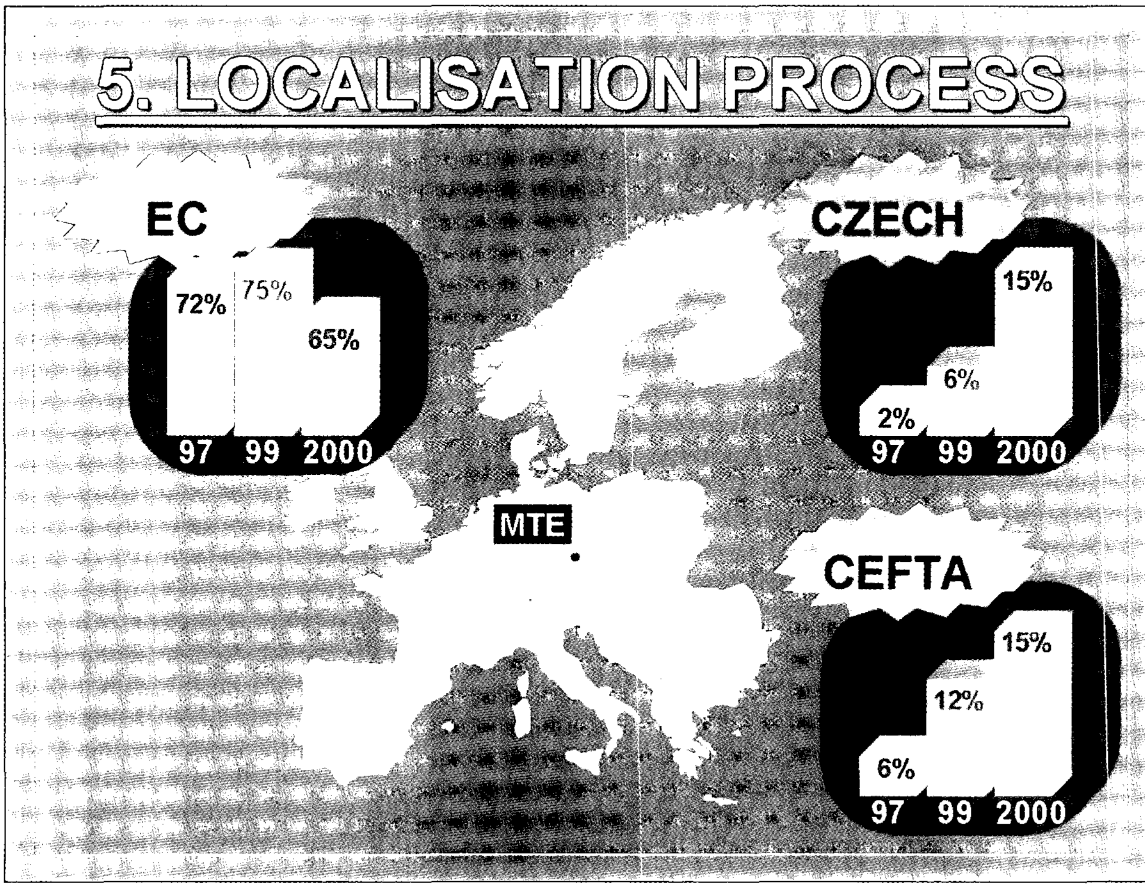
- Over-exploitation of road transport after 1990
- Bottleneck at borders
- Not balanced ratio of incoming / outgoing shipments

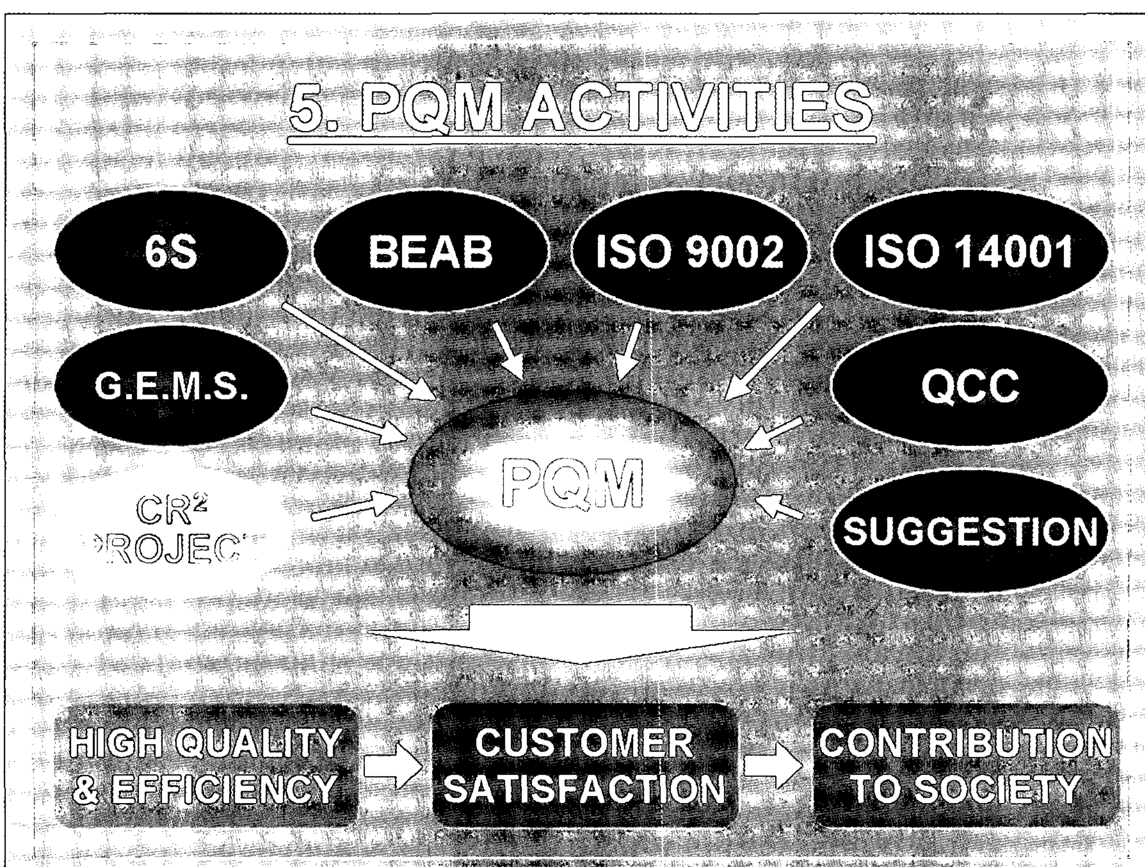
3. Infrastructure

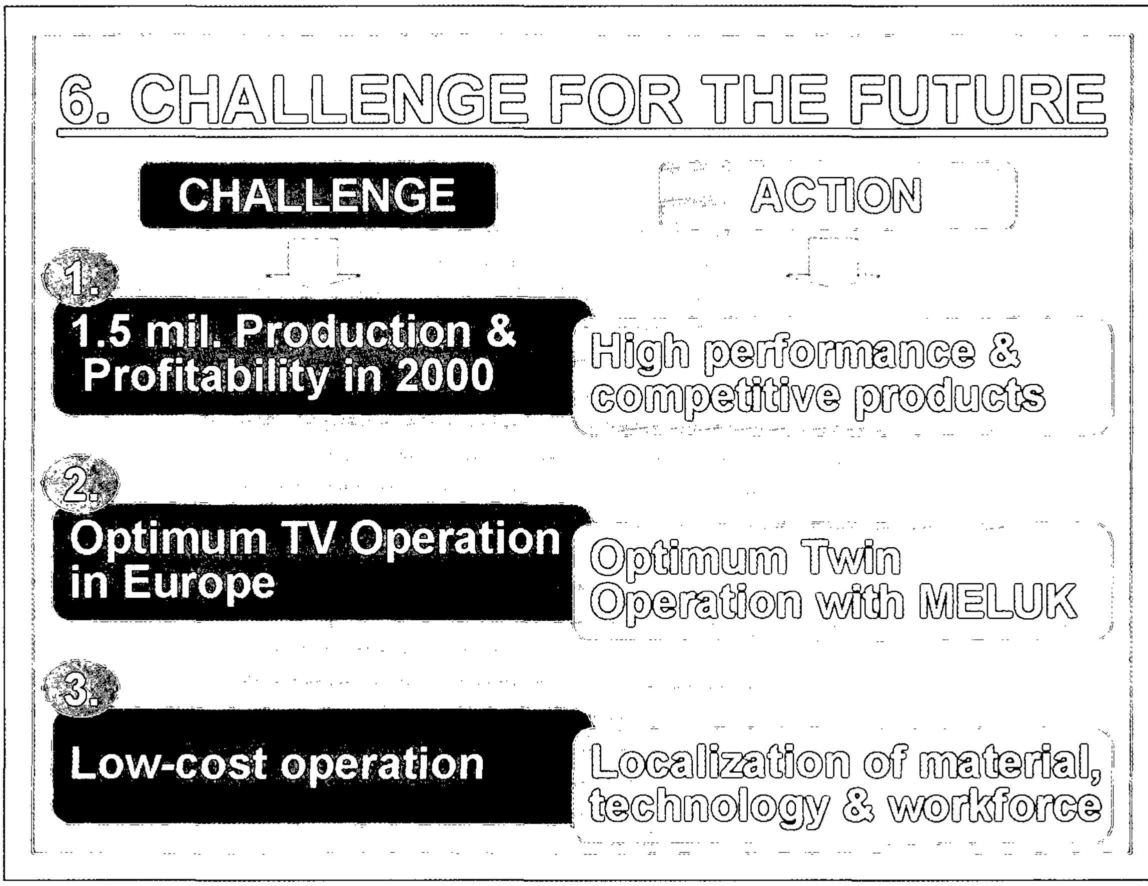
- Lack of state transport policy
- Low quality of roads and rails

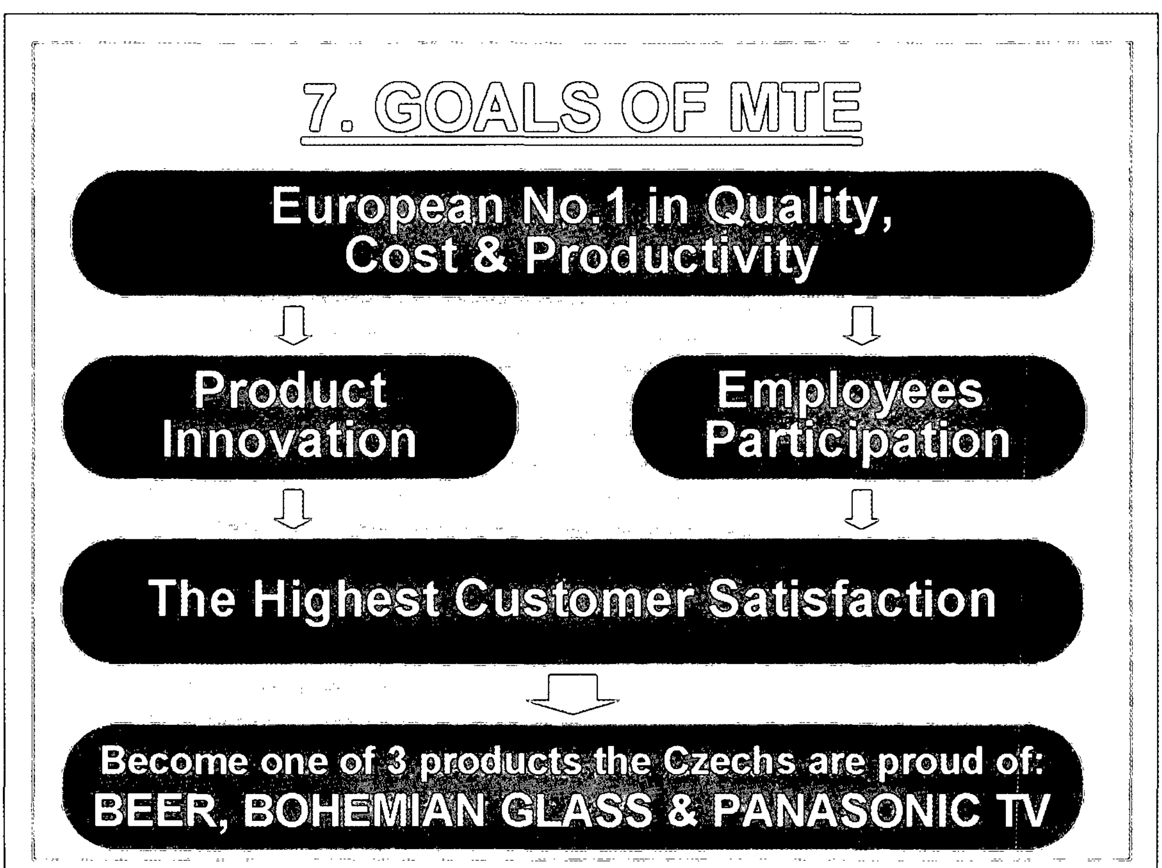
5. LOGISTICS ROUTE




5. LOCALISATION PROCESS
EC
72%
75%
65%
97 99 2000
CZECH
15%
6%
2%
97 99 2000
MTE
CEFTA
15%
12%
6%
97 99 2000


5. PQM ACTIVITIES
6S
BEAB
ISO 9002
ISO 14001
G.E.M.S.
QCC
PQM
CR^2
SUGGESTION
HIGH QUALITY & EFFICIENCY
CUSTOMER SATISFACTION
CONTRIBUTION TO SOCIETY


6. CHALLENGE FOR THE FUTURE
CHALLENGE
ACTION
1.
1.5 mil. Production & Profitability in 2000
High performance & competitive products
2.
Optimum TV Operation in Europe
Optimum Twin Operation with MELUK
3.
Low-cost operation
Localization of material, technology & workforce


7. GOALS OF MTE
European No.1 in Quality, Cost & Productivity
Product Innovation
Employees Participation
The Highest Customer Satisfaction
Become one of 3 products the Czechs are proud of:
BEER, BOHEMIAN GLASS & PANASONIC TV


Please, continue to support
PANASONIC in Czech republic.
Thank you.

VAE in Central Europe

Mohammed Kaddoura
Director, VAE Aktiengesellschaft
Austria

KEY FACTS OF VAE

VAE is a niche engineering company, operating worldwide. VAE competence is based on nearly 150 years of tradition. Our core business is the design and the manufacture of high performance turnouts, switches and turnout components, for the international railroad industry. These are high tech products, which allow trains to move from one set of tracks to another.

MARKET POSITION

We are truly international players with 70% of our business generated outside Austria. We have two Austrian and 15 foreign production operations, as well as a massive export business. And most important, we are market leaders worldwide.

We are the largest company specialising in the world on turnout sector, achieving a turnover of about 4 billion shillings. Our success in this market is the result of our world leading technology.

PRODUCTS

The range of our products comprises three main categories:

High quality turnouts

Special electronic and hydraulic equipment devices and

Rail Movement Joints

TURNOUTS

The core business is the production of turnouts for railway, tramway and underground and related turnout components, for new track, refurbishment and railway maintenance. These products are fundamental to railway development.

VAE ROADMASTER 2000

This system contains special developed transductors and microelectronics in the turnouts to monitor operating conditions and wear on a continuos basis on a central control unit.

Trend calculations allow preventive maintenance, help saving maintenance costs and time and all these lead to a better performance of turnouts and increased operational availability.

HOT BOX AND BLOCKED BRAKE DETECTORS

Hot box and blocked brake detectors are situated on both sides of the track as fixed installations. They control boxes and brakes about overheating.

The fixed detectors controls the moving trains comparing the temperature of the boxes and brakes under recognizing the temperature in the air. These systems give an alarm in case of overheating or higher temperatures to stop the train immediately.

Hot boxes and blocked brakes if undetected, will cause the derailment of the train.

These systems are working on an infrared basis. The detectors are sending so many scans to the axles or breaks that also by speeds at 400 km/h a lot of scans allow exact measurements.

RAIL MOVEMENT JOINTS

These products overcome the special problems which arise from the strain on rail track on bridges which arises from substantial movement in the bridge; the rail movement joints allow the rail to move as a result of traffic, load, speed, temperature and the severe weather conditions.

In other words, the rail movement joints are an extension compensation system ensures that the train always remains in contact with the rails. We supplied with this product the bridges for the new Hong Kong airport and before that the Great Belt bridge in Denmark.

VAE SHAREHOLDERS

Major shareholders are VOEST-ALPINE Schienen, the world market leader in rail business and VOSSLOH, the world market leader in rail fastening systems. They hold both together 90% of the share. The rest of about 10% is still owned by private and institutional investors in Austria and abroad.

GROUP TURNOVER

The group turnover will be this year around 4 billion Shilling or 290 million Euro.

MAJOR MARKETS

Europe is our major market, accounting for 67% of the sales. We are well established here and hold the number one position in Austria, Switzerland, Germany, Spain, Portugal and the Central European Countries.

North America accounts for 25% of group sales and is one of our most exciting opportunities

The Pacific Rim accounted for 4% of sales. The rest of 4% of sales is done mainly in project business in the Near East, in Africa and South America.

THE WAY OF INTERNATIONALIZATION

Think globally and act locally.

VAE IN CENTRAL EUROPE

- 1992 starting a Joint-Venture with the Hungarian State Railways
- 1995/1996 starting Joint Ventures with the State Railways of Latvia and Lithuania
- 1998 acquisition of the majority of the now private turnout plant in Romania and also
- 1998 we started with our joint-venture with the Bulgarian Railways in Bulgaria.

Business Infrastructure from the Viewpoint of the Private Sector

Christian Dörner
International Relations Siemens
Germany

SIEMENS

BUSINESS INFRASTRUCTURE FROM THE VIEWPOINT OF THE PRIVATE SECTOR

30 November 2000, Vienna
International Conference on the 10-year Review of Transitional Economies and Challenges in the Next Decade

Praes/JICA
30 11 2000

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Situation

- high qualified technical staff in companies and agencies
- legal background and enforcement
- goal of FDI could be more precise
- sensitive issue: FDI and/or privatisation

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Motivation

- common past in building up infrastructure
- obvious need
- historic cooperations
- service/solution orientation

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Performance

Cash Flow 1999 (examples):

○ Bosnia:	33 Mio.€
○ Slovakia:	363,4 Mio. €
○ Slovenia:	63,2 Mio.€

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FDI vs. FDI - and the lack of mutual understanding

- Prejudices
  - ⇨ Investor is not interested in local added value
  - ⇨ Government considers FDI (if in case of privatisation) as tool for budget regulation - or as foreign influence
- Different understanding of protection
  - ⇨ employees
  - ⇨ capital
- Goal of FDI
  - ⇨ new - profitable - market
  - ⇨ release of budget
- FDI vs. Privatisation
  - ⇨ role of free trade areas

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Statement

FDI is NOT possible on a large scale if these points are

- not discussed and

- similar understood

by both (all) parties!

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Clarification

Government and investor:

Who is the client? - Who serves whom?

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Investment is a process

- economic activities rely on trust
- clear understanding of influence of FDI on the national economy
- same/comparable systems of business economics in companies

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Political/institutional background

- The intention of the government(s) and investor(s) must be
  - ⇨clear
  - ⇨communicated
- Clear rules and regulations!
- Transparent procedures/implementation (distrust due to failure discourages further investors)

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Employment

- Increase of efficiency does not mean increase of jobless
- Adaptation to market requirements: training and political courage
- Training supports FDI and privatisation

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Development of strategies

The market contradiction:

- Market in C/SEE needs a unified FDI strategy
- Market needs a country by country strategy

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What is needed?

- design phase: participation of industry (Economic Fora etc.)
- political commitment
- adapted model treaty = "de facto" law (pragmatic solution accepted by major IFIs)
- toolkit for Investment Promotion Agencies/Privatisation Agencies
- free trade areas - but just one possibility
- support for local banks

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SESSION 3

FDI POLICY, ADVANTAGES AND POINTS AT ISSUE

FDI in Hungary: Past Patterns and Future Challenges

Miklósz Szanyi
Senior Research Fellow at the Institute of Economics
Hungarian Academy of Sciences
Hungary

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.

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 US$ 2-4.5 billion, and the total stock reached US$ 20 billion (with reinvested profits not included). Changes in inflows and stock are illustrated by table 1.

Table 1. FDI in Hungary (capital transfers through the banking sector)

	1995	*1996*	*1997*	*1998*	*1999*
Inflow	4,453	2,275	2,173	2,037	1,944
Stock	12,829	14,961	16,086	18,517	19,276

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 favoured 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 tier 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 stock of FDI also contains privatized firms, but even more greenfield investments (joint ventures). These figures are introduced in figure 1.

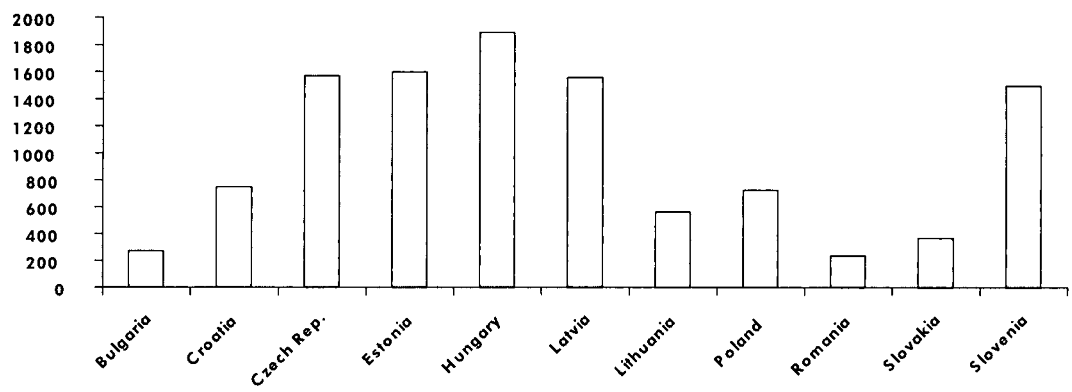
FIEs took very important positions in the Hungarian economy. Figure II illustrates how widespread foreign penetration was in 1997 (more details for manufacturing are attached in the Annex). The higher added value and lower employment figures reflect both higher efficiency of FIEs and their concentration in more efficient branches (higher labour 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 1992-1994 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 ten years later.

FDI-RELATED FUTURE POLICY CHALLENGES

FDI PROMOTION—THE ROLE OF CUSTOMS-FREE AREAS

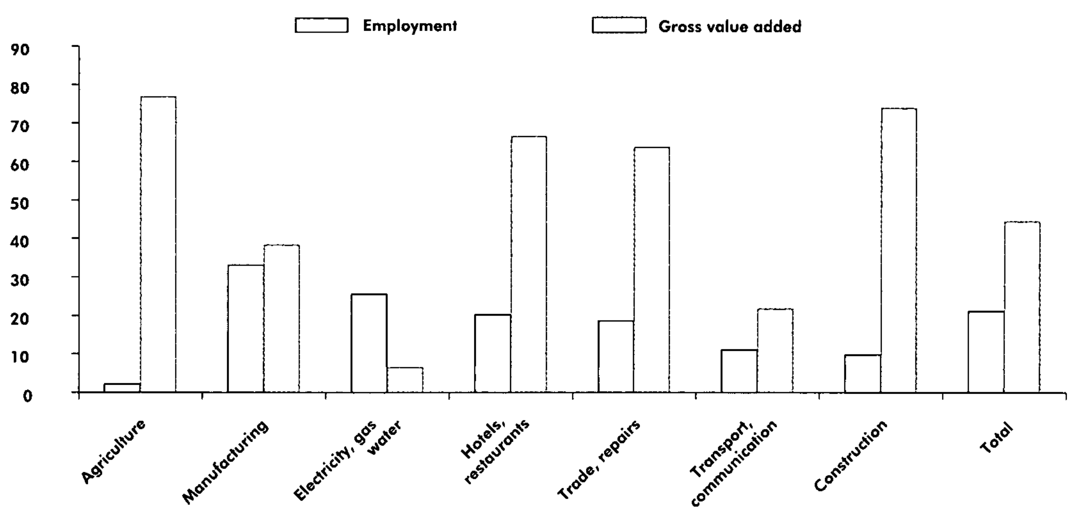
The first issue to be discussed here derives straight from the above observation of slightly declining yearly inward FDI in Hungary. An FDI-based modernization policy must continuously

Figure I. Per capita FDI stock
(in US dollars)



Source: www.bcemag.com/statsdb

Figure II. Percentage share of FIEs in Hungarian economy, 1997



Source: Central Statistical Office.

maintain favourable investment climate that attracts FDI. The accumulated experience of the past ten years 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 & 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 separate 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 are otherwise 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 at 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, the suppliers of multinational companies operating already in Hungary mainly invested in this form. In 1997 89, in 1998 109 in 1999 116 industrial customs-free zones had licences. The number of really productive customs-free zones was 101. The customs-free zones were operated by about 70 companies, as a company—such as Philips, Videoton, Flextronics Group—may possess more customs-free zones.

The activity of customs-free zones is strongly concentrated from more points of view as well. About 70% of them were engaged with production of parts, components and finished goods of telecommunication, electronics, informatics and car industry and engineering goods. 15% produced textile, clothing and shoes articles, so these four areas of activity covered 85% 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 in customs-free zone companies increased by 2.5 times between 1996 and 1999, and totalled 53.8 thousand people at the end of last year. This is about 6% of employees in manufacturing industry, while 28.2% of gross production value added of manufacturing industry_was produced by customs-free zone companies. Also their

[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.

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 best described by foreign trade figures: the share of customs-free zones in Hungarian export increased from 18 to 43% between 1996 and 1999, in import from 14 to 30%. 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%—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 US$ 318 million, in 1998 by 1.8 billion, in 1999 by 2 billion already. Of course export is concentrated significantly as well. In 1999 35% 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% of customs-free zone export aims at developed countries, within that mainly at European Union), in a broader sense to its connection to globalization and to its integration to the world economy.

Table 2. The share of industrial free trade zones in Hungarian foreign trade
(Percentage)

	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

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 in Hungary it was only the possibilities of investing in customs-free zones that was declared as non EU-conforming 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.

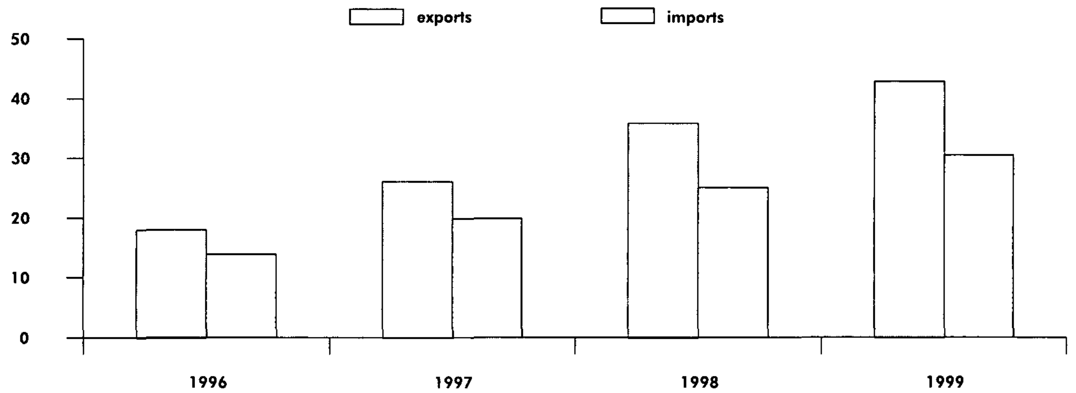
- Both regulations require the physical separation of customs area and customs-free area in order to secure customs control. The entry of the customs-free area functions as customs border and is controlled by the customs office. Processing and storing can be carried out on customs-free areas. Customs-free 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.

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

Figure III. Hungary: percentage share of industrial free trade zones in trade



Source: Ministry of Economic Affairs

Union no change of the current regulation is foreseen and investors qualifying for the requirements continuously receive licences of customs-free areas. Benefits enjoyed until now (production equipment's customs- and VAT exemption) will not be paid back afterwards.

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 US$ 1.3 billion and amounted to US$ 2.3 billion or almost 5% of the GDP. In 1999 the deficit was up again with US$ 2.1 billion. The deterioration of the current account was rather unexpected, since after the successful 1995 stabilization programme GDP continuously grew, exports almost doubled, and economic conditions improved. In the shadow of the international monetary crisis serious concerns were 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 transfer was also negative. Net outflow of incomes open and covert amounted to US$ 1.5 billion. 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 behaviour 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 figure IV. Obviously enough, there was no fundamental change of patterns in 1998. Inward FDI was still around US$ 2 billion (same amount for four subsequent years) business and technical services also amounted roughly US$ 2 billion.[2]

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 (i.e. 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]

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. 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 figure IV. 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 figure V.

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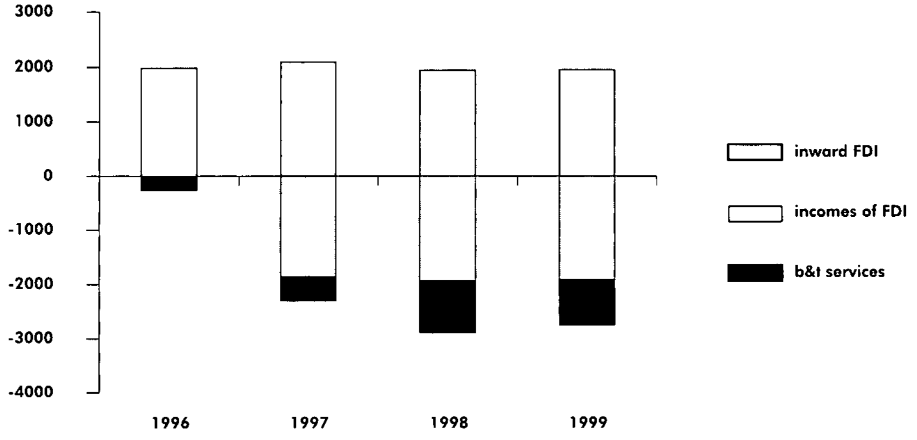
[2]We did not calculate the **net** FDI inflow and **net** expenditures, since this net amalgamates actions taken by Hungarian capital owners abroad, and foreigners' in Hungary. What we tried all over this study was a clear separation of foreign capital owners' actions from nettings. Thus, incomes from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

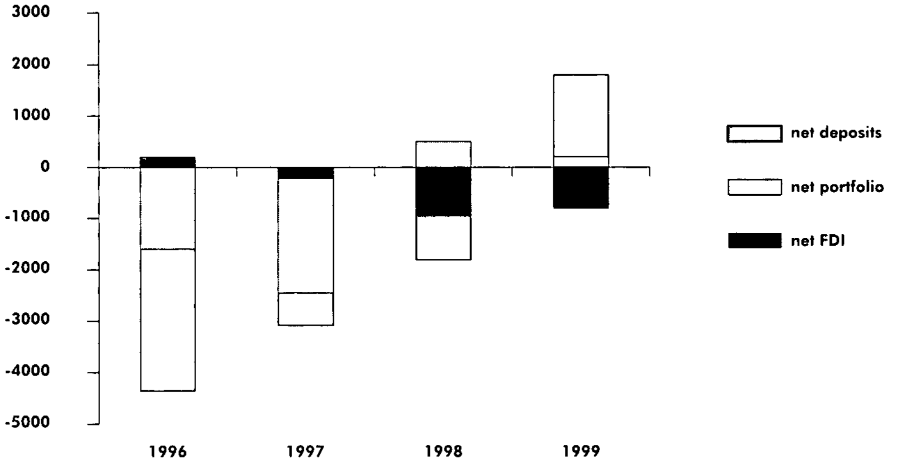
[3]For 1996 no separated business and technical services account was available, therefore figure IV does not contain this data. We may assume, however, that this amount was also in line with the trends, and must have amounted to US$ 1.7-1.8 billion.

Figure IV. Hungary: capital flows associated with FDI
(millions of US dollars)



Source: National Bank of Hungary, own calculations

Figure V. Hungary: capital flows associated with different types of investments
(millions of US dollars)



Source: National Bank of Hungary, own calculations

Figure V. 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 US$ 2.6 billion. 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 behaviour 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 behaviour of short-term investors determined the current account and the capital account to a much larger degree, than foreign direct investments. Changing patterns of FDI's role can be seen from figure 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.

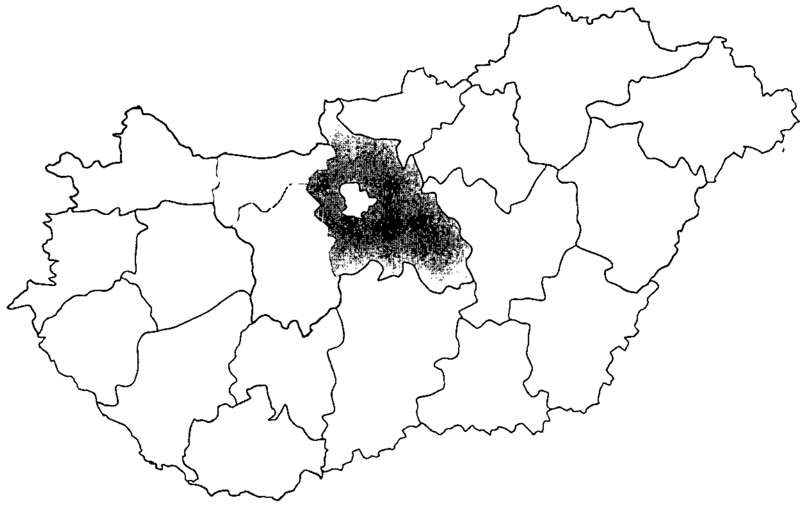
Summing up FDI increases vulnerability of the macroeconomic balances much less, than other capital outlays. Though, there is a clear change in the behaviour of FIEs that started the realization of their profits. Investment promotion should therefore increase efforts at stimulating profit reinvestment.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

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 labour force, that was concentrated in large socialist enterprises. The spatially concentrated stock of high quality and relatively inexpensive labour 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 cooperation networks (e.g. just-in-time production systems). The most important condition for such cooperation 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 figure VI.).

Figure VI. Density of FIEs in regions of Hungary, 1994

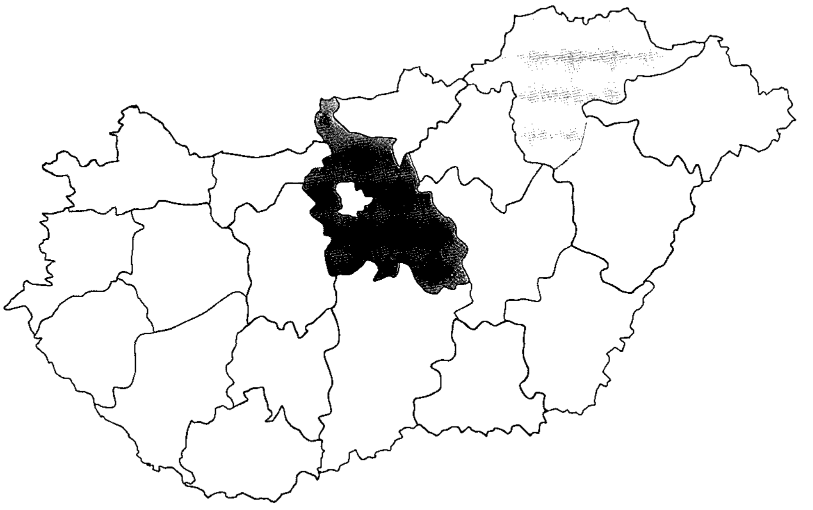


Infrastructure networks were quickly developed during the 1990's in Hungary. Among the nationwide networks it was the mobile phone system that developed most quickly, but the wired telephone system was also vastly improved. Relatively less development was achieved in the transport system, although the achieved limited advance might have influenced FDI flows to some extent. Few hundred kilometres 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.

Infrastructure developments made accessible geographically further lying premises with their valuable production inputs (labour, R & D facilities, higher education centres). Another important change was the relative saturation of the traditional locations with FIE's. In certain areas there was a shortage of qualified labour, that induced labour 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. Figure VI 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 (labour, 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 labour 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 labour and educational hot-spots.

Figure VII. Density of FIEs in regions of Hungary, 1998



Source: Central Statistical Office

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 re-emerge. 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.

APPENDIX

Table 1a. Share of foreign investment enterprises in 1998
(Percentages)

		Number of organizations	*Number of employees*	*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

Source: calculations based on Central Statistical Office data

Table 2a. Regional distribution of the stock of FDI by counties
(Percentage 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	—

Source: Central Statistical Office data, own calculations

Poland's Goal

Adam Pawlowicz
President, Polish Agency for Foreign Investment
Poland

The European Commission said in its latest Regular Report "Progress toward accession" that:

> "Poland is a functioning market economy, with an increasingly thriving private sector and an appropriate legal and institutional environment for economic activity. It should be able to cope with competitive pressure and market forces within the Union in the medium term, provided it keeps up the pace of economic restructuring and proceeds with trade liberalization. Poland continues to register progress in privatization and structural reforms. The privatization programme is being implemented forcefully and successfully. The banking sector has remained fundamentally sound since the middle of the 1990s. Significant progress has been made in the area of tax reform. There are no significant legal or institutional barriers to the establishment of new firms in Poland. Property rights are clearly established and transferable.

Poland took a chance and decided to transform its inefficient centrally planned economy into a market economy. On 1 January 1990, the first post-communist Polish government introduced an unprecedented economic reform plan designed to stabilize the economy, promote structural reforms, and put the country on the right path to becoming a market economy.

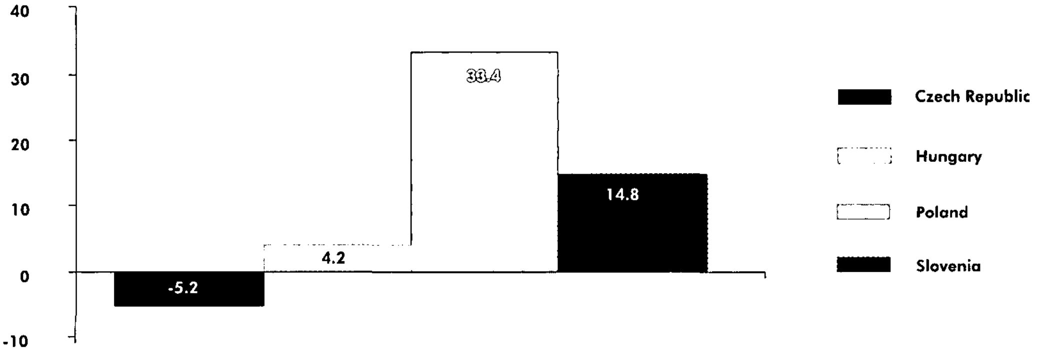
The robust growth (the fastest in Central Europe) during 1995-1999 was driven by a rapid expansion of the new private sector (see figure I).

The changes introduced also made Polish economy strong enough to sustain positive long-term trends in the more demanding external environment.

Poland has ambitious goals for the first decade of the twenty-first century. Its medium-term objective is to achieve high and sustainable growth, 5-6%, to boost employment and narrow the gap between Poland and EU member States.

In the coming decade, Poland hopes to benefit from increasing globalization and liberalization. It will be increasingly integrated with the world economy. Poland's medium-term economic strategy has four main components: macroeconomic stabilization, strengthening of the financial sector, structural reforms, and accession to the European Union and European Monetary Union (EMU) by meeting convergence criteria.

Figure I. Private sector development in Central Europe, 1995-1999
(percentage)



Source: IMF, CESTAT Statistical Bulletin

Effective introduction of truly market-driven mechanisms into the economy in accordance with current NATO, OECD, IMF, UN membership and forthcoming membership in the EU as well as banking on education and infrastructure development should help successfully achieving the goal Poland set for itself more than 10 years ago.

HIGHER AND TERTIARY EDUCATION

Over 1,431,000 people in Poland are whose who study. Over 413,000 people study at non-state schools, which makes them almost a third of all students. There are almost 657,500 full-time students and almost 806,000 of those who take evening classes and extension courses. The percentage of people continuing education in the 19-24 age group equals 38.2% at present.

Table 1. Breakdown by education profile

Education profile	*Students in thousands*	*Graduates in thousands*
Education science	158.4	40.0
Fine arts	14.7	1.8
Humanities	107.4	18.2
Religion and theology	22.2	2.9
Social science	193.7	22.8
Business and management	396.0	59.8
Law	58.8	7.8
Natural science	38.2	5.3
Mathematics and computer science	33.2	3.9
Medical science	35.5	5.5
Engineering	222.0	24.6
Architecture	10.2	1.0
Agriculture	39.3	6.4
Home economics	9.3	1.8
Transport and communications	12.4	1.3
Mass media	7.3	1.1
Services	14.2	2.7
Others	59.1	8.0

Source: Central Statistical Office, 2000

During the academic year 1998/99-74,100 academic teachers gave lectures in 266 tertiary education institutions, 174,800 graduates finished their studies. Presently, 40% of all schools are subordinate to the state administration units and 6% to the religious organizations. Out of the total number there are 13 universities, 30 technical schools, 94 economic schools, 11 medical academies, 11 agricultural schools and 3 naval academies. In 1999 32.9% of students were entitled to a scholarship.

There are over 1 million students in technical schools, 120,000 in agriculture, 330,000 in economics and 8,000 in transport (excluding post-secondary schools). Among them over 600,000 learn English 590,000 German, 420,000 Russian and 140,000 French.

The main centres of tertiary education are Warsaw, Kraków, Poznan, Lódz, Gdansk, Torun, Szczecin and Wroclaw.

TELECOMMUNICATIONS

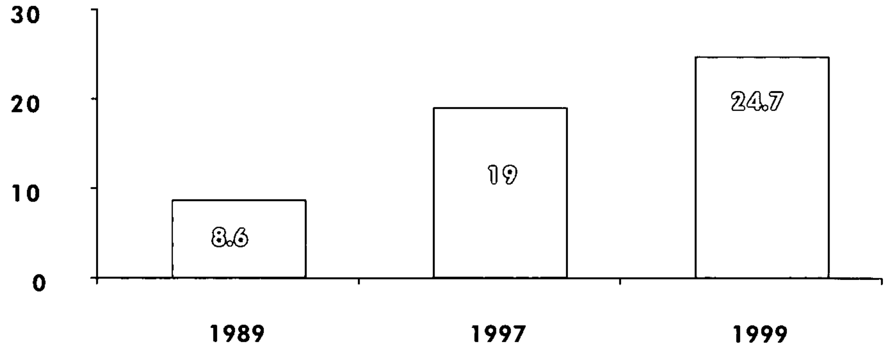
Telecommunications is one of the most dynamically developing sector of the Polish economy. Before the economic changes of 1989, the Polish telecommunications network, offered only basic telephone services. In less than decade, a wide range of services—including cellular phone services, paging, e-mail and Internet access—has become available. In the process of liberalization of the market, considerable progress has been achieved (see figure II).

Starting from the year 2003 the telecommunications market will be fully liberalized and international services will also be provided by other operators.

It is estimated that for Poland to achieve a modest "European level" of average telephone density i.e. 35 phones per 1,000 inhabitants, the installation of another 4 million new lines is required. Considering the market demand, as well as the increasing involvement of private operators it will not be long before this level is achieved.

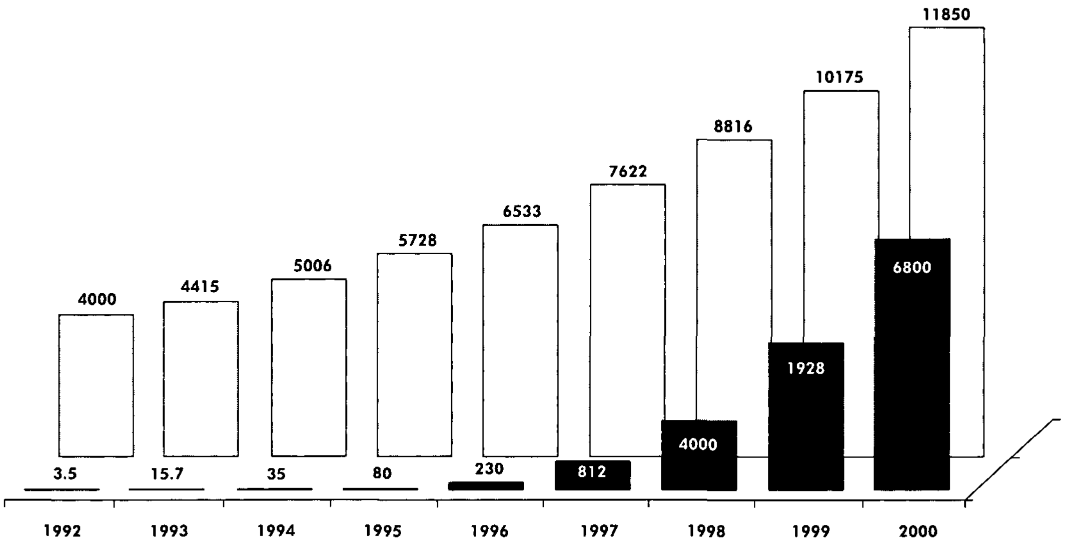
The installation and operation of local telephone networks is not subject to any capital equity restrictions regarding foreign participation. Moreover, many foreign companies have been and still are very much interested in entering the Polish telecommunications market as equipment manufactures, which in view of the sector's expansion is regarded as a very promising business opportunity.

Figure II. Poland: telephone subscribers per 100 inhabitants



Source: Central Statistical Office, 2000

Figure III. Poland: share of telecommunications in mobile and wire phone users



The largest telecommunications equipment plants in Poland were bought out in the process of privatization through the sale of shares in the year 1992-1993 by the following investors:

- Alcatel—bought PZT in Warsaw and TELETRA in Poznan;
- Lucent Technologies—bought TELFA in Bydgoszcz;
- Siemens—bought ELWRO in Wroclaw and ZWOT in Warsaw.

TRANSPORTATION INFRASTRUCTURE AND HIGHWAY CONSTRUCTION

Poland has a well-development transport infrastructure (UNIDO). There are 357,700 km of roads i.e. 114,4 km per 100 square kilometres and an extended railway network of over 23,000 kilometres linking all the major cities and towns.

The Motorway Construction in Poland Programme anticipates the construction of a network of four motorways, two running from east to west, and two from north to south, namely:

- A-1 (597 km) Gdans—Torun-Katowice—and farther to the border with the Czech Republic;
- A-2 (626 km) the Polish—German border with crossing in Swiecko, then running through Poznan and Warsaw onwards to Terespol, the border crossing between Poland and Belarus;
- A-4/A-12 (738 km) running from the Polish-German border with the crossings in Jedrzychowice near Zgorzelec and in Olszyna and next via Wroclaw, Opole, Gliwice, Katowice, Cracow, Rzeszów, to the Polish—Ukrainian border, with the A-12 branching Olszyna-Legnica;
- A-3 (365 km) from Szczecin via Gorzów—Zielona Góra—Legnica to Lubawka.

THE STATE OF DIRECT FOREIGN INVESTMENTS IN POLAND IN JUNE 2000

It follows from data compiled by PAIZ (Polish Agency for Foreign Investment) that US$ 3.7 billion have been invested in Poland by foreign companies in the first half of 2000. Direct foreign investments exceeding US$ 1 million each have reached the figure of US$ 38.9 billion by June 2000. Investment inputs of below one million US$ are estimated at US$ 4.1 billion. Total foreign capital invested in Poland so far has exceeded the value of US$ 43 billion.

Almost 90% of all direct foreign investments came to Poland from OECD countries (US$ 34.6 billion). Investors from the European Union countries have so far invested US$ 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 US$ 6.6 billion (17,1%), while US$ 2 billion (5,7%) was invested by Asian countries.

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).

Table 2. Foreign Direct Investment in Poland—country breakdown (at the first half of 2000)

NO.	Country of origin	Capital invested (millions of US$)	Planned investment (millions of US$)	Number of investors
1	USA	6,396.5	2,648.1	128
2	Germany	6,234.4	2,277.5	189
3	France	4,091.1	1,614	70
4	Netherlands	3,714.7	6,92.8	58
5	Italy	3,273.8	6,07.0	67
6	United Kingdom of Great Britain and Northern Ireland	2,646.1	259.0	36
7	International	2,617.6	401.9	20
Total FDI in Poland		43,017.3		

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 US$ 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 US$ 4.5 billion (11.5%). Products made of other non-metal raw materials have absorbed investment outlays worth US$ 2.3 billion (5.8%). The electrical and optical equipment manufacturing sector with investment outlays of US$ 1.7 billion (4.3%) has ranked fourth (it is noteworthy that this field of endeavour ranked earlier as sixth). More than US$ 1.4 billion US$ (3.7%) has been invested in pulp, paper, printing and publishing. An influx of more than 1.3 billion US$ (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 cate-gories. 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 US$ 9.2 billion, that is 23.7% of the overall inflow of direct investments into Poland.

Investments to the tune of US$ 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 US$ 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 (US$ 269.6 million), in mining and quarrying (US$ 68.3 million) and agriculture (US$ 30.1 million), with investment outlays in the two last sectors remaining on the same level.

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.

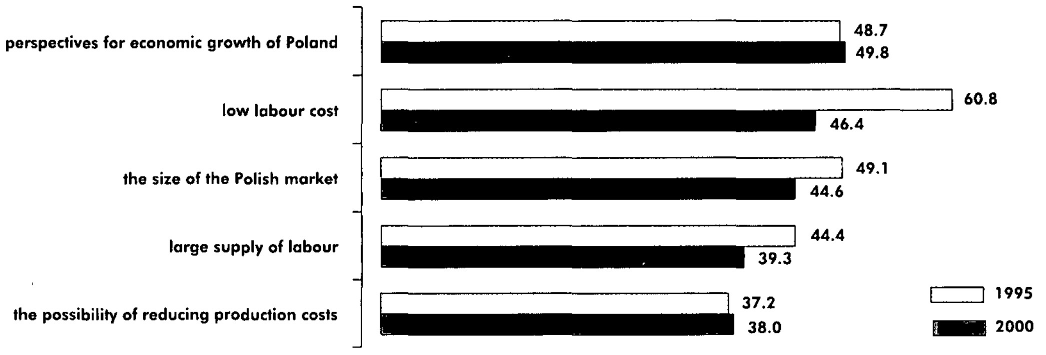
FACTORS WHICH ENCOURAGE FOREIGN INVESTORS TO ENGAGE IN BUSINESS IN POLAND

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 labour, the size of the Polish market, large supply of labour 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%), low costs of labour (46.4%), the size of the Polish market (44.6%), large supply of labour (39.3%), the possibility of reducing production costs (39.3%), qualifications of labour force (35.7%), favourable investment climate (33.0%), legal security (32.3%), ownership guarantees (30.5%) and future membership in EU (30.5%).

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.

Figure IV. Poland: key factors encouraging business growth



OPINION ON POLITICAL SITUATION IN POLAND

The majority of respondents think that the political situation and social climate in Poland are favourable investment. Over 56% 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% of managers. 22% of respondents do not have a clear opinion on this situation, or did not want to reveal it.

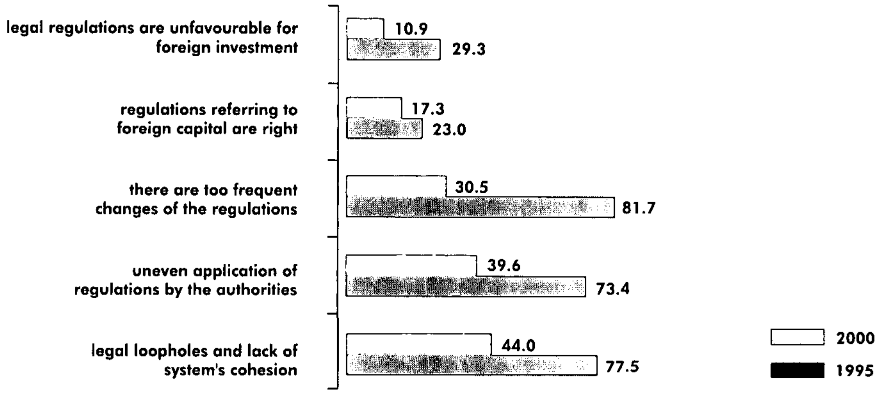
In 1995 only 10.9% of respondents perceived the political situation and social climate in Poland as favourable investment.

OPINION ON LEGAL CONDITIONS OF BUSINESS ACTIVITY

Only 17.3% 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%); uneven application of regulations by the authorities (39.6%); too frequent changes of the regulations (30.5%) and excessive detail level of the regulations, which obstructs the activity of companies (27.5%). One of ten respondents considers legal regulation as unfavourable foreign investment.

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

Figure V. Opinion on legal conditions of business activity
(percentage)

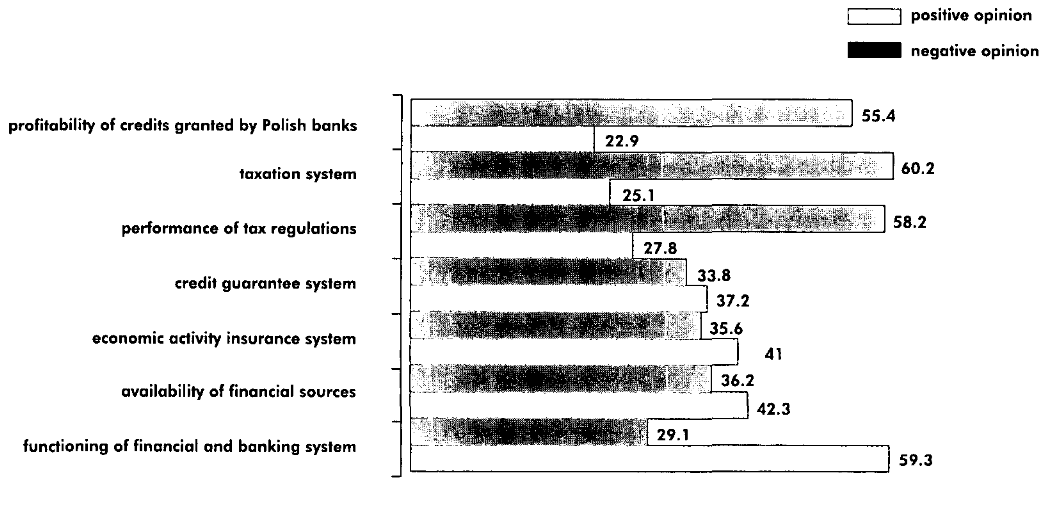


OPINION ON FINANCIAL CONDITIONS OF BUSINESS ACTIVITY

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.

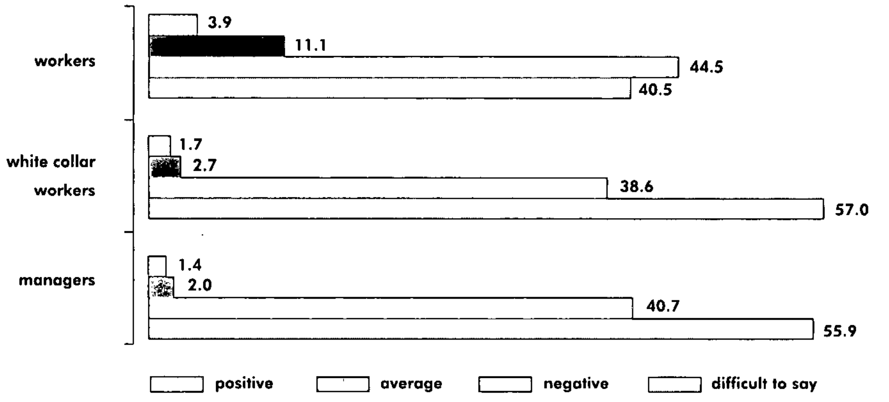
Figure VI. Opinion on financial conditions of business activity
(percentage)



OPINION ON LABOUR FORCE QUALIFICATIONS

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

Figure VII. Opinion on labour force qualifications
(percentage)



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%), satellite communications (14.4%), internet (10.3%) connections.

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% of companies had initial capital exceeding 2 million PLN, and now such companies amount to 40.8% 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.

TECHNOLOGIES USED BY COMPANIES WITH FOREIGN CAPITAL PARTICIPATION

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

QUALITY SYSTEMS

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

COOPERATION WITH POLISH SUB-CONTRACTORS

About 41% 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 cooperation with domestic companies are: good competitive offers, competitive prices, tradition and positive experience, convenient location.

Around 38.1% 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% respondents the deliveries are executed on time. In more than half of the companies with foreign capital, which cooperate with Polish sub-contractors, the share of Polish-made components is at 50% or higher. This confirms the high share of domestic products in the commodities produced by foreign companies in Poland.

CONCLUSION

Why invest in Poland? Considering above mentioned factors it can be said that particularly attract foreign investors are:

- stable and perspective economic growth
- stable economy, regardless of political changes
- future membership in the European Union
- the size of Polish market (almost 40 million people)
- "bridging position" between the EU and Eastern markets
- educated and inexpensive work-force
- openness for all kind of foreign investment in Poland.

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)

   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);

   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)

   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

   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)

   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)

   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)

   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:

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 telecommunications industry,
- Some commodities imported for the purpose of pharmaceutical industry,
- Commodities for the purpose of metallurgic industry.

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.

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:

(1) Means of production, means of transport necessary to perform services rendered in relation with realization of turn key buildings and construction and assembly works based on the contract concluded,

(2) Means of transport and production except for the passenger vehicles, leased or given for use, imported in relation with the business activity.

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:

(1) 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.

(2) Exemption from the obligation to provide backing in respect of tax and customs duties while introducing commodities to DFZ,

(3) Possibility to carry out regular activities without consent of the customs authority,

(4) Introduction of commodities to DFZ allows for application of 0% VAT rate, if such commodity is to be exported.

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.:

(1) 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.

(2) 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.

(3) 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)

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).

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:

(1) Presented registration application and have tax id number (NIP),

(2) Did not undertake activities subject to tax on commodities and services except for import of commodities,

(3) Effected investment purchases whose value without tax totals at least PLN 600,000,

(4) Paid the full amount due under investment purchases and in the case of import—paid input tax on such import,

(5) Have invoice or correcting invoice from which the input tax is derived and in the case of import—SAD document,

(6) 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:

(1) It fails to satisfy all the terms determined in the declaration referred to in Clause 6,

(2) 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,

(3) 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,

(4) 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.

(1) 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)

   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 OSZNiL 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) 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 the Czech Economy

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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 organization. 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 Czech Republic (1990-1997), Slovenia or Poland, and Belarus and Serbia, respectively. In many aspects the "national" approaches alone proved insufficient to overcome 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 industrialized economies, would create a potential for rapid increases in productivity and promote 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 complement 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 brought about by foreign firms. They reflect competent "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 the 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 1994-1996 through its period of growth and self-confidence, now in 2001, eleven years after the toil of restructuring and adjustments, one cannot claim that its transformation has been completed yet. The available time series for 1993-1997, 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]

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, as the Hungarians recognized very soon, 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 based on national self-reliance. By giving priority to the voucher privatization scheme and the scheme of sales to Czech owners (Mejstrik [1996]) it set forth for a highly

[1]Benacek, Visek [1999], Benacek [2000], Benacek, Zemplinerova [1999] and [2000]

unorthodox avenue of development. 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 privatization, 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 criticized by IMF and the World Bank, but very soon it became the Czech most admired achievement. Unfortunately, already in 1996 there were first signals that indigenous Czech firms lagged behind the firms with foreign capital.[2] Czech privatization 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 firms were negative.

The necessity to close the widening trade balance deficit during 1994-1997, 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 1997-1998. In the same period there was a sharp change in the views on ownership. The openness to FDI became the most-favoured policy not only for 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, soft budget and 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 large firms in the Czech economy were firms able to stand on their own with the 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 large 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

[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.

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 a change to the better. The problem to be solved is only managerial: who are those clerks and entrepreneurs who will administer and use these means productively? Without them one can have doubts that there may be anything substantial in that 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 doubt that the FDI entry into the Czech Republic 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 is 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 local activities, what were the industrial patterns, which attracted their attention, and how was it with their effects on the economy.

FOREIGN DIRECT INVESTMENT INTO ACCESSION COUNTRIES

Though not exceedingly high, if compared with the FDI flows to the developed market economies or to some newly industrialized countries in Asia, the FDI to many post-Communist countries of Europe was significant. It was close zero in 1989 and US$ 5 billion in 1994, but in 1997 and 1998 the annual inflows reached US$ 18.5 and US$ 17.5 billion respectively. UNCTAD estimates that the total FDI flows in the world were US$ 644 billion in 1998 (United Nations [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 US$ 4,088 billion in 1998). United Nations [1999] statistics indicate that the FDI stocks in European post-Communist countries reached altogether US$ 83 billion at the end of 1998. That would indicate that their 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 US$ 4.5 billion 1994, US$ 8.1 billion 1996 and US$ 11.6 billion in 1998. Their FDI stock in 1998 was US$ 63 billion.

It is clear that the amount of FDI inflows depends on the stage of transformation to market-based economies. The countries (including Russian Federation, Ukraine, Belarus, Lithuania, Latvia and the Balkan countries, altogether with approximately 260 million inhabitants) have all received in 1998 US$ 5.9 billion, what makes US$ 23 of FDI flows per capita only. Their total FDI stock is estimated at US$ 23 billion. On the other hand, the most intensive FDI total absorption at the end of 1998 was in Hungary (US$ 18.3 billion), Poland

(US$ 24.8 billion) and Czech Republic (US$ 13.5 billion). These countries represent 60 million inhabitants what makes approximately US$ 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 pace for restructuring, modernization 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 the past world financial shocks, the attractiveness of many Pacific Rim countries and some Latin American countries will get under constraints. The stabilization of Germany after the shock of adjusting with Eastern Germany and the present expectations of increased German growth rates due to the implementation of a liberalized taxation scheme—these factors that could strengthen the position of Europe in the three super-power world 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 US$ 173 per capita in 1998, was already higher than what was achieved in 1998 in Latin America (US$ 145) or the world average (US$ 109)—see UN [1999].

FOREIGN DIRECT INVESTMENT INTO THE CZECH ECONOMY

The average intensity of annual volumes of Czech FDI inflows, measured as a percentage of GDP in the period 1993-1998 (converted to US$ at current 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 1991-1996 by Spain (1.4%), Portugal (2.5%—see Corado et al. [1996]) or Chile (2.5% of GDP during 1990-1995). A less satisfactory result would be received if the FDI per capita or FDI per GDP measured in purchasing power parity (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. US$ 11.2 billion) 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 US$ 5.7 billion in 1995. At that time approximately 65% of all FDI were deals negotiated with the government. After 1995 the initiative was moving to stock market and private green field 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 Czech stock of FDI at the end of 2000 is estimated to reach US$ 22 billion.

Table 1 suggests that FDI was not an exclusive foreign funding coming to the Czech economy. Long-term foreign credits, with a net contribution of over US$ 9 billion during 1990-1999, 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, (after consolidation with the negative net balance on the factor payments), amounted to US$ 23.8 billion during 1991-1999. That was more than any of the annual volumes of domestic savings in the post-Communist period.

Table 1. Review of the Czech FDI, portfolio investments, long-term credits and deposits from abroad
(in million US dollars)

Item	*Foreign financial flows*	*1990*	*1991*	*1992*	*1993*	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*1990-1999*
1	FDI annual inflows (in current US$)	49	546	1,003	653	868	2,562	1,428	1,300	2,719	5,108	16,236
2	Growth rate of FDI (previous year=100%)	—	1,114	184	57	152	297	56	91	209	188	—
3	FDI flow per capita (in US$)	4.8	53	97	55	84	250	139	127	265	498	1584
4	Cumulated FDI stock from abroad	49	595	1,598	2,251	3,119	5,681	7,109	8,409	11,128	16,236	16,236
5	FDI/GDP in current prices (in per cent)	0.09	2.25	3.54	1.80	2.18	5.05	2.52	2.50	4.88	9.63	27.4
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	—
7	Net flow of portfolio investment (liabilities-assets)	n.a.	n.a.	–23	1,600	855	1,362	726	1,086	1,069	–1,395	5,280
8	Net long-term credits (liabilities-assets)	n.a.	n.a.	215	806	1,109	3,367	3,110	407	–918	–316	9,014
9	Net short-term financial transactions	n.a.	n.a.	–1,274	56	659	971	–927	–1,687	122	–716	–2,806
10	Annual gross capital inflows (1+7+8+9)	49	546	–79	3,115	3,491	8,262	4,337	1,106	2,992	2,681	27,724
11	Current account balance	n.a.	n.a.	n.a.	456	–787	–1,369	-4,292	–3,156	–1,822	–1,058	–12,028
12	Net factor payments (inclusive dividends)	n.a.	n.a.	-560	–118	–20	–106	–723	–650	–983	–739	–3,899
13	FDI flow abroad (outgoing)	n.a.	n.a.	n.a.	–90	–120	– 37	-41	–25	–110	–197	–620

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

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 a low level of prices that did not attract investors. 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, electric machines and food industry. Agriculture, mining, metallurgy, furniture, shoe and textile industries received low attention. It is evident that the distribution of FDI was not proportional 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 a theoretical point of view, the problems of location and long-term growth have been studied most intensively by the analysis of determining factors of specialization and trade. Closely linked with it, there was the analysis of determining factors of FDI. Let us now bring more attention to these problems.

FACTOR INTENSITIES OF CZECH INTERNATIONAL TRADE

According to the neo-classical trade theories, the patterns of specialization are given by relative factor endowments and factor intensities of domestic production. The principle of relative factor endowments implies that, once a country abandons its original integration block and integrates its economy with a different set of countries, its comparative advantage in factors may change dramatically. This could have happened once the Czech economy switched in its trade alignments from COMECON to an EU partnership. Also the government interventions in a non-market (centrally planned) environment could distort the comparative advantages and lead to trade patterns inconsistent with market signals.

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. For that purpose we have adopted 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.

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 build-up 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 were 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 in industries with advanced technologies can be partially explained by 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 must decline. It was also discovered that advanced technologies have lesser space in domestic production since their engagement lacked the comparative advantages.

Table 2. The share of commodity groups classified by factor requirements in production (Q), imports (M) and exports (X) in 1993 versus 1997 (in per cent)

Commodity groups:	*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%*	

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

The most surprising finding, however, concerned the usage of the human capital. While at the beginning of transition (1990-1993) 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 human capital was rising significantly. We can interpret this finding as a message 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 (estimated from Cobb-Douglas production functions), 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 used by the mainstream of theories of industrial location and specialization.

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

Table 3. Regression coefficients from the analysis of export intensities

Statistics	*b (UE/VA)*	*b (LE/VA)*	*b (K/VA)*	*b (CR3)*	*b (TFP)*	*b (BAL)*	*b (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
R-squared: 0.940	F-statistics (probability of 0 hypothesis): 0.00						

The variable DP describing the change of nominal prices during 1991-1994 deserves 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 the new domestic prices converged to the price levels on world markets. This is also closely related with the improvements in the terms of trade and the improvements in quality. The higher the imported "inflation" in the given industry, the higher 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.

The positive relationship between the intensities of exports and inflation in industries became the statistically most significant factor from all selected variables. This finding refutes the common sense view offered by the PPP hypothesis. According to the PPP reasoning built into the concept of real exchange rate, any inflation, if it is uncompensated by nominal exchange rate depreciation, is taken as a sign of a losing competitiveness in exports. In case that the "inflation" comes from abroad as an increase in export prices, the PPP hypothesis offers a false conclusion. The increased export price may reflect an improvement in quality, image or better marketing technique. The improving terms of trade due to export price increases are also a sign that the competitiveness of exports was rising, notwithstanding the parallel real exchange rate appreciation.

The results of the mentioned estimation, based on the "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 stabilized market economies. That means, the behaviour of firms, as far as their parameters of economic efficiency were 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 that under socialist "ownership". First, it was characterized 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.

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 characterizing the comparative advantages, efficiencies and the economies of scale. The model was specified in the following way:

$$FDI_{it}/VA_{it} = a_0 + a_1*(K/L_i)_{it} + a_2*(p_{it}/L)_{it} + a_3*IRS_{it} + a_4*DP_{it} + a_5*TFP_{it} + \varepsilon_{it}$$

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 ratio (K/L), profits per labour (π/L), increasing returns to scale (IRS), the price level changes (DP) and total factor productivity (TFP). Data covered the period t = 1991, 1992, ..., 1997.

Results, based on OLS regression technique, were more than disappointing. The only statistically significant variable was the matrix of PPI deflators, as represented by DP. It seemed as if the inflows of FDI into industries behaved at random. The vast majority of variations of FDI 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 behavioural relationships behind 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]

By using the robust method of analysis we have found that there have been only very weak permanent 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 seemed to be observed a tendency for a random choice of investment ventures. It looked like a mistake to assume that investments grouped into 15 industries could reveal the causes of investments. We could presume that investments were determined at the level of firms (and not industries), especially if advantageous privatization deals could be achieved under discretionary conditions. Nevertheless, a better general observation could have been drawn even at the given level of industrial break-up.

[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].

Contrary to the findings concerning the specialization pattern of **trade** before 1997, all earlier studies of Czech FDI concluded that FDI seems to be attracted more by capital intensive production than by the labour intensive production. Most probably the stabilization of the Czech economy after 1993 and extremely high investments into capital resulted in a break in the factor comparative advantages. In late 1990s labour has not been any longer the dominant factor that offered an exclusive explanation of Czech economic (comparative) advantages. Its place has been 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 developing during 1995-1997.

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. rising profitability, total factor productivity or, increasing returns to scale) and higher competitiveness (e.g. improving 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 internalized exclusively in recipient enterprises** and the indigenous firms could fall out of the competition.

The analysis by means of the robust method of estimation finally confirmed the existence of two subpopulations of FDI in industries. The difference was not in the behaviour of the K/L variable (it was positive everywhere) but in the relationship to the efficiency variables. In the main subpopulation the FDI was targeting industries where there was high profitability per labour and high total factor productivity. These were industries successful from the very start. The complementary subpopulation of industries contained industries that were not very profitable. However, they revealed a potential in the increasing returns to scale and also its prices were rising fast. By separating the original sample of industries into two groups the coefficient of determination increased from 0.16 to 0.55-0.64. We could see that the FDI was industrially determined (though not completely). Also the economic parameters of industries mattered, though we could not find uniform determining factors for all industries at the same time.

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 foreign-owned enterprises will become the decisive actors in the Czech economy in approximately the year 2003. This will be a final closure of the "Czech way" of privatization that dominated the domestic economic policy-making during 1990-1996. It is already evident that the privatization strategies, that were set for supporting the indigenous (national) ownership, have failed in the majority of such objectives. It was generally believed in the local political circles that the prescriptions for bringing a transient economy into a high growth and prosperity pivot around the macroeconomic stabilization, liberalization of trade and prices, and privatization defined as a de-etatization (i.e. the release of the capital assets out of the hands of the State). While the

Czech macroeconomic policy was relatively successful throughout 1990-1996, the misconceived and poorly implemented privatization brought an extremely heavy price on the whole economy.

Czech approach to privatization was based on the belief that any initial de-etatization (redistribution) of property was a sufficient condition for finding final owners guaranteeing an optimal exploitation 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 was supported by political objectives that brought transaction costs to a low level both in *(a)* acquiring the liquidity and in *(b)* the equity trading. That was why the banks were not privatized and the existence of three parallel stock exchanges was promulgated.

Nevertheless, it was somehow forgotten that there were two additional essential economic conditions: *(c)* property rights should be clearly defined and enforceable; *(d)* capital markets should be efficient.

Once the preference of economic actors for re-distribution of property over its restructuring was eminent, the enforcement of these two latter conditions lacked public support. Thus conditions *(c)* and *(d)* were **not** satisfied from the very start, what negatively influenced the microeconomic decision-making. The interaction of economic players became biased towards soft credits, debts and heavy government bailouts. The fast growing credits granted by banks lead to moral hazard and enormous growth in non-performing debts. The unregulated trading of equity at three isolated stock exchanges was heading to frauds and abuse of minority shareholders.

The crucial importance of the Government throughout the process of Czech privatization caused that the capital markets were not developed and the whole privatization 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, especially if compared with an easy alternative represented by asset stripping. A large part of the indigenous firms (i.e. their managers or owners) even switched in their objectives from redistributional aims to destructive aims.

As the Government was too heavily involved in the privatization, 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 privatization of banks, the introduction of strict bankruptcy laws and the state supervision over the capital markets would be a threat to the stability of the Government. As a result, the dependency of the economy on injections from the side of easy monetary policy was sharply rising, though it was clear already in 1996 that the bubble would have to burst in the future. As the hidden microeconomic pressures were rising, the politics became less willing for a change at the level of macroeconomics. Thus the macroeconomic global revamping was constantly postponed until the out-break 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 now undisputed 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) have not been the decisive factor behind the acceleration of FDI inflows since 1999.[5] What also mattered was the stabilization of the economy after 1999, prospects of future growth, quality of the labour market and the Czech geography where the advantages of a periphery were 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. A short review of these reforms is presented in the supplement to this paper.

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[5]The annual inflows of FDI were US$ 2.7 billion in 1998, US$ 5.1 in 1999 and the forecast for 2000 is US$ 6 billion. As an illustration, let us look at the case of Philips investment into household electronics production at Hranice (North Moravia). The plant will be built in 2001 as a replacement of capacities relocated from Wales (GB) due to rising labour costs and appreciating Sterling relative to Euro. The FDI commitments are US$ 200 million in 2001 with an extension to US$ 600 million in the second stage of development. The incentives represented an injection of US$ 40 million mediated by the Czech government which comprised 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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APPENDIX: LIST OF MAIN PENDING AND/OR PROPOSED REFORMS CHALLENGING THE CZECH TRANSITION

This part of the paper is normative and relates only loosely to the previous analysis in this study.

Though the Czech society has passed through enormous changes in the period 1990-2000, many reforms were not completed and some of them were even detrimental to the development. There is still pending a vast list of further 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 addressed and some pending reforms will be even soon introduced.

Nevertheless, it is easy to see that the transition will attenuate only slowly. The opposition to many changes is very strong. So, even though there could be a social consensus about many changes, their implementation could lead to unexpected and unintended results that reflect the vested interests. Therefore we should expect that many reforms will have to be implemented in several steps, some of them contrary to each other.

- 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 have shown that parties at the right from the centre have been gaining more power and the pendulum of power may again strike even firmer to the right.
- 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 cooperation. This can be called a **moral revival** of the society that can be associated with the changes in the political structures.
- 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.
- The past attempts to **re-vitalize** 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.
- 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 cooperative pragmatic attitude.
- 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 public opinion is opposing it.

- A new wave of a **real privatization** (mostly by foreign owners) will continue and redress the fatal errors of the voucher privatization, which led to dispersed ownership and weak corporate governance.
- The **privatization of banks** should improve the functioning of the **financial market**, helping thus transfer the large fund of savings available into efficient investments.
- 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**.
- The system of **taxation** is inefficient and the tax evasion should be eliminated. The burden of the tax quota should be reduced to approximately 40% or even 35% of the GDP.
- 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 1993-1996.
- 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 the Czech Republic may be delayed from the entry.
- The **regional administration**, included in the constitution since 1993, is due to be established in 2001-2002.
- The principles and the organization of the **public service** are undergoing a process of overhauling and the present practice will be soon regulated by a new law.
- The number of employees in the public sector should be substantially decreased (e.g. by 30%) so that the **power of bureaucracy** be reduced.
- 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 they were in the past.
- The **price deregulation** in energy, fuels and some government services should be speeded up.
- The **prices of housing and land** should be deregulated so that a normal market in real estates can be established.
- 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 segmented **privatization** leading to breaking-up of monopolies.
- The **health system and the health insurance** need a global change that would increase their efficiency, as their system of financing and incentives was neglected and delayed for long.
- 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).
- The reform of **basic and secondary education** should be quickly initiated because these schools fail in providing the necessary skills required in globalized societies.
- 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 a more open approach introduced.
- 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.

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

What Exists is Possible: FDI Prospects and Policies in Bulgaria

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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 a set of policies, which eventually offset the negative developments of 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 shocks. In the post 1997 period, 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, the 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 the circumstances through increased FDI after 1998.

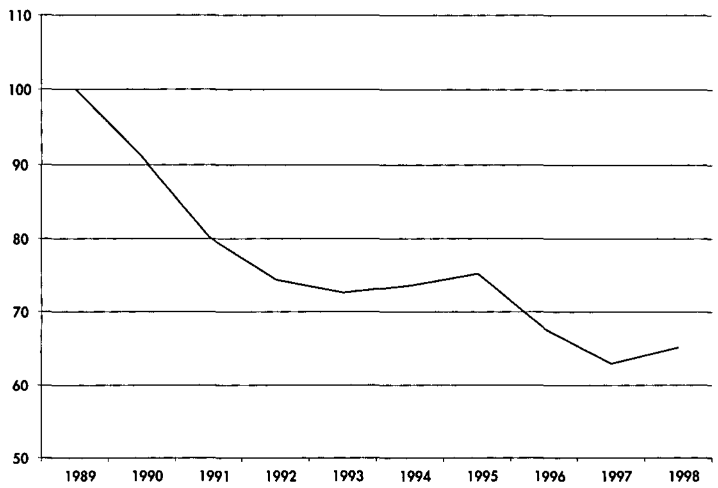
MISMANAGEMENT OF REFORMS (1990-1997)

After 1989, there was only four years registered growth in real GDP. In 1994-1995 growth was modest but fuelled by indebtedness of the state owned enterprises, quasi-fiscal subsidies and international conjecture. It re-emerges 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.

GROWTH FACTORS IN 2000

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

Figure I. Real GDP Index
(1989 = 100)



Source: NSI, IME calculations

Table 1. 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	

Source: NSI

Table 1 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 this sort for ten years. The big question mark, however, is whether it marks a beginning of a trend or is it 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 the early reform years).

Table 2. 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

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

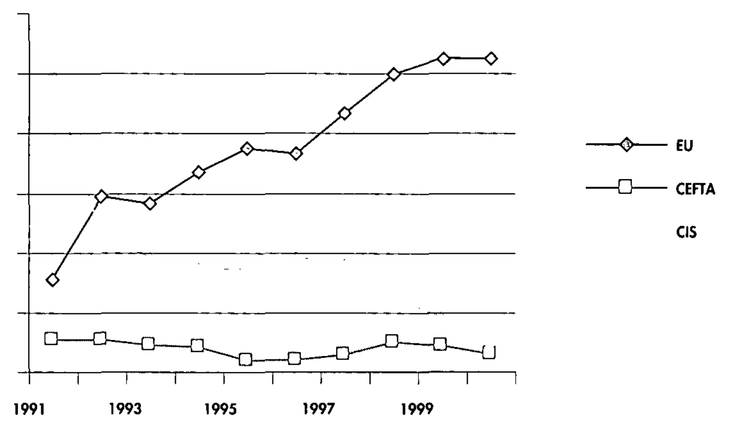
Growth trend seems to be reversed. Investment is steadily higher in the last three years than in the previous period. Foreign investment is higher than in years before 1998 but still unused factor. Institutional background was also providing for greater government discretion, which allow eventually to 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 favourable in 1998-2000 period, than they could be at early years of transition.

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 and then, at the eve of dissolution CMEA, seek other markets. Bulgaria's starting point of reforms was significantly worse than that of other emerging economies. Also, Bulgaria lost markets in Iraq, Libyan Arab Jamahiriya, and Islamic Republic of Iran. Sanctions against Iraq and Libyan Arab Jamahiriya blocked US$ 2 billion of their debts to Bulgaria.[1]

[1]It happened simultaneously with the default on foreign debt payment in March 1990, announced unilaterally by the 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. The elected new 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.

Figure II. Geographical distribution of the Bulgarian exports (percentage)



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

WHAT EXISTS 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 breakthrough after the crisis of 1996-1997, Bulgaria attracted US$ 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 were only three countries: Latvia, Slovenia and Cyprus.

Table 3. Bulgaria's share in global FDI flows*

Country	*FDI in US$ millions*	*Population millions*	*Share of world population %*	*Share of global FDI %*	*FDI per capita*	*FDI/ Population ratio*	*Percentile rank*
Singapore	10,326	3,164	0.05	0.78	3,264,20	14.43	95
Ireland	4,038	3,705	0.06	0.30	1,089,88	4.82	88
Spain	32,539	39,371	0.67	2.45	826,47	3.65	83
Czech Republic	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
Former Yugoslav Republic of Macedonia	118	2,010	0.03	0.01	58,51	0.26	42
Bulgaria	401	8,257	0.14	0.03	48,61	0.21	37

Source: World Development Indicators, JAA calculations

*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 US$ 620 million.

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.

The development is the following. In 1998, FDI's as percentage 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.[2] On the SEE scene similar is the performance of Croatia and Romania.[3] An interesting development is that of

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

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

the Italian investment. Italy used to be a prime trade partner for the last ten years, but in terms of direct investment has been bottom of the list with only US$ 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.[4] As of the end of 2000, Germany, Belgium and Italy would amount to over 40% of the investment in Bulgaria.

Table 4. FDI by source and year for 1992-2001**

Year	*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

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

Earlier foreign investors, like Belgium based Solvey and Union Miniere, have bought respectively a 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 sustain exports without relying on quasi-fiscal transfers. Similar developments have taken place in the textile and knitwear industry.

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 percentage 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.

[4]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 year 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 textiles.

Table 5. Indicators of foreign direct investment in SEE economies, 1998-1999
(in million US dollars)

	FDI										*Cumulative*	
Country	*Inflow*		*FDI abroad*		*Net*		*Inflow per capita*		*% of GDP*		*USD*	*Per capita*
Country	*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
Bosnia and Herzegovina	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	1,290	195	298	4.0	6.6	3,552	793
Romania	2,031	961	9	-12	2,040	949	90	43	4.9	2.8	5,441	243
Former Yugoslav Republic of Macedonia	118	40	—	—	118	40	59	20	3.4	1.1	217	108

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 the peculiar history of FDI suggests that for the government there is limited space to manoeuvre relying predominantly on domestic savings and investment. *Even in the 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 the otherwise unfortunate fact that in 1998 and 1999 a 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 avoid 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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EVALUATION OF THE PERFORMANCE OF FDI OVER THE PAST 10 YEARS

During the period 1990-2000 (August) FDI in Romania reached the level of US$ 4.89 billion, an additional US$ 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 on separately.

The level of FDI stock in Romania is definitely much lower than in some other countries in the area[1] (Poland—US$ 30 billion; Hungary—US$ 19 billion; Czech Republic—US$ 16 billion; data for the end of 1999). At the same time, the level is also low in relation to the economic potential 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 US$ 3 million per month—that is much less than 1991 levels).

[1]World Investment Report 2000—Cross Border Mergers and Acquisitions and Development, UNCTAD, New York and Geneva, 2000, Chapter II—Regional Trends, p.64

Table 1. Evolution of setting-up companies with foreign participation December 1990-August 2000

	Number of companies with foreign investment		*Total of amount of registered capital*		*Of which: in convertible currency*	
Year	*No.*	*%*	*million lei*	*%*	*thousands $U.S.*	*%*
1991	6,326	8.2	15,758,641.7	25.9	779,610.6	15.9
1992	12,194	15.9	3,287,315.7	5.4	377,249.5	7.7
1993	10,793	14	3,207,886.3	5.3	417,434.2	8.5

Table 1. *(continued)*

	Number of companies with foreign investment		Total of amount of registered capital		Of which: in convertible currency	
Year	*No.*	*%*	*million lei*	*%*	*thousands $U.S.*	*%*
1994	11,521	15	5,874,128	9.7	913,472.7	18.6
1995	3,795	4.9	1,917,121.5	3.2	245,961.4	5
1996	4,056	5.3	7,986,439.6	13.1	738,908.2	15.1
1997	5,752	7.5	6,588,024.8	10.8	484,684.3	9.9
1998	9,114	11.8	5,287,596	8.7	344,845	7
1999	7,862	10.2	6,866,085	11.3	393,135.9	8
2000	5,518	7.2	402,592	6.6	202,841.7	4.1
Total	76,931	100	60,797,830.8	100	4,898,143.5	100

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

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).

Table 2. Actual cashed amounts in privatization 1993-2000

Year/Currency	*CHF*	*DEM*	*ITL*	*US$*
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
Total by currency	132,779.38	26,677,274.12	382,943,165	1,099,587,332.13

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 ofprivatization contracts has beenof US$2.216 billion. The data above refer to amounts that were effectively paid in the privatization process.

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 labour;
- association with European Union and strong NATO support.

The **negatives** referred to:

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

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 affected by negative international circumstances (such as 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:

- **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 from positive discrimination (more incentives than local investors), automatic registration of investment in case no official answer to the request for investment was 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 unmountable 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 US$ 33.1 million.

- **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, a 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 that 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 a result of the growing poverty of the population.
  During the period 1997-1999 the GDP declined by more than 14%, an unusual reduction during peace times, a 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.

EVALUATION OF FDI POLICY AND ITS IMPLEMENTATION PROCESS

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

GENERAL COMMENTS

The attractivity of Romania for FDI has been negatively affected by a number of aspects related to the evolution of the 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 established a number of priorities in the development 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 was 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 rhythm 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 possibility 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 assessments 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 down-**

[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

grading 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 disappearance 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.

THE INSUFFICIENT INTERNATIONAL PROMOTION OF THE 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 1999 of 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.

LEGAL ASPECTS 1991-1996: A EUROPEAN BEGINNING

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

However, Romania did not start from zero in this complex domain of activity, having 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 beginning towards international circles was the wish of Romania to attract foreign investments was represented by the publishing in 1992 of a Statement by the Romanian Government regarding the support, encouragement and guarantee of foreign investment.

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

What made the 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 as an institution specific to the market economy, being completely harmonized with the legislation and practices of the European Union.

Thus, the organization of the Romanian Development Agency was initially based on the support from the British Know How Fund and then, in the medium term, from the European Union PHARE Programme. This support 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.

ACHIEVEMENTS AND INTERNATIONAL RECOGNITION DURING 1991-1996

Among others, Romanian Development Agency was the first government institution in Romania to publish an annual report starting 1991, the first government institution 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, investment 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 institution, 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 site 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.

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.);
- supply of complex consulting services for potential foreign investors, services that could include organizing of site visits to government and non-government institu-

tions, 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 analyses 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 1 January, 1995;
- directly supporting the foreign investor through Romanian Development Agency in its approach for setting up a company in Romania by:
  - providing complete 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.

1997-2000: LEGAL UNCERTAINTY, POLICY AND INSTITUTIONAL CHANGE

The Romanian governments after 1997 have kept a strange silence on the FDI subject. Apart from 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 six years, was replaced by the

Emergency Ordinance no 31/1997. This Ordinance could not be enforced because its application norms were enacted only on 29 December, 1997. At the same date, 29 December, 1997, the institution nominated to implement the Emergency Ordinance no. 31/1997 (Romanian Development Agency) was abolished.

One day later, on 30 December, 1997 was issued Emergency Ordinance no. 92/1997 regarding the stimulation of direct investment. This Ordinance introduced 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 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 five years (a rather unusual provision), only three 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 1 January, 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 five 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 US$ 50 million. Only one month later, in June 1999, Government Decision no. 519 established (following discussions with the International Monetary Fund) an 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]Dr. Costea Munteanu, From recession to growth through FDI, International Center for Entrepreneurial Studies in Bucharest, November 1999

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 US$ 500,000 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 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.

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 access 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 their privatization process. In the transition economies in which the level of FDI is high took place during 1994-1996 privatization 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 characteristics of the Romanian economy during the 1990s: a transition economy, with an internal market of 22.5 million inhabitants (second largest in the area) with a low and diminishing purchasing power, the existence of a high industrial potential 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.

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%.

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 (aeroplanes, helicopters), shipbuilding, oil extraction equipment, chemistry, textile, furniture and wood processing, etc.

After a decade, the analysis 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.

PROSPECTS FOR THE NEAR FUTURE

On 26 November, 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 forthcoming after the elections depends upon 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.

Strategy of the Slovak Government to Support the Influx of Foreign Direct Investment

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Slovakia

INTRODUCTION

The new Slovak government is fully aware of the importance of FDI and realises what kind of entrepreneurial environment it has to create in order to attract needed investment. First of all, it is necessary to create stability and trustworthiness. At present, the Slovak government is adopting explicit and specific measures aimed at decreasing the fiscal deficit, which is the most important precondition for macro-economic stabilization. At the same time incentives, supporting the restructuring of the economy—primarily the decrease of the tax burden—are being introduced.

GOVERNMENTAL STRATEGY FOR SUPPORT OF FDI

The Slovak government prepared a "Strategy for Support of Foreign Direct Investment Inflow" which was fully endorsed on 9 March, 1999. The government's strategy also features a range of measures and activities that include:

- Stabilization of Slovakia's legal system and its EU approximation
- Company and Penal Codes are being amended to minimize risks to the foreign investor
- Amendments to Income Tax Act bringing law into line with EU norms
- Convergence of VAT and other indirect taxes with EU norms
- Establishment of legal framework regulating activities of natural monopolies
- Conclusion of bilateral treaties on investment support and protection primarily with strategic investor countries
- Accelerating company registration process
- Preparation of legislative framework regulating the establishment of industrial parks and special economic zones

- Stipulation an acceleration of the settlement of property relations on sites

INVESTMENT CLIMATE IN THE SLOVAK REPUBLIC

Slovakia offers the following to the investor:

- Most importantly Slovakia wants and welcomes foreign inward investment
- A well qualified work force, with a high percentage of university graduates
- A precision engineering and manufacturing tradition
- Duty Free and VAT Free import of new machinery
- As an Associate Member of the European Union, Slovak industrial goods have free access to the European market
- Excellent industrial relations responsive to modern management techniques
- Low labour costs
- A first rate location to support traditional trading ties with the developing economies to the East, including the former Soviet Union providing a low cost base for supplying the EU
- First class road and river communications to market areas
- A stable macro-economic environment within Eastern Europe based upon low per capita foreign indebtedness and a stable currency
- Up to 100% company ownership
- Up to 100% repatriation in hard currency of all post tax profits
- Liberal regulations permitting importation of goods and components used in further production process Double taxation and Investment protection agreements
- Possibility of financial support from local authorities in selected regions when the entrepreneur creates new job opportunities for registered unemployed.

STATISTICS

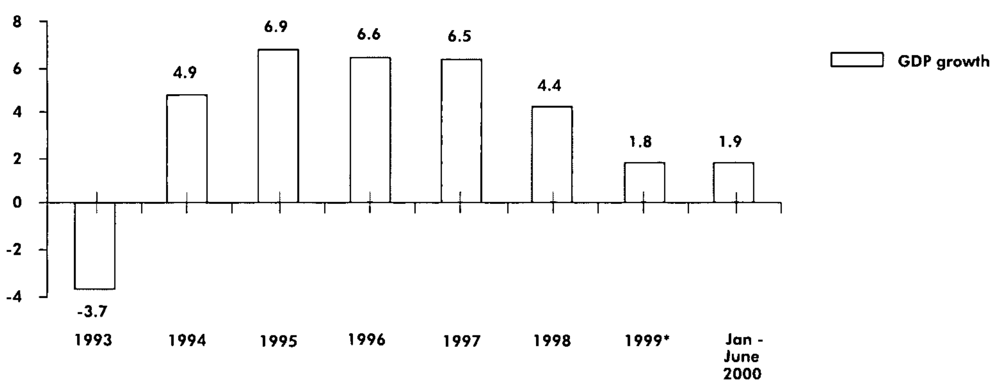
FOREIGN CAPITAL IN SLOVAKIA 2000

Table 1. Volume of FDI in Slovakia at 30 June

	Corporate sector		*Banking sector*		*Total*	
	million US$	*%*	*million US$*	*%*	*million US$*	*%*
Total volume of foreign capital	1,828.4	100.0	315.4	100.0	2,143.8	100.0
Structure of capital by investor						
Germany	428.5	23.4	45.4	14.4	473.9	22.1
Austria	348.9	19.1	86.1	27.3	435.0	20.3
Netherlands	260.3	14.2	57.9	18.4	318.2	14.8
United States	227.2	12.4	36.6	11.6	263.8	12.3
Czech Republic	118.6	6.5	57.9	18.4	176.5	8.2
United Kingdom	120.0	6.6	8.1	2.6	128.1	6.0
France	75.4	4.1	9.9	3.1	85.3	4.0
Italy	38.0	2.1	7.8	2.5	45.8	2.1
Hungary	30.4	1.7	0.0	0.0	30.4	1.4
Cyprus	28.3	1.5	0.3	0.1	28.6	1.3
Other countries	152.9	8.4	5.2	1.6	158.1	7.4
Total	1,828.4	100.0	315.4	100.0	2,143.8	100.0

Structure of capital by sector						
Agriculture, hunting and forestry	3.2	0.2	0.0	0.0	3.2	0.1
Mining and quarrying	24.6	1.3	0.0	0.0	24.6	1.1
Manufacturing	1,053.9	57.6	0.0	0.0	1,053.9	49.2
Electricity, gas and water supply	9.5	0.5	0.0	0.0	9.5	0.4
Construction	39.9	2.2	0.0	0.0	39.9	1.9
Wholesale and retail trade, repairs of motor vehicles	417.6	22.8	0.0	0.0	417.6	19.5
Hotels and restaurants	24.8	1.4	0.0	0.0	24.8	1.2
Transport, storage and communication	68.4	3.7	0.0	0.0	68.4	3.2
Financial intermediation	105.8	5.8	315.4	100.0	421.2	19.6
Real estate, renting and business activities	69.8	3.8	0.0	0.0	69.8	3.3
Health and social work						
Other community, social and personal service activities	10.5	0.6	0.0	0.0	10.5	0.5
Total	1,828.4	100.0	315.4	100.0	2,143.8	100.0
Structure of capital by regions						
Bratislava region	978.5	53.5	315.4	100.0	1,293.9	60.4
Trnava region	203.2	11.1	0.0	0.0	203.2	9.5
Trenčín region	130.7	7.1	0.0	0.0	130.7	6.1
Nitra region	81.8	4.5	0.0	0.0	81.8	3.8
Žilina region	64.1	3.5	0.0	0.0	64.1	3.0
Banská Bystrica region	96.0	5.3	0.0	0.0	96.0	4.5
Prešov region	73.2	4.0	0.0	0.0	73.2	3.4
Košice region	200.9	11.0	0.0	0.0	200.9	9.4
Total	1,828.4	100.0	315.4	100.0	2,143.8	100.0

Figure I. GDP growth between 1993 and 2000



Source: Statistical Office

Table 2. Gross Domestic Product in SKK billion

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
GDP at current prices	369.9	440.5	516.8	575.7	653.9	717.4
GDP at constant prices	461.4	483.4	516.8	550.8	586.8	612.7

	1999	*1st half of 2000*
GDP at current prices	779.3	429.3
GDP at constant prices	624.5	327.9

Table 2. *(continued)*

	1993	*1994*	*1995*	*1996*	*1997*	*1998*
GDP growth in %	–3.7	4.9	6.9	6.6	6.5	4.4

	1999	*1st half of 2000*
GDP growth in %	1.9	1.9

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*1st half of 2000*
Private sector Share in GDP	39.0%	58.2%	65.6%	76.8%	82.6%	82.4%	84.3%	83%

Demography

Population as of year 1999:
Total: 5,398,657
of which females: 2,773,531

Population structure

Pre-productive age: 22.3 %
(aged: from 0 to 14 year)
Productive age: 59.2 %
(from 15 to 59 years old men, from 15 to 54 years old female)
Post-productive age: 18.5 %
(60 and more years old men, 55 and more old female)

Economic activity rate in %: 59.7

Breakdown of working population by education

Primary education: 10.4 %
Trained: 31.3
Secondary education: 45.7 %
University: 12.6 %

Table 3. Wages (SKK)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*Mid 2000*
Average monthly wage	5,379	6,294	7,195	8,154	9,226	10,003	10,728	10,863
Average monthly wage in industry	5,523	6,501	7,492	8,583	11,058	11,533	11,107	11,563
Average monthly wage in construction	5,617	6,530	7,503	8,737	12,301	10,795	9,899	9,912
Average monthly wage in transport	5,461	6,561	7,733	8,865	10,803	10,228	10,750	11,608

Table 4. Foreign Trade (billion SKK)

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*Mid 2000*
Total Export	168.1	214.4	255.1	270.6	295.6	377.8	422.3	258.4
Total Import	195.0	211.8	260.8	340.9	394.0	460.7	468.0	268.5
Trade Balance	–26.9	2.6	–5.7	–70.3	–49.5	–82.9	–45.7	–10.1

Table 5. Industry

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*Mid 2000*
Industrial production (billion SKK)	362.6	413.3	497.2	531.8	567.7	619.6	670.2	369.6
of that private sector companies (billion SKK)	109.0	237.8	321.4	362.8	415.3	483.6	529.1	282.6
Private sector share in industrial production (%)	30.1	57.5	64.6	68.2	73.2	78.1	79.3	76.5

Table 6. Construction

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*Mid 2000*
Construction production (billion SKK)	44.3	45.8	51.5	62.0	74.1	77.6	63.9	29.0
of that private sector companies (billion SKK))	23.6	34.0	42.2	51.6	61.0	64.9	58.6	28.8
Private sector share in in construction production (%)	53.2	74.2	81.8	83.2	82.2	83.7	91.5	99.4

Table 7. Domestic trade

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*	*Mid 2000*
Retail sales at current prices (billion SKK)	202.1	233.8	262.1	296.4	328.8	379.4	442.1	225.2
of that in the private sector (billion SKK)	163.6	206.9	240.3	280.4	315.2	367.3	422.3	220.8
share of private sector in total retail sales (%)	80.9	88.5	91.7	94.6	95.9	96.8	99.5	98.1

INCENTIVES FOR FOREIGN INVESTMENT

TAX RELIEVES AND DECLARATION OF THE GOVERNMENT OF SLOVAK

Import regulations depend on the kind of goods and materials. According to the association agreement with EU, the import duty with EU countries will be on zero level to the date 1 January, 2001.

- Tax relieves for foreign companies investing in Slovakia
- Declaration of the Government of Slovak Republic on support of foreign investment
- Duty free and VAT free import of new machinery equipment
- There is a possibility of getting grants in the case of new job creation

Figure II. Unemployment rate beteween 1995 and the first half of the year 2000 (percentage)

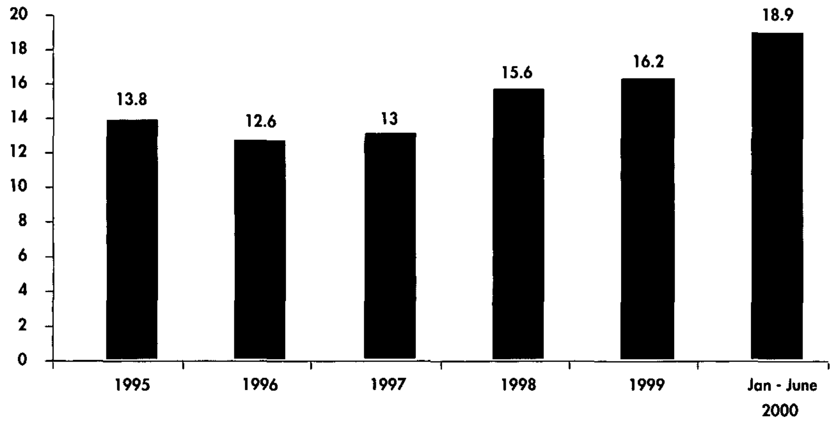
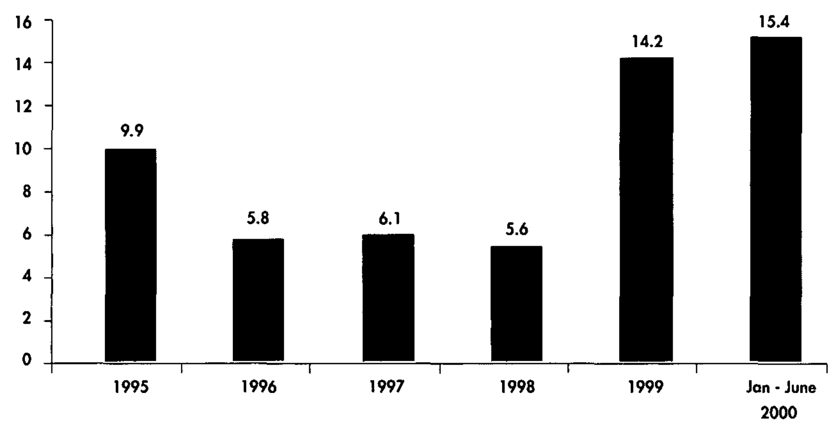


Figure III. Inflation rate between 1995 and the first half of the year 2000 (percentage)



Source: NBS

DECLARATION OF THE GOVERNMENT OF SLOVAKIA ON SUPPORT OF FOREIGN INVESTMENT

The Government of Slovakia, in line with the goals of its economic policy aimed at the strengthening of structural reform process, is determined to increase trust of foreign investors in the legal and regulatory framework of foreign direct investment, and declares, hence, its determined interest to support all kinds and forms of foreign direct investment inflow to Slovak economy.

The Government of Slovakia endeavours to complete the privatization process and transfer all of its equity interests into private ownership. Pursuing this goal, The Government is determined to incite active participation of foreign investors in the privatization process and ensure that foreign investors will have an access to privatization programmes on the basis of foreseeable and transparent rules and regulations. National treatment principle shall be used at every stage of privatization process including the sale of share by The Fund in the future.

Foreign direct investment policy will be fully in line with principles of transparency, non-discrimination and national treatment contained in OECD documents with the reserve to liberalization codes of OECD and with the exception to the OECD national treatment instrument, which can be applied by Slovakia during the accession process and which will be accepted by OECD.

The Government of Slovakia welcomes the progress in negotiations aimed at the formation of broad multilateral framework for foreign investment with the high level of liberalization and protection of investment flows and efficient dispute-solving mechanism.

The Government of Slovakia declares its intention to act as a founding member of The Multilateral Agreement on Investment and declares, hence, its interest to achieve full membership in the negotiating group.

TAX CREDIT

Taxpayer for the corporate income tax with the corporate domicile on the territory of Slovakia which has been established until 31 December, 2002, shall be granted reduction of the tax declared in the tax return (hereinafter referred to as "tax credit") in the amount of 100% of the respective tax for five consecutive taxation periods, starting with the taxation period in which the tax base and tax was first declared, if:

(a) the respective taxpayer is a company whose value of paid-up cash contribution into registered capital, as of 31 December of the first year the tax credit applies, is at least:

- i) EUR 5,000.000 and the subject of the business is manufacture of goods, which were imported to the territory of the Slovak Republic prior to the incorporation of the tax contributor drawing the tax credit and which were not manufactured or are manufactured for their exportation.
- ii) EUR 2,000.000 and the subject of the business is production, if at the same time, the corporate domicile and place of company's business is on the territory of district with unemployment rate exceeding 15%, as of 31 December of the year preceding the year of company's establishment
- iii) EUR 1,500.000 and subject of the business are provision of selected services (tourism, system programming services and user program tools, application software programming services)

(b) the share of paid-up contribution of the foreign person from foreign sources in registered capital of the company is at least 75% for the whole period of tax credit drawing.

(c) while revenues generated from those activities represent at least 60% of the overall revenues of the taxpayer.

(d) taxpayer that has drawn the tax credit shall be obligated to use the resources gained by tax credit in order to acquire tangible and intangible assets those serve his line of business.

The tax contributor may claim the tax credit every year in the tax return proceeding in accordance with special legislation. The tax return shall be filed by 30 June of the year following the fiscal year with respect to which the tax credit was claimed.

FURTHER DRAWING OF THE TAX CREDIT AT LEAST IN THE VOLUME OF HALF TAX

Taxpayer may for five consecutive taxation periods draw an additional tax credit in the amount of 50% of the tax declared in the tax return, if he increases company´s registered capital by cash contributions or material contributions from foreign sources to the sum at least:

(a) EUR 5,000.000 in the case the subject of the business is manufacture of goods, which were imported to the territory of the Slovak Republic prior to the incorporation of the tax contributor drawing the tax credit and which were not manufactured or are manufactured for their exportation

(b) EUR 2,500.000 in the case the subject of the business is production, if at the same time, the corporate domicile and place of company's business is on the territory of district with unemployment rate exceeding 15%, as of 31 December of the year preceding the year of company's establishment

FINANCIAL CONTRIBUTION FOR EMPLOYEES

EMPLOYMENT SUPPORT SCHEME

A company may qualify for a grant to help cover wage costs, social security payments, accommodation of staff, boarding and the costs of transportation. This assistance is discretionary and is negotiated on case-by-case basis with the Regional Labour Office. This support could be provided to entrepreneurs in two ways:

Returnable contribution (negotiated with Regional Labour Office)

Returnable contributions may be granted as a support of a business project supporting employment to entrepreneurs created minimally 100 new jobs or lowered unemployment with minimally 300 employees and can cover:

Wages or salaries, healthcare and social insurance, retirement scheme, Employment Fund,

accommodation, boarding and travelling costs and loan interests.

Non-returnable contributions (negotiated with District Labour Office)

Non-returnable contributions may be granted to the employer in the period of 12 month and can cover:

Wages or salaries, healthcare and social insurance, retirement scheme, Employment Fund,

Accommodation, boarding and travelling costs.

Above mentioned support is provided by the way of contributions made to employers for jobs created and engaged with registered unemployed citizens or fresh graduates and citizens of minor age or citizens above 50 years of age.

A decision about the level of support is the responsibility of the board of directors of the District/Regional Labour Office.

ZERO IMPORT DUTY AND THE ABOLITION OF VAT

The exemption of import duty is applicable on import of machinery and equipment specified in Customs Code:

1. Parts HS 84 and HS 85 in accordance with the Europe Unions Harmonised Duty System
2. Parameters of machinery and equipment secure high technical-economical level of the products or production of high quality goods.
3. Total customs value of imported machinery and equipment has to be minimum 5 000 000,- SKK.
4. The import of the machinery and equipment will be finished within 3 years.
5. Machinery and equipment will be owned minimum 3 years by importer.

TAX STRUCTURE

The taxation framework in Slovakia builds on the following types of taxes: *(a)* Direct taxes; *(b)* Indirect taxes.

DIRECT TAXES

Income tax :

(a) personal income tax—the tax rate is determined according to the income and is from 12% to 42%

(b) corporate tax—the tax rate is 29%.

Companies, which were incorporated prior to or on December 2002, can get tax credit (see incentives for foreign investors)

Road tax—the tax rate is:

- in the case of passenger cars used for business the tax is from 1,600,- to 5,600,- SKK/ per year/
- in the case of trucks, busses with one or two axles the tax is from 1,800,- to 63,800,- SKK/
- in the case of other vehicles with three or more axles the tax is from 14,600,- to 61,200,- SKK/per year.

Real estate tax

(a) tax on land—from 0.50 SKK/m^2 to 11.60 SKK/m^2 according to its fertility

(b) tax on buildings/structures—1.0-10.0 SKK/m^2/year + 0.75 SKK for each additional store multiplied by coefficient, coefficient ranges from 1 to 4.5,/1 for smallest villages and 4.5 for Bratislava.

Inheritance tax, gift tax and tax on the transfer of real estate

INDIRECT TAXES

Value added tax

- VAT Goods 10-23%
- VAT Services 10-23%

Excise duties, including:

- excise duty on hydrocarbon fuels and lubricants
- excise duty on alcohol and spirits
- excise duty on beer
- excise duty on wine
- excise duty on tobacco-based products

LABOUR CODE

RELATION BETWEEN EMPLOYEES AND EMPLOYERS LABOUR LEGISLATION

The key law governing employment is the Labour Code. Under this code, all employers in the Slovak Republic are obliged to conclude written employment contracts with their employees. The employment contract usually covers matters such as the gross monthly wage and the length of the trial period (up to three months). Employment contracts can be concluded for limited or unlimited periods.

The unlimited employment contract may be terminated as follows:

- by agreement
- by notice
- immediate cancellation
- cancellation in the course of the trial period Cancellation by agreement must be documented in writing and include the reason for cancellation.

Either the company or the employee may cancel a contract by providing written notice. The employee is permitted to give a minimum of two months notice with no reason specified. Where notice is given by the company to the employee one of the following reasons must be supplied:

- The company (or a part of the company) is disbanded or transferred by government order.
- The company ceases its activity or a part of the company is transferred to another company, which is not able to provide job for the employee.
- The employee is not able to work for long-term health reasons.
- The employee does not meet the preconditions for the job.
- Other serious reasons e.g. substantial restructuring of the company.

The notice period for reasons 1-3 is three months, for reasons 4-5 it is two months. Furthermore the company can cancel the employment contract immediately if:

- the employee is convicted of a crime
- the employee continually disrupts normal working discipline.

The maximum working time in one week is 43 hours. However the usual weekly working time is 42.5 hours, which includes half an hour for lunch and rest each day. Employees may not work more than 8 hours overtime per week, with maximum of 150 hours per annum. Remuneration for overtime, which may consist of granting additional time off or the payment of additional wages (for example 100% more for Sundays), may be agreed between the employee and the employer. Some companies permit flexibility in working hours for certain days of the week. During these days the employee must work what is called essential working hours of not less than five hours per day.

The minimum annual holiday is four weeks. Any employee who has worked for 15 years or more is entitled to five-week annual holiday. Many employers, including state administration, are now extending this period by another one week. The Labour Code also specifies the length of maternity leave which is 28 weeks (37 weeks if mother is single or gives birth to more than one child). If the mother requests it, the employer is obliged to grant her additional maternity leave until her child reaches the age of three. During maternity leave and additional maternity leave the mother does not have the right to wages but receives sickness benefits. Similarly, employees who are sick are given unpaid time off by the employer and their material security is covered by sickness benefits.

Men are entitled to retirement pension when they reach 60 years of age, while women can retire earlier, at between 53-57 years of age depending on the number of children.

Sickness insurance, pension insurance, health security, unemployment fund and social fund.

The employer covers insurance payments totalling 38.6 % of the assessment base of his employees. The employee is obliged to make insurance payments amounting to 12% of his assessment base.

Table 8. Insurance rates

Insurance rates (per cent)	*Employer (per cent)*	*Employee (per cent)*	*Self employed person (per cent)*
Sickness insurance	3.4	1.4	5.8
Pension insurance	21.6	5.9	26.5
Health security	10.0	3.7	13.7
Unemployment fund	3.0	1.0	4.0
Social fund	0.6	—	—
Total	38.6	12.0	50.0

Structure of average wages of employees in the economy of the Slovak Republic (Sampling survey on labour costs):

Table 9. Average wage of employees

	Average gross monthly wages*		Employer contribution 38.6% (in US$)	Total costs (in US$)
	SKK	US$		
Unskilled Operator	6,323	152	58.7	210.7
Skilled Worker	8,754	210.5	81.2	291.7
Technician	10,474	251.8	97.2	349.0
	12,804	308.5	119.1	427.6
Engineer	13,000	312.6	120.7	433.3
Middle Manager	15,000	360.7	139.2	499.9
Senior Manager	17,150	412.4	159.2	571.6
Bookkeepers	9,184	220.8	85.2	306.-0
Administrative associate professionals	8,348	200.7	77.5	278.2

Note: Exchange rate as of 11 November, 1999: 1 US$ = 41.59 SKK
*As of October 1999

EDUCATION AND SCHOOL STRUCTURE

Education

Grammar schools:

schools: 198
students: 80,116
school-leavers in the last school year: 16,098

Secondary vocational schools:

schools: 365
students: 116,681
school-leavers in the last school year: 29,615

Secondary vocational apprentice training centres:

schools: 346
students: 126,798
school-leavers in the last school year: 44,173

Table 10. Number of students learning foreign languages, 1997-1998

Type of school	English (per cent)	German (per cent)
Primary schools	47	44
Grammar schools	55	52
Secondary vocational schools	48	48
Secondary vocational apprentice training centres	30	60

Pupils in the primary schools have to learn one foreign language. Students in the grammar schools have to study two foreign languages. The most wide—spread are English and German.

There are six bilingual grammar schools where more than 1,000 students are studying in English (towns: Sučany, Bratislava, Tisovec), 900 students are studying in German (two schools in the town Bratislava, one school in Poprad). There are also several grammar and secondary commercial schools where students are studying three foreign languages (in the towns Bratislava, Košice, Banská Bystrica, Prievidza).

Institutions of higher education

institutions: 18

faculties: 80

students: 101,982

graduates in the last school year: 13,030

There are 16 state civil universities with more than 80 faculties, two state civil universities without subdividing into faculties in Slovakia. University in Slovakia realize wide multilateral and bilateral cooperation in science and technique area with partner institutes in United States, United Kingdom, Italy, Hungary, Spain, Czech Republic, Germany, Denmark, Slovenia, Portugal, Sweden, Netherlands, Norway, Finland, France, Austria, Israel and Turkey.

The international schools in Slovakia:

British International school Bratislava (English medium day school for boy and girls, age range 3 to 18, accredited centre for international school examinations of the University of Cambridge)

QSI International School of Bratislava (offers full academic curriculum in English for children from 3 through 18 years of age), school is a member of the International and Inter-regional Accrediting Assoc. And Middle Atlantic States Accrediting Assoc.

CITY UNIVERSITY Bratislava.

MAINTENANCE COSTS

ELECTRICITY

Enterprises

The price of the electric power depends on voltage, quantity and day regime. Below is an average overview of the price list.

Table 11. Tariffs for the electricity usage

Group	*Top tariff (Sk/kW.h)*	*High tariff (Sk/kW.h)*	*Low tariff (Sk/kW.h)*
A very high voltage (over 52 kV)	115-1.58	0.91-1.58	0.80-1.58
B high voltage (from 1 kV to 52 kV)	1.25-6.60	0.95-4.21	0.89-2.10
C low voltage (up 1 kV)	—	2.19-4.64	0.98-1.10

WATER COSTS

Enterprises

Water 12.73 incl. 10% VAT

Sewage 16.53 incl. 10% VAT

The fees depend on consumption locality

Fee for rainwater directed into public sewage system roof surface: $m^2 \times$ precipitation/ calculated by regional hydro-meteorological institute/$\times$ type of surface = total sum

GAS COSTS

Enterprises

Up 20 millions m^3/year—3.76 Sk/m^3 + 10% VAT

Over 20 millions m^3/year—3.75 Sk/m^3 + 10% VAT

Renting

Table 12. Average cost of land purchase

Purchasing costs for industrial land	
Bratislava	About 1,000-1,500 SKK/m^2
Western part of Slovakia	500 SKK/m^2
Eastern and Middle part of Slovakia	100-200 SKK/m^2

Renting costs for industrial halls

Renting costs for offices:	1,000 SKK/m^2
In Bratislava	3,500-7,000 SKK/m^2
Others area	3,000 SKK/m^2

PROCESS OF SETTING UP A BUSINESS IN SLOVAKIA

INTRODUCTION

A foreign entrepreneur, legal entity or an individual can engage in business or entrepreneurial activity in the Slovak Republic by:

- establishing a branch office in the Slovak Republic
- relocating its existing registered office to the Slovak Republic
- establishing a 100% foreign owned business entity in the Slovak Republic
- investing its equity in the Slovak Republic registered business
- engaging in a business activity under provisions of the Trade Licensing Act.

COMMENTS:

- The Slovak Republic is aiming for eventual membership of the European Union and government lawyers are working hard to ensure that Slovak laws are fully compatible with those of the EU.

- Bankruptcy laws are already in place, security laws are well advanced. All entrepreneurial activities have to be established according to Slovakia's Commercial Code. The Commercial Code represents the basic legal regulation in the following areas:
  - Definition of the most important terms in commercial affairs i.e. the entrepreneur, name of the firm, unfair competition etc.
  - Business activity undertaken by local and foreign companies
  - Types of commercial companies and cooperatives
  - Commercial obligations, general provisions and types of contracts

The Commercial Code No. 65/1965 has been amended few times, and the latest changes are described in the laws of the National Council of SR No. 10/1993, No. 275/1993, No. 304/1995 and No. 90/1996. Foreigners may pursue business activity on the territory of the Slovakia under the same conditions and to the same extent as Slovakian citizens. A company is founded by articles of association and in some cases the Code requires basic capital.

THE COMMERCIAL CODE DESCRIBES FOUR TYPES OF COMPANIES:

Public Commercial Company (Commercial Partnership)

Limited Partnership Company

Limited Liability Company is the most typical kind of company for the common kind of business and the Commercial Code deals with it in great detail. This company is responsible by all its assets for fulfilling its obligations. The founding partner is liable for the obligations of the company up to the amount of his investment, which is registered in the Commercial Register. The value of the basic capital is at least SKK. 200,000,- and the minimum amount of the investment of a partner shall not be lower than SKK. 30,000. The investment may be also non-monetary. The executive of the company is the statutory body of the company and is appointed by the general assembly.

Joint-stock Company The basic capital of the company is a minimum of SKK 1 million. The statutory body of the company is a board of directors elected by the general assembly or sometimes, depending on the bylaws, the members of the board of directors may be appointed by the supervisory board.

PROCEDURE OF SETTING UP A COMPANY

The pre-requisites for establishment of the above mentioned companies are as follows:

- Articles of association signed by all the partners. In the case of a single founder the notarial deed on establishment of the company is required.
- An application for registration in the commercial register signed either by all the partners (in cases mentioned under A and B) or by the statutory representatives (in cases mentioned under C and D).
- A statement of the administrator of investments. This states what portion of the basic capital of the company has been paid up by the partners. The statement is signed by the person who is appointed as an administrator of investments in the articles of association.

- A trade license is a license, which is an inevitable precondition for registration of a company in the commercial register and is issued according to the law no 455/1991 Trades Act by the trades offices. Before one applies for a trades license, the place of business of a company must be specified. A local authority approves the place of business of a company on the basis of a rent agreement or any other document, which evidences the necessary data.
- A residential permit is required only in the case when the statutory representative of a company is a foreigner. An application is made at the foreigner's police department. In this case the foreigner is required to state whether he has any criminal record.

When the documents are ready the commercial register can register the company. The commercial register is a public list of the companies with their specific data and any person has right to demand a registration record of any registered company.

REGISTRATION

The commercial register is a public list kept by regional register courts, nearest the legal entity or place of domicile of the person concerned. In Bratislava the register court is the local district court. A Slovak limited liability company or a joint stock company is founded when its articles of association are notarised. More persons or legal entities may found either by one or the company. In the case where the company is founded by only one person the articles of association are drawn up in the form of a notarial deed otherwise just the signatures of the founders are notarised. The notarised document is known as the notarial deed. After the company is founded, it submits a petition to the court whose jurisdiction covers the entity's seat or the individual's address. The petition must contain officially authenticated signatures of the agent of the company according to the articles of association and must be accompanied by:

- The entity's founding documents or similarly verified document establishing the foreign entity branch office in Slovakia

  notarised excerpts from the foreign founding memorandum and an extract from the commercial register

  a power of attorney authorising the applicant company's representative to sign documents and agreements relating to the establishment of a company in Slovakia and to act on behalf of the founder

  the name, location of the registered office and scope of business activity in Slovakia

  the amount of equity capital

  the amount of the reserve fund created at the time of establishment

  the names and addresses of members of the management board and supervisory board. If a foreigner is to act on behalf of the company on one of these boards, he or she must have a residential permit.

An application for a joint stock company must also provide the following information:

proof that the joining general meeting was properly held (if less than 100% of the share capital has been paid up) proof that the members of the board of directors and supervisory board were elected

proof that the status, or bylaws, of the company were approved by shareholders

number of par value of shares

number of par value of shares in each class

portion of the share capital that has been paid up

proof that the entire value of the equity has been subscribed, with the exception of employee shares, which may not exceed 5% of such value.

- Confirmation that an account has been opened with a Slovak bank and initial capital deposited. The minimum capital is mentioned above.
- Declaration of the administrator of contributions that the contributions were paid up and bank confirmation of the paid up capital
- Specimens of signatures of the company's agents
- Trade license from the local trade authority, including the name of a person who meets the qualification requirements for engaging in the trade to be practised by the new company.
- A foreigner must also obtain a residential permit authorising residency in Slovakia.

RESIDENCE AND WORK PERMITS

Foreigners may work in the Slovak Republic only after they have been granted residence and work permits. Application for a residence permit must be submitted to the Slovak Embassy in the applicant's country of permanent residence on the official form and accompanied by:

- a provisional work permit from the local Labour office in Slovakia
- letter from the future employer guaranteeing a fixed income or other proof of sufficient funds as well as proof of accommodation in Slovakia
- the Crime and Criminal Proceedings Register from Slovakia
- a certificate from the applicant's GP proving that the applicant does not suffer from any infectious diseases and tested HIV-negative
- five photographs.

All the documents are to be submitted in the Slovak language or accompanied by an authorised translation verified by the Slovak Embassy or an official court interpreter in Slovakia. For the purpose of granting work and residence permits additional documents may be requested by the local authorities at their own discretion. The processing of the application may take up to 60 days and the applicant is not allowed to start working before being granted the residence permit and entry visa from the Slovak Embassy. Foreigners granted an entry visa are required by law to register with the local police according to the address of their accommodation within three days after arrival in Slovakia.

ANNEX. STRATEGY OF THE SLOVAK GOVERNMENT TO SUPPORT THE INFLUX OF FOREIGN DIRECT

On the ninth of March 1999, the Slovak government approved a document concerning the support of incentives designed to increase the influx of foreign direct investment to Slovakia. Following are excerpts from the key points of that document

The Market for Foreign Direct Investment (FDI)

A pragmatic government prefers the inflow of foreign direct investment to that of other forms of foreign capital investment (i.e., portfolio investments). FDI goes hand in hand with the arrival of new technology and know-how, also the foreign investor takes on a large portion of the financial or business risk. In comparison to securities, factories are not the most easily convertible form of equity; thus, speculative capital is discouraged.

The inflow of FDI can bring the following benefits to the host country: the creation of jobs, an increase in exports and access to new markets; the transfer of state-of-the-art technologies, resulting in the production of goods with higher added value; higher competitiveness on the world markets; an improved trade balance; and, consequently, economic recovery through a combination of the multiple advantages of FDI.

Goals of FDI in the SR

Currently, FDI inflow to Slovakia is too low to positively influence or sustain economic growth and accelerate the process of EU accession. Three main indicators can be used when evaluating the overall level of FDI in a given country: the ratio of FDI vis-à-vis GDP (gross domestic product), FDI per capita, and percentage of FDI in the creation of gross fixed capital.

Based on data from July 1998, it can be shown that FDI per capita in Slovakia amounts to just US$ 320 seven times less than that in Hungary, almost four time less than Slovenia, two and a half times less than the Czech republic and, finally, two times less than Poland.

An effective strategy for the attraction of FDI to Slovakia should include goals to be achieved in the investment field, as well as the specific steps to be taken in order to meet these goals.

It would be a good idea to create a, so-called, "evaluation group" of comparable countries. This group should include Hungary, Slovenia, Poland and the Czech Republic. The main comparative indicator to be used should be per capita FDI.

Ideally, within the course of the next three years (by December 2001) Slovakia's per capita FDI should reach a level on a par with the average of the evaluation group countries. Currently, the average level among these countries (including Slovakia) is US$ 1,055, which indicates a need to raise the global amount of FDI from today's US$ 1.73 billion to US$ 5.7 billion. Assuming we can achieve a steady 10% annual increase in growth, in three years, FDI should climb to US$ 7.6 billion in order to meet that target.

Sector strategy of FDI inflow support

The inflow of FDI will be actively supported and specially focused on both the manufacturing and service sectors. At the same time, it will be aimed at the production of goods with higher added value.

The emphasis on industry is based on the following observations: so far, investments in the service sector have been preferred—in the future, FDI should be focused more on the sectors orientated towards export. The industrial sector is the key factor, which determines the overall economic situation in the SR. Subsequently, FDI will serve to resolve external imbalances, which stem mainly from developments in the industrial sector.

Based on analysis by the Slovak Academy of Sciences these criteria should by considered with structured sectors of FDI inflow:

- *modernisation of manufacturing capacities*—new technologies to be brought in to industries with the lowest labour productivity compared to developed economies
- *selection of sectors recording highest growth on the world market*—Slovak industry will divert from producing goods for which demand is stagnating or diminishing
- *attention to production lines*—final production is to be preferred to that of production lines with high levels of processing
- *attention on production with low export dynamics*—an increase in exports is possible by new financing and producing higher quality goods.

FDI and Investor profiles

Non-strategic investors

These investors employ short-term strategies oriented mainly at industries with low labour costs. Their investments are relatively small and only remain active until a more competitive region with lower labour costs emerges. Upon discovering such possibilities production is often transferred to the cheaper region.

Strategic investors

These investors employ a long-term view of their involvement in Slovakia. They usually invest in new technology and human resources, as well as build new facilities. There are currently several well known foreign companies with sizeable strategic investments in Slovakia—namely; Whirlpool, Siemens, Sony, Hoechst, Rhône Poulenc, Heineken and so on. Their approach should be used as an example to support the inflow of new investment. In general, the presence of large companies with international importance on the Slovak market is desirable for several reasons: their investment in a particular country is a sign of confidence in its stability and low investment risk; internationally known companies bring with them a strong position on the international market, their managerial expertise, and the possibility of extensive research and development.

FDI inflow and regional development

Slovakia is currently experiencing huge disparities in social and economic development in its various different regions. FDI inflow is presently concentrated in areas surrounding bigger cities; in particular, in the western part of the country.

Government goals include the increase of FDI inflow into regions with high levels of unemployment and low entrepreneurial activity, rerouting FDI to insufficiently industrialized regions and channelling FDI to regions with insufficient utilization of potential production capacity.

The government suggests that the following steps be taken:

- Analytical studies of each regions' ability to absorb FDI must be made considering the following criteria: location, structure and costs of labour, readiness of potential areas in consideration of utilities, transport structures and initial costs of implementation (e.g. real estate prices). The outcome of such analysis should be a categorical breakdown of regions in according to their potential for growth and yield (category A).
- Undertake analysis of regional distribution of FDI in terms of state needs. The following criteria will be considered: level of unemployment; business activities (some regions lack internal entrepreneurial activities or are considered unattractive because of the structure of the population). This evaluation will pertain to regions in category B.
- above mentioned categories (A and B) will merge, based upon particular significant criteria, into general, individual, and group categories; with state preferences, respecting FDI inflow, defined for each category. The Ministry of Economy with the cooperation of other state bodies

will elaborate the overall breakdown into categories. In particular, those responsible for regional development. This categorisation will be used as the basis for selective incentive measures designed by the state and municipal governments.

FDI and environmental issues

One of the key aspects of foreign capital inflow is the backlog of settlement of old environmental problems. Therefore, measures for the resolution of old environmental obligations, as well as a set of criteria for land and underground water pollution, will be taken. There is also the question of responsibility for the, so-called, old environmental debt of companies already privatised, or companies that are yet to be privatised. If the foreign investor is to bear this responsibility he will certainly expect a discount in the price equal to the degree of environmental obligations. The government also intends to come up with a set of common procedures for financing reparations for which the Slovakia is responsible (July 1999).

Means and measures for the support of FDI inflow

Governments throughout the world try to attract foreign investors both by financial (tax relief, tax holidays, duty-free imports) and non-financial incentives (costs of re-qualification of employees assumed by the host country). Present experience with FDI inflow into the region of Central and Eastern Europe has shown that capital tends to flow to those countries which have implemented the necessary institutional and legislative framework of a market economy and experience political and economic stability.

Legislative area

- Stabilization of the Slovak legal system and its approximation towards other systems in practice in the European Union.
- Amendment of Business and Penal Codes; focused on minimising the risks of any person acting against the interests of his/her own company, a clear definition of criminal responsibility of company's statutory bodies and their responsibilities, and strengthening the rights of minority shareholders.
- Simplification and fundamental acceleration of judicial proceedings and enforceability of judicial decisions in commercial affairs (Civil Judicial Order, Arbitration Act), accelerating the realisation of declared bankruptcy (Bankruptcy Code) and increasing procedural responsibility of executory courts (Executory Code). Improving the state supervision of the fluency of judicial proceedings and elimination of personal factors in court procedures.
- Amendment of the Income Tax Act aimed at adopting norms of depreciation equal to those practised in the EU.
- Gradual convergence of VAT and other indirect tax-rates with rates valid in the market area of the EU.
- Creation of the natural monopoly regulation law aimed at the establishment of legal framework regulating activities of natural monopolies.
- Changes in legislation aimed at creating standard measures for effective enforcement of legal rights of contractual parties.
- Conclusion of bilateral treaties on investment support and protection; particularly with countries considered to be potentially strategic investors, as well as those with important levels of Slovak foreign trade.
- To use technical assistance programs offered by the World Bank and EU for the preparation and legislative implementation of programs aimed at the fight against corruption, increasing the transparency of the economy and reforming the public sector.

- To simplify legislation on real estate development and construction—current arrangements result in unbearably long deadlines for obtaining the necessary documents and permission (in July 1999).
- To remove selective rules for the evaluation of real estate for domestic and foreign entrepreneurs (in August 1999).
- Prepare legislative framework regulating the establishment of industrial parks, special economic and advantageous zones (in September 1999).
- To establish a framework for providing grants from special funds, including financing from the EU budget (structural funds).
- To speed up the process of company registration (in July 1999).

Financial Area

Research on FDI in the region of Central and Eastern Europe has shown that inflows of investment capital are motivated by the possibility of lower operating costs, resulting in higher export competitiveness; also by the possibility of attaining a share on a particular market and/or gaining a geographically strategic position in the region. The former motivation can be supported by the existence of Slovakia's comparative advantage regarding the labour market. As for the later, the Slovak market does not have an overly large potential because of its relatively small size. For this reason, financial incentives will be more intensive in the future than to date; and also more competitive, considering the environment in other countries in the transition period. Overall support will be balanced in such a way to be focused on two main areas: substitution of imports and export orientation.

Upon fulfilling certain specified prerequisites new investors will be offered incentives, as elaborated in detail below, which will be incorporated into the relevant legislation.

The Amendment on Income Tax Act statement

Tax contributors liable to the corporate income tax—the tax rate is 29% with their registered offices in the territory of the Slovak Republic that were incorporated prior to or on December 2002, shall be granted a reduction of 100% of the tax declare in the tax return for 5 consecutive fiscal years starting from the one in which the first tax base and tax due were declared following the effective date of this Act, provided that:

- The tax contributor is a company, the paid up contribution in cash to the stock capital of which achieves as of 31 December, of the year in which the first tax credit is drawn not less than:

  5 million EURO; manufacturing of goods as the basic line of business; manufacture of goods, which were imported to the territory of the Slovakia prior to the incorporation of the tax contributor drawing the tax credit and which were not manufactured or are manufactured for their exportation,

  required line of business and production the same as above; registered capital requirement may be lowered to 2.5 million euro in the case where the enterprise is located in a particularly favoured district by the unemployment rate in excess of 15% as of December 31 of the year preceding the year of incorporation of the company;

  registered capital of at least 1.5 million euro; providing selected services in the field of tourism, system programming services and user program tools, application software programming service,

  if the tax contributor invests the funds obtained through the drawing or the tax credits, within 5 years from the end of the fiscal year for which a tax credit was granted, into the acquisition of tangible and intangible assets use for the scope of its business,

  if the revenues of the tax contributor from the business make up at least 60% of its aggregate revenues.

The tax contributor may claim the tax credit every year in the tax returned processing in accordance with special legislation. The tax returned shall be filed by 30 June of the year following the fiscal year with the respect to which the tax credit was claimed.

- Enterprises are also eligible to receive an additional tax relief of 50% of tax on profits during the subsequent 5 years if they met the following conditions:

  aggregate increase of basic assets in the form of financial input from foreign sources of 5 million euro during the first 5 years; manufacture of goods as the line of business; manufacture of goods, which were imported to the territory of the Slovak Republic prior to the incorporation of the tax contributor drawing the tax credit and which were not manufactured or are manufactured for their exportation,

  aggregate increase in capital stock may be lowered to 2.5 million euro on condition the enterprise is located in a particularly favourable district by the unemployment rate in excess of 15% as of 31 December of the year preceding the year of incorporation of the company.

  This tax relief can be increased annually by 20%, based on the amount the enterprise spends on search and development.

  if the tax contributor invests the funds obtained through the drawing of the tax credits within 5 years from the end if the fiscal year for which a tax credit was granted, into the acquisition of tangible and intangible assets use for the scope of its business,

  if the revenues of the tax contributor from the business make up at least 60% of its aggregate revenues.

The tax contributor may claim the tax credit every year in the tax returned processing in accordance with special legislation. The tax returned shall be filed by 30 June of the year following the fiscal year with the respect to which the tax credit was claimed.

- Import of machinery and equipment included in the OECD select list (Parts HS 84 and HS 85—high technologies, in September 1999) is charged with a zero import duty, provided the equipment is new and has not been depreciated in another country to date. This measure will be applied in an enterprise established after 1 September, 1999 with a line of business prevailingly oriented on the manufacture of goods or provision of services (with the exception of banking and insurance services, commercial services and brokerage), and which establishes registered capital in a pecuniary or non-pecuniary manner from foreign sources.
- Land adapted for investment purposes (investment-ready) will be provided to investors for a symbolic price. This requires that an interest free loan, up to the amount equal to 50% of costs incurred by building the industrial infrastructure, be arranged by the municipalities (in September 1999).
- Investors entering regions with high unemployment rates will be provided with subsidies for the creation of new jobs, maintaining of existing work places, and re-qualification.
- The government will implement measures for strengthening the function of financial and Capital markets since these are considered to be an important source of liquidity for the business sector.

Institutional Issues

The process of encouraging FDI to come to Slovakia has to be strengthened in the following areas:

- The creation of a positive image of Slovakia: to actively present incentives for investment in the SR, thus directing the foreign investors' attention towards Slovakia.
- The active search for FDI inflow: directly offering particular investment possibilities; creation of respective investment projects. Effective implementation of strategies requires the existence of an institutional framework for FDI support, along with the necessary financing.

In practice, three forms of organizational and legal arrangements of a FDI support agency are conceivable:

- *Government agency*. There are substantial disadvantages associated with this possibility. A government agency may not be able to gather the experience needed for professional management of its activities (non-competitive wage level in the public sector; the government's natural discomfort of focusing on long-term profitable activities such as FDI).
- *Quasi-government agency*. An organization of this type is to a large extent financed by the government. Although subordinated to the government it is not a part of the general public sector. Compared to a private agency its substantial advantage is in its close link to the government. It is, in fact, an executive body of the government. This model has proved itself to be the most effective one.
- *Private agency*. In this case there may occur a conflict of interests resulting from the fact that the goals of private owners of the private agency may not always act in the nation's best interest (having a preference for short-term profitable projects).

SARIO, a.s.

SARIO is a full service investment attraction agency concentrating on satisfying the needs of the foreign investor and assisting Slovak enterprises to identify suitable foreign partners. The range of services offered by SARIO includes:

- Assisting potential foreign investors with their investment appraisal and site selection through the provision of pertinent information
- 'Matchmaking'—acting in the best interest of both the foreign investor and local company to help establish optimal partnerships
- Arranging detailed visit programmes featuring meetings with Slovak enterprises, ministries, central and regional governmental offices, relevant industry associations and introductions to existing foreign investors to share their experiences
- From business planing to start-up and beyond, SARIO remains on-hand to provide advisory support including legal aspects of company registration, recruitment, customs legislation and taxation

Quality information

- SARIO's most valuable asset is its staff and its most valuable commodity is information. A range of sector studies has been commissioned by SARIO to help fully quantify Slovakia's operational benefits and a breakdown of these publications is provided below. As SARIO seeks to anticipate the needs of the foreign investor a wealth of data is available including:
- Key site selection data covering labour availability and skills; factors influencing the return on investment; real estate provision; logistics and market accessibility along with local sourcing
- Sector studies that accurately profile important industries, help underline investment opportunities and benchmark Slovakia with neighbouring countries
- Analysis of economic and statistical data
- Profiles of the regions of the Slovak Republic
- Information from SARIO's database of Slovak companies which features around 300,000 entries

Publications

SARIO produces a wide range of publications in print and in electronic form. The sector studies, which reflect Slovakia's strengths and highlight investment opportunities, cover Automotive Components, Information Technology, Engineering, Machine Tools, Wood Processing, Pharmaceutical and Health Care along with the Electro-Technical industry.

SARIO also produces an essential information manual for investors called 'Investor's Guide to Slovakia' along with this particular publication which elaborates on the role and the services of the investment agency. A regular publication, frequently commended for the quality of its editorial content, is SARIO's monthly magazine, 'Slovakia—News for Investors' which details investment opportunities and provides current macroeconomic information. It also facilitates a 'matchmaking' service by profiling Slovak enterprises seeking foreign partners.

SESSION 4

PROMOTION OF SME's

Promotion of SME's

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INTRODUCTION

For any country, the implementation of significant policy change is challenging, but for the countries in transition, implementing major policy shifts poses special challenges. Although the proposed policy change may be recognized as necessary and vital by many, it may face widespread opposition, or it may be undertaken without the benefit of adequate resources to get the job done.

One of Bulgaria's goals after the World War II was industrialization, understood as economic, technical and technological development along the way to progress and "modern societies". Private property and market institutions were abolished. Industrialization, technical and technological modernization were sought within the central-planned economy. The dominating idea was that the state ownership was the best form of management. Compensation of labour was not based on its effectiveness, but on government decrees and state regulation, thus destroying labour motivation. The economic and social status did not depend directly on labour efforts or educational degree. The society faced the need of a transition towards democracy and market economy.

So in the dawn of deep economic changes in 1989, the private ownership had an insignificant presence in Bulgarian economy.

The development of the private sector is a main condition for the transition to market economy. Therefore the appearance of entrepreneurs stratum is an essential characteristic of society's transition. This stratum has been established under the conditions of intensive changes in society structure and legal norms. The market economy institutions are not fully built yet.

The encouragement of small business aims at solving fundamental economic tasks. The small business is quickly adapting to the changing economic environment. It can utilize local resources, thus enlivening the economy of regions and settlements. In this way the small business could become a generator of economic growth for a sustainable development.

The small business solves social tasks, being practically the sole alternative to the growing unemployment due to the economy restructuring. The strengthening of small business also solves political tasks, as it is the one of the pillars of the democratic society, the middle class being its backbone. The economically independent proprietors can oppose the attempts of any authoritarian structures.

SME'S DEVELOPMENT IN BULGARIA 1989-1999

The development of a vital and competitive private sector is an inseparable element of the structural reforms in Bulgaria. The emergence of SME private companies and the creation of an entrepreneurial spirit are both parts of new business culture and the democratization of society. Small and medium businesses are a major force for the creation of new jobs, for the development of a more dynamic market, the formation of a middle class, a competitive and market-orientated economy. Regrettably, much less support and attention was allocated to the SME sector compared to other elements of the structural reform process.

By contrast with some of the East European States, Bulgaria embarked on a transformation with market orientation and full domination of the state property in national economy. At the end of the 1980s the share of the private sector in the gross domestic product (GDP) was merely 5%, according to 1992 National Statistical Institute data. The effective Constitution at that time did not allow the right of private property, while private business activity was possible only through self-employment and within strictly defined limits and sectors—handicrafts, agriculture, cattle breeding and services.

A large-scale registration process of private companies—mainly sole traders, began in 1990. The highest number of registered private companies was measured in 1991-1993. Data from the balance sheets of the economically active private firms in Bulgaria (in 1995 they were 194,800) indicated that more than half of them (54.2%) operated in trade. In 1995 more than one third of the companies functioned in the sectors of industry, construction and transport.

The classification of the companies in conformity with the number of employees indicated that the private business was predominantly the family type. Up to three persons were employed in 90% of the firms according to 1995 National Statistical Institute Companies Information and reports. More than 1.2 million people were employed in the private sector.

The socio-physiological characteristics of the Bulgarian entrepreneur differ by year. In 1990 most of the businessmen were motivated by quick achievement of profit. Firty per cent of the owners of private companies sought self-realization and public recognition in 1992. Ensuring the family living and the economic necessity were the main incentives in 1995.

The economic policies after 1990—although evidently controversial, created relatively favourable conditions for the private sector development. The prices were liberalized; the state monopoly in foreign trade was abolished; real estates were restituted and privatization began. At the same time the weak control over the banking system, the currency policies and the increasing taxation burden undermined the normal functioning of the private sector.

The period 1996-1998 was the most difficult for the Bulgarian economy. After two years of modest economic growth (1994-1995), in the first half of 1996 the financial sector was under the impact of a deep crisis, affecting the entire economy. As a result, in 1996 and 1997 an extremely strong decline of the GDP, continuously increasing inflation rates, reaching even hyperinflation levels in the first two months of 1997 and an excessive decrease of real incomes were reported.

In 1996 the GDP decreased by 10.1%,—it represented the most significant decline since 1991. In 1997 a new reduction of the GDP by 7% was registered, entirely due to the severe crisis during the first half of the year. In 1996 the economy marked the most significant decline of the gross value added (GVA) in trade (-21.5%) and construction (-20.8%). The main reason was the reduction of the internal demand related to the rapid decline of real incomes and the exceptionally low investment activity—both of companies and households. The only two sectors that indicated rates of growth in 1996 were forestry (5.8%) and communications (8.1%). Communications and transport (zero growth in 1996) were the only sectors having positive rates through all the years after 1991. These two sectors were among the ones with the highest labour productivity in Bulgaria. In 1997 the sharpest decline of value added was reported again in trade and construction.[1] These two sectors proved to be affected to the greatest extent by the severe economic crisis in the country. It had a negative impact on the private sector development, because of its higher share in the both industrial branches (about 80% of the gross value added in trade and about 70% in construction). In 1997 agriculture and the production and distribution of electricity, gas and water registered an exceptionally high growth (respectively 37.1% and 23.7%). The traditionally well performing industries in the service sector—communications and transport, marked also a considerable increase.

The dynamics of the components in the final consumption of the GDP indicates that in the period 1996-1997 the reduction in the gross fixed capital formation was most significant (by more than 20% annually). The low investment activity was determined both by the unstable macroeconomic environment, limiting to a great extent the planning horizons of the companies, and by the high prices of the investment goods. In 1997 a strong decline was registered in the household's final consumption expenditures (-17.2%) due to the drastic reduction of real incomes in the first months of the year.

In the second half of 1997, immediately after the newly elected Government started to implement its economic policy whose major component was the introduction of the Currency Board, the Bulgarian economy started to stabilize. In the last two quarters of 1997 a 2-3% growth rate was registered. Over the next two years the economic growth continued. Thus, in 1998 the GDP increased by 3.5%.

In 1998-1999 the anticipated 4-5% growth rate was not reached,[2] because of the sequence of external shocks that affected the Bulgarian economy. The Asian crisis at the beginning of 1998 affected the dynamics of Bulgarian economy through the reduction of external demand and the international prices of some key commodities. The Russian crisis in 1998 had even stronger negative impact on the Bulgarian economy.

In 1998 a GDP decline was registered only in the third quarter compared to the same period of the 1997. Thus, the external demand, which was the engine of the modest economic

[1]The reduction in Gross Value Added in forestry (-44.6%) and the financial services in 1997 (-74.6%) were significant. The decline in forestry, hunting and fishing was due to the great reduction in wood processing and the closing of "Ocean Fishing" company in 1997. The decline in the financial services sector was related to the big differences in the nominal interest rate spreads in 1996 and 1997, as well as to the stabilization and the subsequent fixing of the foreign exchange rate.

[2]In the first nine months of 2000 the final data of the National Statistical Institute indicated 5.6% growth.

growth in the 1994-1995 period, as well as the driving force for the increase of the other CEE countries, failed to induce a GDP growth and on the contrary—had a negative effect. Actually the growth of the GDP was boosted by the increased household demand as a result of the real increase in incomes, also by the higher investment demand. The latter began growing in the third quarter of 1998.

The traditionally well performing sectors—transport, communications, agriculture and forestry experienced the highest growth in 1998. The industrial sector registered growth as well, which was due mainly to the private sector development. It is very likely that the enterprises privatized over the previous years have contributed to the gross value added growth in the sector.

In 1999 the pace of the economic growth slowed down. The Kosovo crisis added its effect to the two external shocks experienced in 1998, which negatively influenced the development of traditionally strong sectors such as transport. However, the results were higher than the expected and the latest data indicate a GDP growth of 2.5% in 1999. The major contribution to the increase of this indicator is the gross fixed capital formation (28.9% for the nine months of the year), and the increased household consumption (8.7%) as well.

Over the period 1996-1999 the Bulgarian economy experienced periods of varying price level dynamics. In 1996 the inflation accelerated abruptly. At the onset of the year prices used to increase by 1-2% monthly, and after May 1996 the average monthly increase was in the range between 15-25%. At the year-end, when the economic crisis deepened, Bulgaria faced a hyperinflation cycle. In January 1997 consumer prices raised by 43.5%, while in February another 242.7% were added.

The appointment of a Caretaker Government, which started the implementation of an economic policy, pursued later by the Government appointed by the newly elected National Assembly, as well as the introduction of a Currency Board Arrangements in mid-1997 were the major stabilizing factors on the prices' dynamics. Monthly inflation rates dropped in the second half of 1997 to about 1%. The stabilization of prices continued in the next two years and the inflation rate in 1998 was 1% (December 1998/December 1997) and –6.2% in 1999 (December 1999/December 1998).

The main framework of the Currency Board arrangements was laid down in a number of regulations outlining the new monetary policy to be implemented by the Government and the Central Bank. In fact the Currency Board limits the opportunities of the Government and the Central Bank to influence the macroeconomic indicators through the instruments of the monetary policy and shifts the emphasis mostly to the fiscal, income and foreign trade policies.

The advantages of the Currency Board for the small and medium-sized enterprises are as follows:

- Stabilization of the macroeconomic environment and its improved predictability, which allows better planning of operational and investment activities of enterprises;
- Possibilities for real incomes increase and hence internal demand and consumption. Certainly, whether the domestic producers would satisfy the increased internal demand depends to a great extent on their competitiveness.
- Stabilization of the macroeconomic environment which may decrease the cost of credit and thus improve the access to capital *ceteris paribus*. The extent to which

commercial banks will increase credits to non-financial enterprises in the country will depend on other factors too, which are not related directly to the Currency Board arrangements such as the efficiency of the judicial system, the quality of business projects; the reputation of companies, etc.;

- A complete internal convertibility of the national currency has been achieved. Local economic agents do not encounter any problem in obtaining foreign currency. In general, there are no obstacles to exchange the national currency to the reserve currency and in fact there are no difficulties to the exchange of the national currency to any international currency mostly used in international transactions. This reduces substantially the financial costs for the companies.

Since the Currency Board rules are neutral, it could be claimed that its advantages and disadvantages affect to the same extent all economic agents in the country. However, most of the large companies are big exporters and under the flexible exchange rate they were in a position to reap profits on exchange rate differentials (especially when the lag between production and sales is big). The fixing of the foreign exchange rates eliminated the opportunity for such profits, thus affecting the SMEs to a much lower extent.

MAIN CHARACTERISTICS OF SMEs IN THE PERIOD 1996-1999

The analysis of small and medium-sized enterprises' place and sector contribution to Bulgarian economy draws on the aggregated data from balance sheets and profit and loss accounts of 178,000 firms in the year 1996; 189,367 firms in 1997, 205, 643 firms in 1998 and 211,329 in 1999. This number of firms does not extensively represent the single-person farmers actively producing, part of the financial institutions (commercial banks, insurance companies, etc.) and the budget sector organizations.[3]

Firm classification by size remained more or less constant in the period from 1996 to 1999. Micro-firm share was some 92.5% and the share of small firms fluctuated within the range of 5% and 5.6%. Thus the micro-firms and the small firms make up a share of a little more 98%. On the other hand, in the period under consideration the share of big firms goes gradually from 1.5% for year 1996 down to 1% for 1999 of the total number of firms. Assuming that the medium-sized and big firms really operating in the economy come better represented in the sample, we can infer that in the period from 1996 to 1999 the really operative small and medium-sized firms have constituted over 99% of all the country's active firms.

The SMEs share is most significant in the services sphere. The industries where SMEs predominate in total analysed sample are hotels and catering, trade, financial services (excluding banks, insurance companies and some other financial institutions), education (excluding the budget educational establishments) and health care. The industrial branches where the medium-sized and big firms take up the prevailing share are exclusively in basic industry like the production and distribution of electricity, gas and water and the mining industry as well. In these sectors one out of three firms falls under the big firms group. Relatively high is the share of the medium-sized and big firms in the branches of farming, forestry and construction.

[3] The budget sector represents predominantly centrally and municipally run organizations, as well as companies providing services financed mainly through budget subsidizing like those in education and health care (schools, hospitals, etc.).

Table 1. Firms classification by size
(percentage)

Firm size	*1996*	*1997*	*1998*	*1999*
Micro-firms	92.19	92.47	92.40	92.42
Small firms	5.12	5.19	5.41	5.57
Medium-sized firms	1.17	1.08	1.05	1.00
Firms with staff from 101 to 250	1.00	0.86	0.76	0.67
Big firms	0.53	0.41	0.39	0.34

Source: NSI and our calculations

Table 2. Firms classification by aggregated industrial branches and size
(Percentage)

Industry	*Micro-firms*	*Small firms*	*Medium-sized firms*	*Firms with staff from 101-250*	*Big firms*
Farming, forestry, hunting, fishery	69.48	24.03	4.12	1.82	0.55
Mining industry	44.51	19.08	8.67	11.56	16.18
Processing industry	78.81	12.97	3.47	2.87	1.88
Electricity, gas, water	41.30	15.94	7.97	9.42	25.36
Construction	80.13	14.12	3.02	2.11	0.61
Trade and repair	96.50	3.10	0.27	0.11	0.02
Hotels and catering	97.24	2.20	0.31	0.18	0.09
Transport and communications	95.30	3.12	0.79	0.52	0.29
Finance, credit, insurance	92.27	7.13	0.40	0.13	0.07
Real estate operations and business services	94.43	4.40	0.67	0.36	0.14
Education	96.04	3.33	0.35	0.21	0.07
Health care	96.77	2.83	0.32	0.08	0.00
Other services	91.67	6.15	0.94	1.10	0.14
Total	92.42	5.57	1.00	0.67	0.34

Source: NSI and own calculations

Everywhere around the country SMEs prevail (over 98%). The relative share of big firms is within the range from 0.7% to 1.5%. Greatest concentration of small and medium-sized firms is again observable in the city areas of Sofia, Plovdiv, Varna, Bourgas, Stara Zagora and Blagoevgrad. Along similar lines have been the regional distributions for the previous two years.

DEMOGRAPHY OF SMEs

Data on SME company age, survival rates, birth rates have been extracted from sample studies popular under the titles PECO PANEL and DoSME (Demography of Small and Medium-Sized Enterprises) where Bulgaria participates and which are carried out jointly by Eurostat and eleven countries from Central and Eastern Europe (CEE).

First survey provides data[4] on the private enterprises carrying out commercial and non-farming activities, that had been registered in the business registers of the eleven countries before 1 January 1995. This survey highlights certain characteristic aspects of

[4]Panorama of Enterprises in the Central and Eastern European Countries in 1995, Eurostat, Phare.

Bulgarian enterprises holding true also for the group of small and medium-sized enterprises as long as they predominate.

Enterprises age:[5] Bulgarian enterprises registered before 1 January, 1995 were relatively young since scarcely 4.2% of them had started operation before 1990, while in Slovenia, Hungary and Poland the percentages were 26%, 21% and 20% of enterprises over 5 years of age respectively.

Table 3. Percentage distribution of enterprises by age as of 1 January 1995*

	Enterprise age					
Country	*1 year*	*2-3 years*	*4-5 years*	*6-10 years*	*>10 years*	*%*
Albania	37.9	52.2	9.9	0.0	0.0	100
Bulgaria	20.4	42.5	32.9	2.7	1.5	100
Czech Republic	18.9	44.6	33.7	2.0	0.7	100
Estonia	30.3	50.8	15.5	2.9	0.5	100
Hungary	21.0	33.4	24.7	12.1	8.7	100
Latvia	37.7	45.6	14.1	1.5	1.2	100
Lithuania	38.9	34.6	20.4	3.9	2.2	100
Poland	17.3	33.4	29.0	10.9	9.4	100
Romania	32.6	48.7	17.5	0.4	0.7	100
Slovakia	18.9	44.0	34.5	2.2	0.4	100
Slovenia	18.2	31.9	23.8	11.1	15.0	100
Total	21.1	39.2	28.0	6.6	5.2	100

*Enterprises registered in 1995 were not included in the group of one year of age.

SME INPUT IN THE GROSS VALUE ADDED (GVA)

In year 1996 the SME sector was the source of 27.3% of the total gross added value in Bulgaria.[6] In 1997 this portion is reduced to 22.4%, while in 1998 certain recuperation took place of up to 25.4%. In 1999 the SME share of gross added value—32.14%, was already higher than in 1996.

The drop of SME input in the newly created income in 1997 is exclusively attributable to the acute financial and economic crisis of the second half of 1996 and early 1997. The most negative impact it had on the sphere of services (excluding transport and communications) and trade especially, where small companies are extremely numerous. Due to frustrated investment activity the decline was also considerable in the construction industry, an area where many small and medium-sized private companies had rapidly emerged and developed in the early and mid-nineties.

[5]Quoted survey measures the enterprise age from the start of actual operation, not the entry in the business register of the statistical institution. Usually registration date precedes by several months, even several years the operation, still can happen later, as a result of improved coverage of the business register and entering enterprises already in existence yet so far left outside the observation scope of statistics.

[6]The indicator here accounts for the sum total of firms' pre-tax and pre-interest operative profit (that is the actial difference between incoming and outgoing operation funds), labour expenses (including the payroll costs, social security costs, professional qualification and unemployment funds and any other due related to the payment of salaries) and the depreciation costs. The firms belonging to the financial services branch have something more here—the difference between profits and losses from financial operations. We believe it all comes close to the concept of gross added value in terms of the national accounts system.

Table 4. Firms share by size and sector in GVA
(Percentage)

Size of firm/sector	*1996*	*1997*	*1998*	*1999*
Micro-firms	9.81	6.44	9.08	14.77
Small firms	11.37	9.56	9.94	10.98
Medium-sized firms	6.11	6.40	6.36	6.39
Firms with staff from 101 to 250	11.04	12.26	12.20	12.75
Big firms	61.67	65.34	62.43	55.11
Total	100	100	100	100

Source: NSI and own calculations.

In 1999, after the stabilization of the macro-economic environment, the small and medium firms once again contributed relatively more to the gross added value. The micro- and small firms shares grew respectively from 6.4% in 1997 to 14.8% in 1999 and from 9.6% in 1997 to 11% in 1999. Medium-sized companies maintain their share position while the big firms decreased their share in the added value. It's an indication that small companies are highly sensitive to changes in the macro-economic environment and quick to respond. This is due to the relatively thin investment in long-term fixed assets in these firms; and on the other hand the entrepreneurs can be more flexible employing varying numbers of people depending on the changes in the economic conditions. Thus the micro-firms and the small firms can serve as a very good indicator for the current condition of the economy.

The distributions of Bulgarian firms and their potential to generate added value allow a conclusion to be made:

- Small firms have limited potential to generate added value. Newly constituted firms in the period of restructuring of the economy emerge most often in industries with lower that country's average efficiency of utilisation of production resources like agriculture, trade, etc. This was probably preconditioned by the difficult entrepreneurial access to credit.

The potential for small and medium-sized firms sector development actually lies in their more massive invasion of the processing industry area, where they could undertake small but highly competitive projects to considerably expand the average gross added value generated in this sector of the economy.

SME CONTRIBUTION TO EXPORT AND IMPORT[7]

SMEs' economic performance varies with respect to Bulgarian exporting and importing. Their role in Bulgarian export is comparatively moderate. The two subgroups of the largest firms take over 80% of country's export. Bulgarian import, on the other hand, is not exclusively dominated by a single group of firms. Micro- and small firms in Bulgaria used to hold 34.5% of the total import. In 1999 they has taken on their relative share from the import up to 31.8%. The other group playing crucial part in the dynamics of Bulgarian import is the largest companies group holding between 50% and 60% of country's total import volume during the period from 1996 till 1999.

[7]NSI data derived from customs declarations.

Table 6. Firm participation by size and sector in foreign trade
(Percentage)

Sector	Micro-firms	Small firms	Medium-sized firms	Firms with staff from 101-250	Big firms
Import share					
1996					
Economy–Total	21.98	12.52	3.45	6.76	55.29
Public sector	15.57	0.36	0.92	3.38	79.77
Private sector	33.09	33.58	7.82	12.61	12.89
1997					
Economy—Total	11.37	13.96	3.34	10.86	60.47
Public sector	0.43	7.84	0.50	1.98	89.26
Private sector	23.46	20.73	6.48	20.68	28.65
1998					
Economy—Total	15.13	17.70	5.69	11.36	50.12
Public sector	0.40	7.95	1.21	1.73	88.71
Private sector	23.30	23.10	8.17	16.70	28.72
1999					
Economy—Total	14.49	17.28	5.42	11.34	51.47
Public sector	0.13	0.83	1.11	1.25	96.68
Private sector	21.33	25.12	7.47	16.15	29.93
Export share					
1996					
Economy—Total	10.60	7.65	3.22	7.44	71.09
Public sector	0.08	1.09	1.09	6.07	91.67
Private sector	37.08	24.17	8.60	10.89	19.26
1997					
Economy—Total	8.82	6.50	3.34	8.52	72.82
Public sector	0.09	1.60	0.69	5.00	92.62
Private sector	19.58	12.56	6.60	12.87	48.39
1998					
Economy—Total	9.53	7.85	4.74	11.03	66.85
Public sector	0.05	1.05	2.80	3.92	92.18
Private sector	16.14	12.59	6.09	15.98	49.20
1999					
Economy—Total	9.17	7.30	4.68	11.16	67.69
Public sector	0.02	0.67	0.70	2.83	95.79
Private sector	14.35	11.04	6.93	15.87	51.80

Source: NSI and own calculations

Extremely important for Bulgarian export are the firms from the processing industry—they had realized 79.8% of 1999 export. Comparatively, a great deal of the country's export is carried out by the firms involved in trade (14.9% in 1999). The exporters of industrial and agricultural products are mainly micro- and small firms.

Thus the two major groups of players in Bulgarian foreign trade can be delineated. The first one mainly constitutes micro- and small firms, coming predominantly from the private sector. Their principle activity is to import goods in order to satisfy domestic demand. Some of them also intermediate in the export of Bulgarian industrial products. This group activity depends largely on the structure and dynamics of domestic and particularly on the end consumption. Hence the dynamics of their importing relates with the dynamics of real incomes in the country.

MAJOR ASPECT OF THE NATIONAL POLICIES ON SME PROMOTION

GOVERNMENT POLICY WITH RESPECT TO SME

In the first years of transition to market economy Bulgaria did not practically have any government policy for the promotion of SME development. With the years isolated activity took place, failing though to follow one common strategy and with very little efficiency. As concrete example here may serve the missing normative system to regulate SME activity, or the inefficiency of the "Small Enterprises" Fund. In reality consistent government policy for the promotion of SME became an issue as late as in 1997. Apart from the introduction of regulatory framework for SME sector the period saw the establishment of the institutional setting to formulate and pursue government policy with regard to SME, also National Strategy for the Development of SME was adopted in 1998. Our country joined in EU programmes for the promotion of SME, the process of harmonization of our legislation with the Acquis Communautaire was initiated.

An SME Agency under the Ministry of Industry was established in 1997 as a state body, which supports the development and implementation of state policies on SME promotion. An SME Act was adopted in September 1999. Its enactment changed the statute of the SME Agency, which was transformed into a body under the Council of Ministers.

An Advisory Board for SMEs was established by virtue of the SME Act as a consultative body, comprising state and non-governmental organizations. The Advisory Board includes representatives of ministries, chambers of commerce, unions and branch associations with SME promotion as their main task. Its main objective is to contribute to the elaboration of the SME policy, development of SME support measures and business impact assessment.

ASME coordinates the establishment of a partnership network of state, governmental and non-governmental institutions and economic organizations, aimed at the achievement of asynergy effect in SME promotion. This network involves business centres, technological parks, business incubators and innovation centres. It facilitates the dissemination of data and information, related to tenders, programmes, projects, training and external financing opportunities. The SME Agency, jointly with the National Statistical Institute, has been preparing a preliminary study and analysis of the SME sector.

NATIONAL STRATEGY FOR PROMOTION OF SME DEVELOPMENT AND WORK PROGRAMME FOR ITS IMPLEMENTATION

The main purpose of the National Strategy is to establish a favourable institutional, regulatory, administrative, financial and competitive environment enhancing the development of SMEs in Bulgaria. Its implementation is anticipated to result in:

- Development of private ownership, free competition and entrepreneurship;
- Job creation through relatively low capital investments;
- Development of managerial skills of entrepreneurs;

- Improvement of the export potential of SMEs;
- Introduction of high-tech sectors;
- Investment promotion in the SME sector;
- Europeanization and internationalization of the SME sector.

The National Strategy includes a set of specific measures for promotion of the small business, aiming at the following priority objectives: facilitation of the administrative and legal framework on SMEs; improvement of financial services rendered to SMEs; improved competitive environment and competitiveness of SMEs; europeanization and internationalization of the sector. The Strategy outlines the role of legislative and executive authorities, as well as their coordinated actions towards its implementation. The key role is assigned to the SME Agency, which is charged with the drafting, regular updating and implementing of the Strategy. An integral part of the National Strategy is the Work Programme for its implementation. The Work Programme, defining the approaches for attaining the objectives of the National Strategy on SME development, provides measures for establishing an SME favourable environment, along with a series of programmes with specific short-term and mid-term (1999-2001) initiatives in the following areas:

- Improvement of the legal environment for SMEs;
- Provision of access for SMEs to financial sources and venture capital;
- Diversification of the services designated for SMEs;
- Dissemination of information on development programmes, existing and newly emerging partnership networks, R&D study reports, innovations and opportunities for technology transfer;
- Support to the existing and establishment of new training centres;
- Regional and branch programmes for existing and newly emerging SMEs, taking into consideration their specific characteristics;
- Programme for micro crediting and collaboration with donor organizations.

MAJOR SMEs SUPPORT POLICIES

IMPROVEMENT OF THE REGULATORY AND ADMINISTRATIVE ENVIRONMENT

The legislation in force so far, as well as the new laws enacted recently, have produced twofold effects on SMEs—while the legislation certainly makes considerable steps forward in many regulatory areas, it also sometimes introduces new administrative burdens for SMEs. The experience of the EU Member States shows that the task for improving the regulatory and administrative environment is a continuous and a long process in which there has to be consistency and perseverance. The measures, which the government has already taken, to achieve this aim are as follows. Public procurement procedures have been streamlined by the new Public Procurement Act/1999/. The new Statistics Act/1999/, envisages the introduction of unified identification number for the registration of the economic and other legal entities in Bulgaria. The Currency Act/1999/, changed the payment regime and abolished some restrictions on the export and import of foreign currency in cash.

The National Standardization Act entirely repealed the mandatory statute of the Bulgarian Standards (approximately 13,000) and thus, SMEs in general, have been relieved from the obligation to observe rules, some of which have not been adjusted for decades.

The Government launched last year the process of review and simplification or abrogation of the various license and permission regimes: 93 regimes with direct impact on entrepreneurship have already been abolished or simplified. The Government also suggested a detailed analysis of the acts on the local governance, in view of the fact that small and medium-sized businesses often meet with local bureaucracy.

ASME has initiated a review and simplification of the administrative procedures for obtaining licences, permissions, registrations and other forms for authorization for carrying out business activity. The introduction of "one-stop-shop" system will considerably reduce the cost and time of entrepreneurs and therefore ASME is working on a pilot project for its implementation.

EMPLOYMENT POLICY

The Ministry of Labour and Social Policy and the National Employment Service managed to establish a countrywide institutional network of Regional Employment and Labour offices, supported also by Regional Employment Councils consisting of state and civil organizations. Through this network the Government implements national projects and regional employment programmes with the support of national and international funding. Under the agenda of the forthcoming update of the Government's Programme 2001, the National Council of Tripartite Cooperation shall discuss measures and initiatives related to the problems of unemployment, poverty and children.

FINANCIAL POLICY

External financing is crucial for the development of SMEs, but the access to such financing is strongly restricted by the stringent bank legislation. Regardless of whether the credit resource in question is part of the bank's own cash assets or is provided under credit lines and programmes through intermediary banks—agents, the major barriers for the access of SMEs to credits are the complicated banking procedures and the inability of SMEs to provide the collateral required by the Act on Banks, as well as the regulations of the Bulgarian National Bank. (For instance a mortgage on real estate, adequate pledges on fixed assets or state securities, etc.)

The end of 1998 and the early 1999 marked the start of the first consistent actions towards alleviating the procedures for improving the access of the small and medium-sized businesses to credit resources. They created opportunities for applying new financial instruments, including micro crediting programmes.

The main factors influencing the process of crediting SMEs include:

- Restrictive acts and regulations related to the Currency Board agreements;
- Discrepancy between official accounting reports of SMEs submitted to the tax authorities and the actual financing position of SMEs;
- The absence of skills and experience of the entrepreneurs to manage investment projects;

- The attitude of bank officers towards SMEs is an additional obstacle to crediting;
- Credits are solely short-term and are guaranteed by highly liquid assets (securities, bonds. etc).

A Promotional Bank was established upon initiative of the Bulgarian Council of Ministers in the beginning of 1999 as a state-owned bank. The priority target group of the bank are the medium-sized enterprises and in particular the production and export oriented ones. The Promotional Bank operates strictly on a commercial basis. Like the existing Micro-Credit Scheme (financed by KfW), the advantage for the entrepreneur of a medium-sized business is not necessarily a low interest rate, but the opportunity to work together with a bank that is committed to SME. The Promotional Bank provides long-term credits, a product that is rarely offered to SME in Bulgaria.

FINANCING THROUGH INVESTMENT FUNDS

Investments through venture funds in Bulgaria are made via the acquisition of shares of company against the implemented investment. The financing institution obtains the right to participate in the company management with the objective to minimize the risk. Most often the investment is made for a period of 5 to 10 years, after which the investors sell their shares to the major shareholders or on the stock exchange.

A guarantee scheme of the United Bulgarian Bank /UBB/ is under preparation in accordance with an agreement between the USAID and the Bank. The Agency for Small and Medium-Sized Enterprises, the State Agency for Energy Efficiency and UBB signed a cooperation agreement for the implementation of the scheme. The amount of the guarantee provided is US$ 6 million for credits to SMEs during the period until 2004 and US$ 6 million for credits for energy saving projects for the period until 2006 respectively.

PARTICIPATION IN THE PRIVATIZATION PROCESS

The Privatization Programme for the year 2000 takes into account that the process of privatization and economic decentralization is an integral part of the strategy for development and enhancement of SMEs' competitiveness. The SMEs' Act provides for preferential participation of SMEs in the privatization of separate parts of state-owned and municipal enterprises and unfinished construction sites. The preferential terms and conditions involve a rescheduled payment of the price within a period of either 3 or 5 years, with an initial instalment of respectively 50% or 30% on the price at the contract's conclusion. If a SME is the only potential buyer of shares and stakes of state or municipal ownership, it is entitled to the same incentives provided by the management buy-out procedure. An initial instalment of 10% of the price, a 10-year rescheduled payment of the balance and one-year grace period.

REGIONAL POLICY

In the context of regional development policy, SMEs are considered mainly as an instrument for the accomplishment of its particular goals.

The result of the regional development legislation (in particular the Regional Development Act, the Regulations on the Organization and the Activities of Regional Development Council with the Council of Ministers, the District Development Councils and Regulation on

Defining the conditions and order for the implementation of strategies and programmes co-financed by EU programmes in the field of regional development and economic and social cohesion) is the following: The improvement of the institutional framework for regional development policies' implementation and the creation of better conditions for coordination and partnership, along with the greater opportunity for consideration and protection of SMEs' interests in the preparation and implementation of regional development plans. SMEs organizations have been offered the possibility to be represented in regional development councils. Besides the newly established councils, the responsibilities for the preparation and implementation of the National Plan for Regional Development (NPRD) are shared among institutions and units on national (the Council of Ministers, the Ministry of Regional Development and Public Works, other ministries and agencies), district and local levels.

The key instrument for the implementation of the regional development policies pursuant to the Regional Development Act, is the National Plan for Regional Development over a 7-year period. The first National Plan for Regional Development (2000-2006) was adopted by virtue of Decree of the Council of Ministers (DCM) No. 208 of 1999. The National Plan for Regional Development outlines three objectives further elaborated by the district development plans. They are: the creation of conditions for a sustainable and balanced development of the individual regions; mitigation of regional disparities in the spheres of unemployment, income and the opportunities for development and opening to international and cross-border cooperation as a means to solve regional and local development problems.

Strong emphasis has been attached to the role and mechanisms to coordinate sector policies with regard of resolving regional problems. The NPRD is being perceived as an aggregate on three levels of elaboration, coordination, adoption, implementation, control and updating of development plans, respectively of particular projects and programmes incorporating SME development programmes, the set-up of entrepreneurship promotion centres, etc. The plan proposes standard measures differentiated by regions of target intervention, covering also SME promotion, especially in the regions in need of diversification in the economic structure (less developed rural regions and regions in industrial decline).

The NRDP has been amended by the Council of Ministers Regulation No. 54 of 2 March, 2001. The prerequisites that called forth the necessity of amendments consist of: *(a)* Bulgaria started accession negotiations to the EU; *(b)* The Stability Pact for South East Europe, the policy for regional development and realization of the key regional projects for Bulgaria and *(c)* the end of Kosovo conflict. A bottom-up approach was used to prepare the NRDP.

PROVISION OF INFORMATION AND CONSULTING SERVICES

The SME Agency developed its Information Strategy in 1999 with the major objective to establish an information system providing timely and reliable information about the standing and problems of the SMEs. This system encourages the process of alignment of SMEs with European and international business practices, and facilitates their access to information on international training programmes, international markets and foreign partners. It is a catalyst in establishing partnership networks and in the exchange of experience. The system is the necessary medium for discussions and information exchange. The consulting assistance for the SMEs focuses mainly on their access to credit resources from credit lines, banks, specialized financial institutions and funds; the SMEs are provided with timely information about the financing terms and conditions of the specific programme, credit line or loan.

ENHANCING SMEs' COMPETITIVENESS POLICIES

In 1998, the Parliament passed the Export Insurance Act. The Act regulates the statute of the Bulgarian Agency for Export Insurance, Inc. The Bulgarian trade offices abroad facilitate the exports of SMEs and assist them to establish contacts. Regular initiatives and presentation events are organized there, thus promoting and facilitating the export of Bulgarian goods and services to foreign markets.

A series of measures for the enhancement of SMEs' competitiveness has already started. They involve: incentives to the introduction of quality assurance systems (applying the procedures of the ISO 9000 series of standards); recognition of European rules of business culture and ethics; encouragement of environmentally friendly production (ISO 14000); access to modern technologies and R&D achievements.

TAX POLICIES IN THE SME SECTOR

The tax policies implemented aim at maintaining the country's financial stability. Positive examples of changes in the tax regime are the decreased tax rates, the depreciation deductions, etc. As of 1 January 1999 the rate of the corporate income tax was decreased from 30% to 27%, while the VAT rate went down from 22% to 20%. The Government plans to reduce from the beginning of 2001 the corporate income tax further to 20% for big companies and to 15% for small companies.

Small companies with a turnover up to 35,000 Euro are entitled to pay a patent /flat rate/ tax in three instalments per year being relieved from double entry book-keeping.

CONCLUSIONS

The general opinion about state policies on SMEs is positive and supportive. The predominant opinion is that the weakest aspect of the policy is SME financing, basically due to the restrictive credit policies of the commercial banks, i.e. not directly related to state policies. The estimates of the policies on information and consulting services for SMEs are often controversial—they vary from "good" to "unsatisfactory". The criticism is mainly directed to the lack of easily accessible and reliable information about the general economic and market environment.

We should note that the above mentioned problem is of national significance not only for SMEs. The priority sectors need to be identified and particular measures for the development of SMEs in these specific sectors should be undertaken.

A controversial question, having initiated many debates recently, is whether SMEs should enjoy any preferences and if so, what they will be. Some have no definite opinion on the matter, others consider that preferences should not exist and the principle of equality has to be retained, while favourable macroeconomic environment for the business in general, needs to be created. However, some people consider preferences as essential, especially in crediting; in taxation (even a tax holiday for SMEs has been suggested), especially for high-tech companies and technological parks.

It should be pointed out that for the countries in transition the development of the SME sector is of great significance. The SME development can be achieved only by making our country more entrepreneurial and innovative.

Major elements of the future SME support strategy should include the following key issues:

- the creation and strengthening of financial intermediaries/banks, equity or risk capital funds, seed capital funds, etc./to better support SMEs;
- broadening of the technical assistance aimed at covering the needs of SMEs;
- strengthening the links between governmental officials, SME organizations and donors in favour of result-oriented policy;
- assessment of business impact.

Having in mind the globalization of the market and the emerging new information society there is a need for speedy diffusion of new technologies, the latter can be provoked by:

- support and better use of innovation by creation of new managerial skills and improvement of the attitude towards creativity, by marketing new products with the help of SMEs and improving the knowledge and competence of the people, by better financing of innovation—seed capital, reduction of taxes, development of more effective business plans;
- Government efforts to liberalize and de-regulate markets for products and services and the most important—to simplify procedures for licensing and introducing the "one-stop-shop" system for registering new companies/reducing time and cost/;
- Consistency in legislation.

Improvement of knowledge/science and technology/can be accomplished through:

- better education;
- establishment of research centres with the universities in close cooperation with SMEs as way to commercialize new ideas;

In order to create a workforce capable to meet the challenges of the future in the field of education there is a need to make available the use of computers in schools and to provide daily access to Internet.

Easier access to financing can be assured through:

- seed capital for start-ups especially for high-tech companies;
- business angels;
- venture capital funds;
- reduction of the tax burden in case of R&D;
- acceleration of taxes depreciation and investments in case of R&D.

The current state policies on SMEs certainly need further improvement, particularly in certain aspects like financing, crediting and taxation, as well as in the simplification of administrative procedures. It is critical to ensure good coordination, when formulating specific targets, objectives and priorities for their realization in line with the changes of the economic environment. Another key to the success of SME policies is their timely implementation. Thus, the flexibility needed will be achieved; the tendency to fragmentary and contradicting measures in some areas will be eliminated, hence a better ultimate effect will be attained.

Romanian SME's Situation in the Context of the Transition to the Market Economy

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In this paper we focus on the three objectives:

- To present the Romanian SME's situation in the framework of the transition to the market economy
- To reveal the main characteristics of the Romanian entrepreneurs
- To outline the possible actions to enhance the competitiveness to the knowledge-based economy

In order to obtain these objectives we have structured the paper in three parts and one annex.

(a) *Situation of Romanian SME's regarding:*

the evolution of the SME's number during 1991-1999

the distribution of the SME's by sectors

the comparative situation of SME's registered and, respectively, SME's worked

the structure of SME's turnover and employees by branches

the main negative factors and threads for SME's

the main SME's resources and opportunities for SME's

(b) *Characteristics of the Romanian entrepreneurs*, based on the empirical investigations, did by us together with Cambridge University and DePaul University Chicago, from the following point of view:

age

sex

education

experience

motivation

working time

priorities for the next 2 years

(c) *Ways to enhance the competitiveness of Romanian SME's* through innovation based on the holistic approach. The main aspects are the following:

the necessity of the SME's holistic approach

the Romanian priorities for SME's

the relation between global and economic national strategy—national strategy for SME's development—specific policies for enhancing the innovation in the SME's

the strategic objectives for SME's development

the concrete actions for enhancing competitiveness through innovation

the suggestions for Japanese involvement in Southern Eastern Europe in the SME's sector

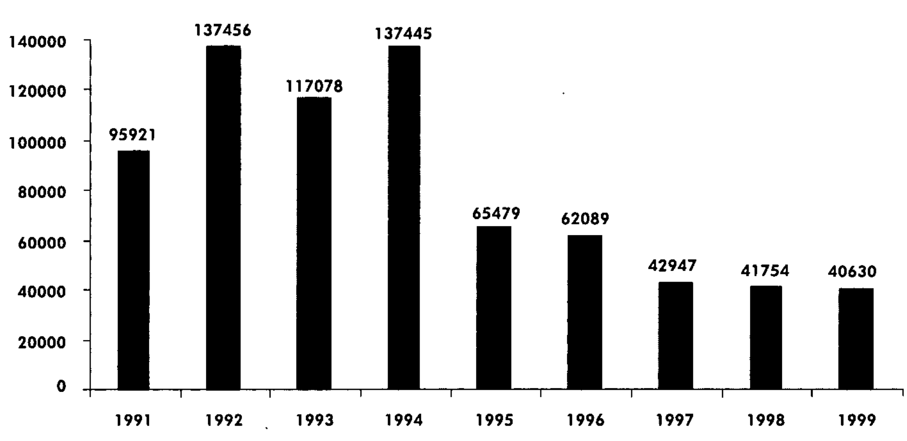
the strategic recommendations for SME's development in Romania

Annex 1—which contains the main strategic objectives and measures for SME's development in Romania, included in the second version of the Romanian strategy for EU integration.

SITUATION OF ROMANIAN SME's

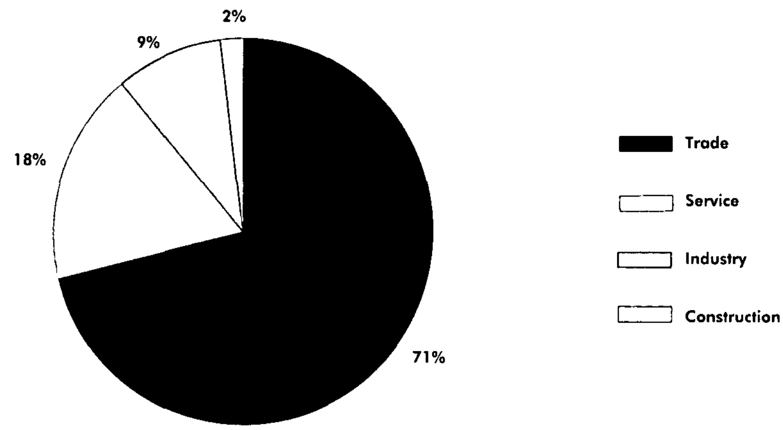
In figure I we present the dynamic of the SME's creation. It is obvious that after a very intensive creation of the SME's during the first years of the market economy transition, this process decreased to a large extent. The main causes of this evolution are the following: the decreasement of the market opportunities due to the concurrence of the existing SME's and the reduction in 1995 of the facilities for SME's.

Figure I. Number of the new SME's



The majority of SME's are in the trade and services fields (see figure II).

Figure II. Distribution of SME's by sectors



At the end of the 1999 the situation of the Romanian SME's is the following:

760,600 SME's—registered

401,326 SME's which worked

This big difference could be explained by the unfavourable environment for SME's during 1996-1999. Distribution of the SME's by sectors is shown in the table 1.

Table 1. SME's by sector

	SME's	
Sector	*Turnover (%)*	*Employees (%)*
Industry	34.9	63
Agriculture	97.4	97
Constructions	94	86
Trade	62.9	90.1
Tourism	99.5	99.6
Services	94.5	90.7

Analysis of the SME's situation has revealed the following, main negative factors and threads:

- Difficulty for SME's access to unused spaces and equipment in state companies
- Difficulty for SME's access to credit and, mainly to development (investment) credits
- Relatively high level of fiscality
- Absence of investment, development and export incentives for SME's
- Private SME's discrimination against state and public companies
- "Hard" bureaucracy regarding the SME's foundation and the "liquidation"
- Very low level of the SME's guarantee fund
- Only occasional business contacts for Romanian entrepreneurs with foreign businessmen
- Negative impact of "certain" government and local administration decisions and actions on the SME's

- Difficulty for SME's access to internal and foreign business information
- Partial lack of managerial and business training for entrepreneurs
- Excessive control on SME's activities
- Incomplete and fluid contradictory legislation regarding SME's activities
- Economic culture of the population not favourable enough to SME's and the entrepreneurs
- SME's non-governmental bodies not strong enough to promote and project specific entrepreneurs interests

At the same time the analysis has identified many resources and opportunities for SME's. The most important are the following:

- About 40% of the state companies spaces and equipment are not used
- The majority of Romanian entrepreneurs are hard working persons and are available for large projects
- Good education level of the Romanian population
- Important indigenous natural resources oil, gas, cool, forest, water, sulphur, etc.
- Outstanding natural conditions for agriculture and tourism
- Relatively large internal market—23 millions inhabitants
- "Interesting" geo-political position of Romania—placed at the crossroads of the European communication ways
- High level of education and training system
- Numerous R&D institutions and centres
- Credits lines offered—especially for the import-export activities—by the international banks (BERD, World Bank, etc.)
- Low interest credits for companies which hire jobless persons
- New created financial institution (American-Romanian Fund, etc.)
- EU assistance programmes for SME's

MAIN CHARACTERISTICS OF ROMANIAN ENTREPRENEURS

These characteristics are based on several empirical investigations done in recent years. A research achieved in 1999 on 1,000 entrepreneurs from 20 counties of Romanian allow us to identify the structure of the entrepreneurs by age (figure III), by sex (figure IV), by level of education (figure V and by field of education (figure VI).

It is important to know the previous work experience of the persons before they became entrepreneurs. As we can see from the figure VII more than one third of entrepreneurs have worked not in the economy, but in other fields—education, science, trade unions, political organization, police, administration, etc. Almost the same proportion of entrepreneurs have worked in industrial companies. Surprisingly, only 15% have worked in trade companies.

Figure III. Structure by age

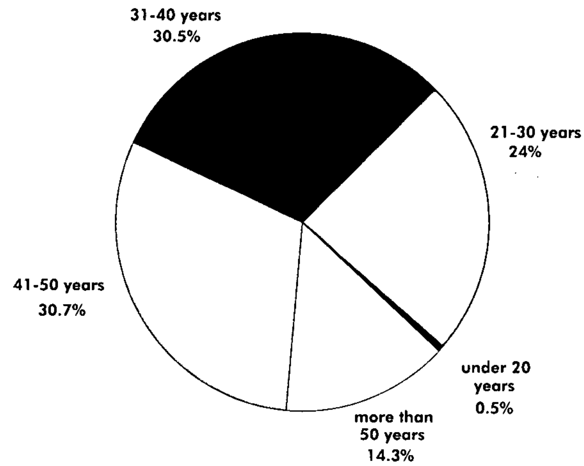


Figure IV. Structure by sex

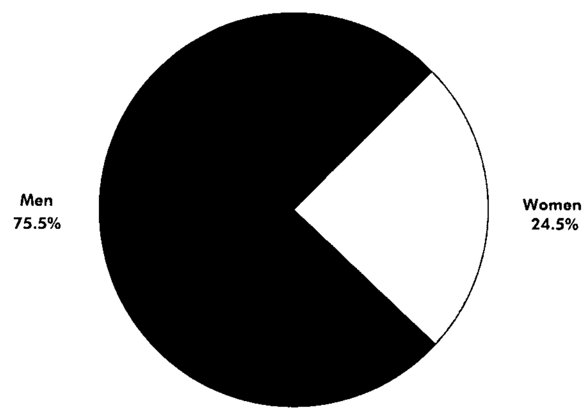


Figure V. Education level

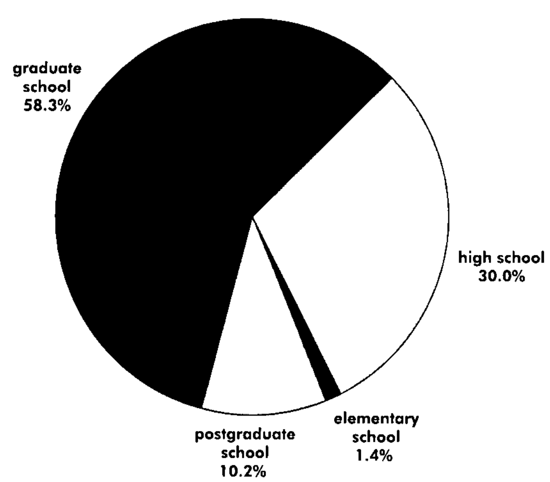


Figure VI. Educational fields

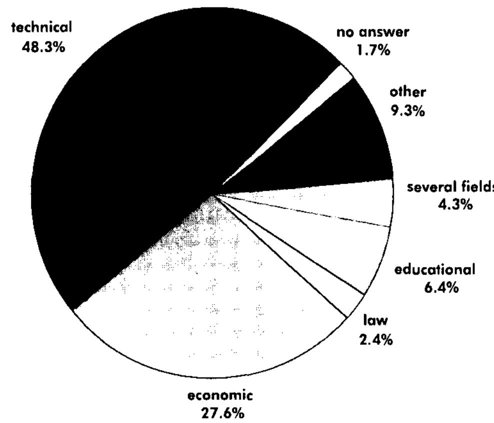
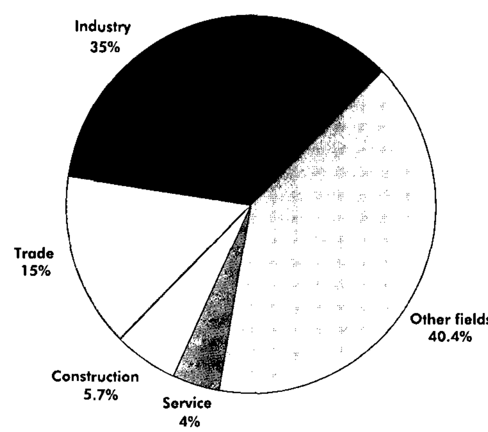


Figure VII. Entrepreneurs fields of activities prior to their present business

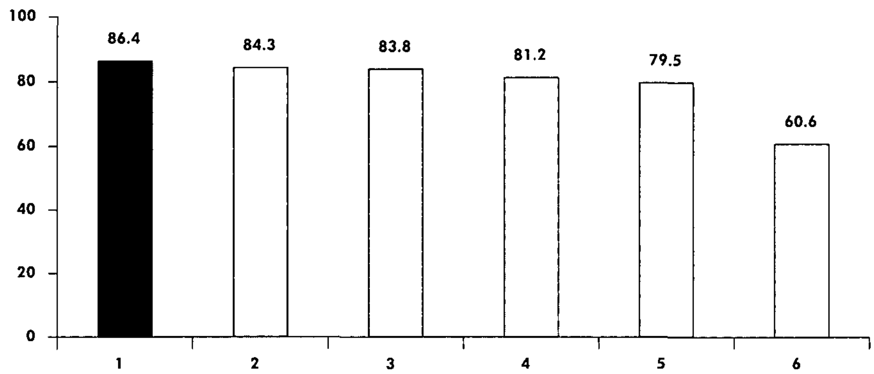


Entire work and results of the entrepreneurs depend heavily on their motivations. For this reason we have evaluated the entrepreneurs using multiscale motivations. From 15 possible motivations they have been asked to select the five most important. In figure VIII we could see what are the most frequent motivations for the Romanian entrepreneurs. In the first position is placed "the development and application of a business idea or a product" followed by "work with selected persons". These are mainly a reflection of the professional and human frustrations felt by many specialists during communist time. Surprising the desire to get more money is ranked only on the fifth position.

Romanian entrepreneurs are very hard working persons. The majority of them work much more than 40 hours weekly (see figure IX). This situation is caused by the strong desire of the entrepreneurs to be successfully and more so by difficult environment conditions during the first years of the market economy transition. Entrepreneurs who work less than 40 hours weekly are mainly from industrial companies, where they have not enough financial resources to work normal time.

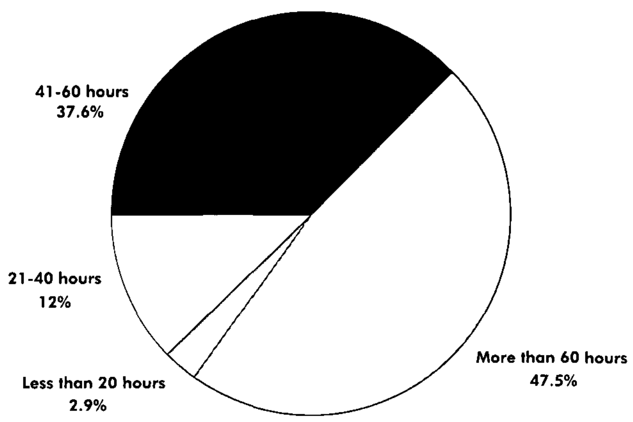
Using the same multiscale approach we have examined the priority directions of firm development for the entrepreneurs during the first two years. In the first position have been placed the new products and service, penetration on the new market, hiring new specialists

Figure VIII. Motivations for becoming an entrepreneur



Key: 1 - Development and application of an idea, or a product, or a business
2 - Work with selected persons
3 - Personal and family security
4 - Self-achievement
5 - Better earnings
6 - Contribution to the welfare of the community

Figure IX. Average weekly working time



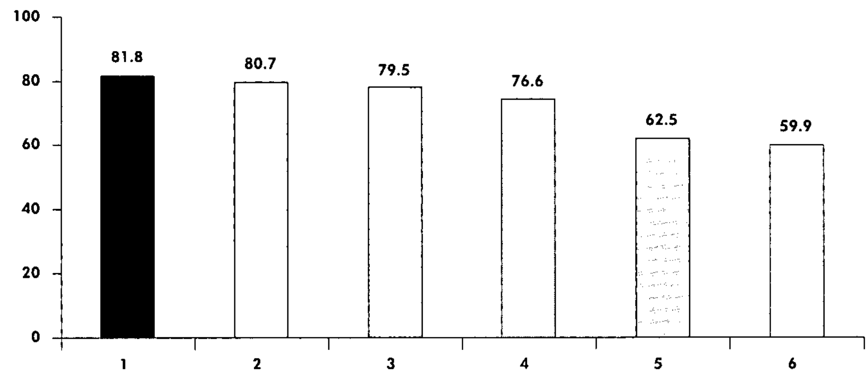
and buying new equipment (see figure X). It is obvious that a strong orientation for company development by innovation is essential for performance in this period towards the transition to a knowledge-based economy.

A more recent research done in the beginning of the 2000 on entrepreneurs in the field of export, has revealed interesting features. A model is presented in table 2.

Table 2. Model portrait of a Romanian export entrepreneur

- Married man
- Engineer
- 46 years
- Long experience (26.5 years)
- Foreign languages—average 2
- Development oriented—average 2 postgraduate courses
- Large foreign experience—average 16 foreign professional and private trips

Figure X. Priority directions of action in the first two years



Key: 1 - Adding a new product, service
2 - Selling in a new market
3 - Hiring of specialists
4 - Acquisition of new equipment
5 - Development
6 - Use of professional consultants

ENHANCING THE COMPETITIVENESS OF ROMANIAN SME's THROUGH INNOVATION BASED ON A HOLISTIC APPROACH

Our approach of the Romanian SME's development is based on several premises: SME' problems are very heterogeneous, complexes, dynamic and intercorrelated. For this reason, SME's problems needs a holistic (systemic) approach, in each country based on:

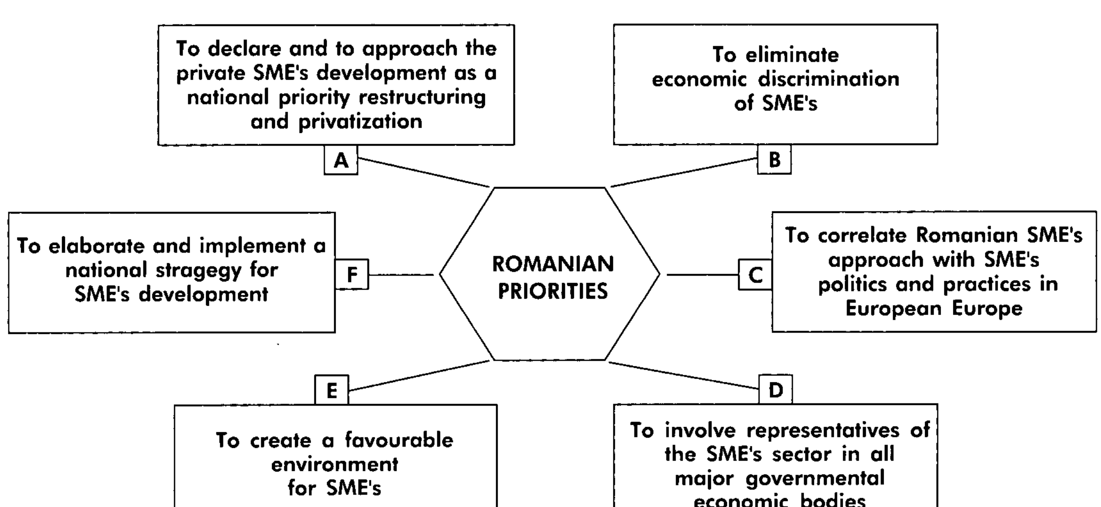
specific conditions on every country

implications of the internationalization and globalization

requirements of the next knowledge-based economy

Analysis of the Romanian SME's situation and environment by the specialists of the National Council of Romanian Private SME's allow us to establish six priorities for SME's development (figure XI).

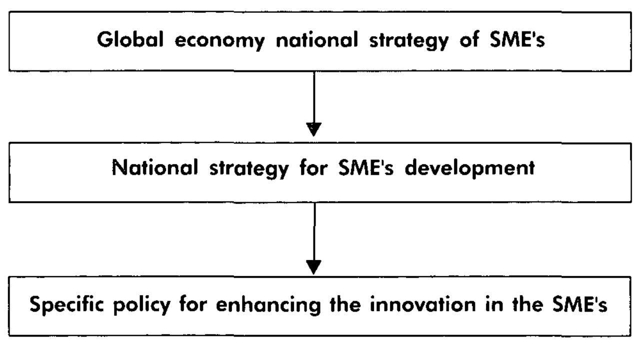
Figure XI. Romanian priorities



Of course, an approach to SME's should be correlated with two other major economic processes—economic privatization and restructuring. SME's development is no less important than privatization and restructuring. In all developed economy, SME's produce more than half of GNP and assure the majority of the jobs in the economy. We emphasis this aspect because in many Central-Eastern European countries there is a tendency to focus on privatization and restructuring, neglecting SME's development.

In order to develop a competitive and sustainable SME sector it is necessary to elaborate and implement an SME strategy based on a global economy strategy (figure XII). The main objectives of the SME's strategy is the creation of an enabling environment for SME's. Within SME's strategy a central place should be paid to the innovative SME's. They represent the engine for the construction of the new economy—knowledge-based economy.

Figure XII. Strategic SME's approach



We formulate—according to our analysis—in order to achieve an enabling environment for SME's the following strategic recommendations:

1. Access of the private SME's by leasing, renting, buying the companies spaces and equipment
2. Differentiation of the profit taxes, according to the SME's branch, age and profit size
3. Reducing of the profit taxes on the profit reinvested
4. Financial assistance for the SME's which are exporters of local products and services and create new jobs
5. Fiscal facilities for the SME's which invest in unfavourable areas
6. Conversion of the one state bank in the investment bank for SME's
7. Creation of the guarantee fund for SME's
8. Involvement of the entrepreneurs and SMEs' organizations representatives in bilateral and multilateral governmental business meeting and contacts
9. Foundation of the specialized information bank for SME's
10. Organization of the comprehensive and permanent training programmes for entrepreneurs and SME's managers and specialists
11. Introduction in the high schools and universities of the entrepreneurial management courses
12. Development of the powerful national R&D centres and training network for SME's
13. Allocation of a substantial amount of the R&D state budget for the SME's major problems

14. Development of the incubators and industrial districts network
15. Involvement of the SME's representatives in the managerial bodies of national and local administration
16. Development of the intensive national programme in mass-media focused on the improvement of the entrepreneurs image (as one of the main "actors" of the market economy) and status and for its perception
17. Assistance to the SME's non-governmental organization development
18 Improvement of the Romanian legislation regarding the SME's activities, eliminating the present necorrelations and contradictions

Referring mainly to the innovative SME's, we propose a set of concrete measures presented briefly in table 3.

Table 3. Concrete actions for enhancing competitiveness of the SME's through innovation

No.	*Main actions*
1.	Improvement of the SME's management through: • Management consulting centres • Management training programmes for entrepreneurs • Incubators
2.	Increasement of the financial stimulants for innovative SME's: • Seed capital • Special credits • Taxes reduction
3.	Development of the entrepreneurship within large enterprises: • Juridical aspects • Economical aspects • Managerial aspects
4.	Achievement of the effective information network for SME's at: • Regional level • National level • International level
5.	Development of the entrepreneurial culture, especially for the young generation: • High school special entrepreneurial courses • University special entrepreneurial courses • Mass media entrepreneurial presentation, financed by state
6.	Assistance to the SME's organizations for developing: • SME's networking • Entrepreneurial services • Enabling environment
7.	Involvement of the SME's representant in all major governmental economic bodies at: • National level • Regional level • Local level
8.	Transfer of the aquis communitaire to the Romanian SME's regarding: • Legislation • Institutions • Business approach and methods • Specific measures for stimulating SME's

In the annex we present the objectives and measures regarding SME's included in the second version of the Romanian strategy for EU integration.

ANNEX 1

Objectives and measures regarding SME's included in the Romanian strategy for EU integration

Objective 1. To simplify and improve the legal and administrative framework regarding SME system

Actions and Measures for implementation:

- To promptly and entirely enforce the Law 133/1999 regarding SME's. Date to implement: 2000
- To elaborate economic and social impact studies, taking into account the implications on SME sector, for all the proposals of legal acts; to consult the representatives of the business community. Date to implement: 2000-2004
- To elaborate unique methodologies and to set up a mechanism for the elaboration, monitoring, control and evaluation, which could ensure the coherence of the policies for the SME system development Date to implement: 2000

Objective 2. To support the organizations representing SME system and to consult them

Actions and Measures for implementation:

- To elaborate and implement programmes to support the organizations representing the SMEs interests at national and local level. Date to implement: 2000
- To develop advocacy system and to legalize the lobby system. Date to implement: 2001

Objective 3. To identify priorities for development and efficient allocation of resources

Actions and Measures for implementation:

- To elaborate and implement programmes for SME's through socio-economic partnership among public authorities, commercial societies, SMEs associations, chambers of commerce and industry, counselling and training centres; the partnership could be established at central, local, regional and cross-border level. Date to implement: 2000

Objective 4. To improve SMEs access to finance, the market failure being supported by the government by support for viable business projects

Actions and Measures for implementation:

- To support the establishment of a specialized SME bank, for investment and export. Date to implement: 2001
- To co-finance and assist the development of modern systems for financing SME's (leasing, factoring, venture capital etc.). Date to implement: 2001
- To develop specific projects and actions for the SME access to financial sources (credit lines with an accessible interest rates; setting up the legal framework for the establishment of non-profit micro-credit schemes; credit guarantees and co-guarantees; setting up the operational legal framework for the establishment of non-banking financial institutions authorized to extend loans for SMEs and of venture capital companies). Date to implement: 2000

- To co-finance and assist the management of new enterprises (grants, business internationalization). Date to implement: 2000
- To deliver financial resources for co-financing and efficient use of the financial aid from EU and donors. Date to implement: 2000-2004

Objective 5. To improve services offer in order to enhance business performance

Actions and Measures for implementation:

- To elaborate and implement state assistance programmes for counseling, training, information centres for SMEs; to elaborate an operational training plan. Date to implement: 2000
- To deliver resources for high quality training and counseling, at accessible costs. Date to implement: 2000
- To develop business incubators, innovation centres, and business parks. Date to implement: 2000
- To formulate a strategy to promote human resources, to introduce entrepreneurial disciplines in the high school and university curricula. Date to implement: 2000

Objective 6. To increase SME's capacity to operate, including on foreign markets

Actions and Measures for implementation:

- To establish mechanism stimulating sub-contraction for SMEs, especially in industry. Date to implement: 2001
- To elaborate and implement support programmes for export promotion. Date to implement: 2000
- To deliver and subsidize counseling, participation and good execution guarantees, etc., in order to support SMEs participation in tenders. Date to implement: 2000-2004

Objective 7. To identify spatial initiatives to promote the development of SMEs

Actions and Measures for implementation:

- To implement a strategy based on projects as: business parks, technological parks; clustering, special economic zones, tourism, commercial centres, business incubators, innovation centres. Date to implement: 2000

Objective 8. To develop a strong SME system in regenerating the disadvantaged areas

Actions and Measures for implementation:

- To include specific measures in favour of the SME system in the development plans for the disadvantaged areas. Date to implement: 2000.

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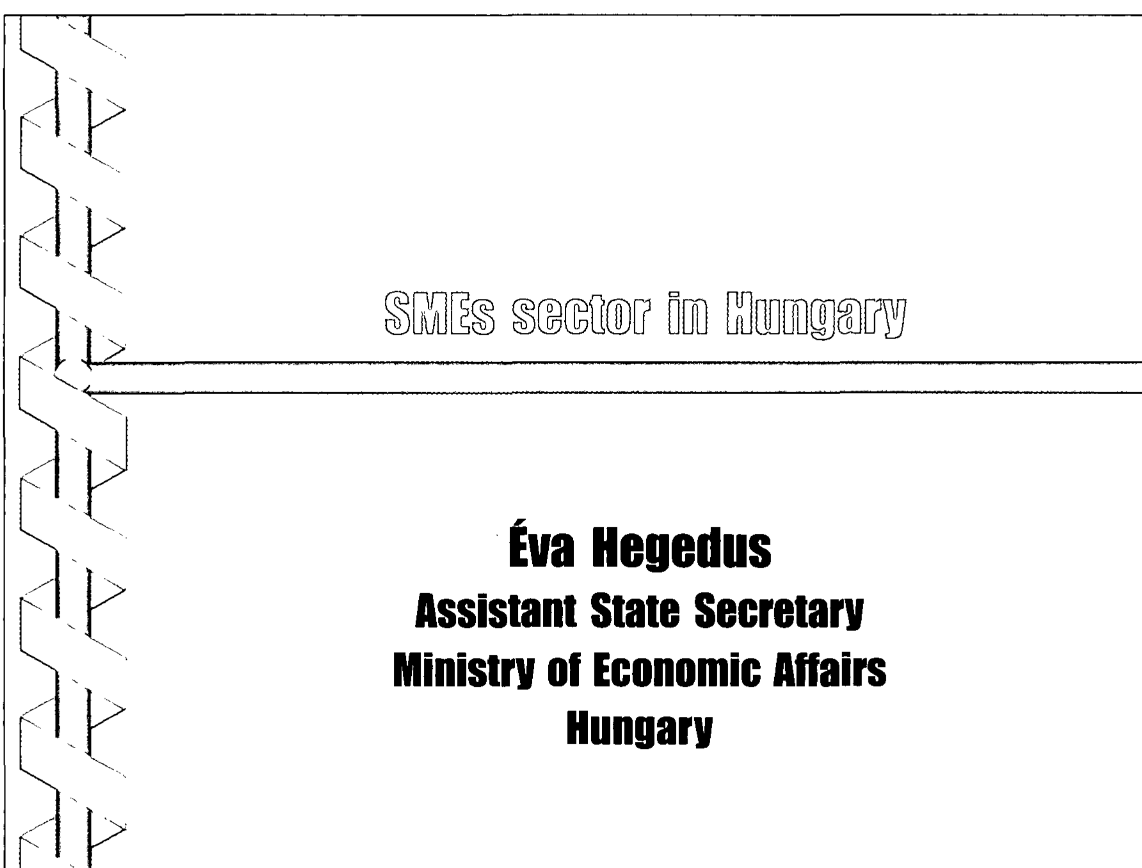
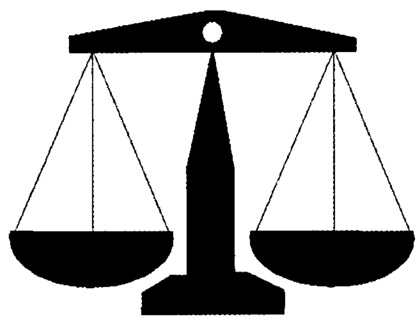
SME Sector in Hungary

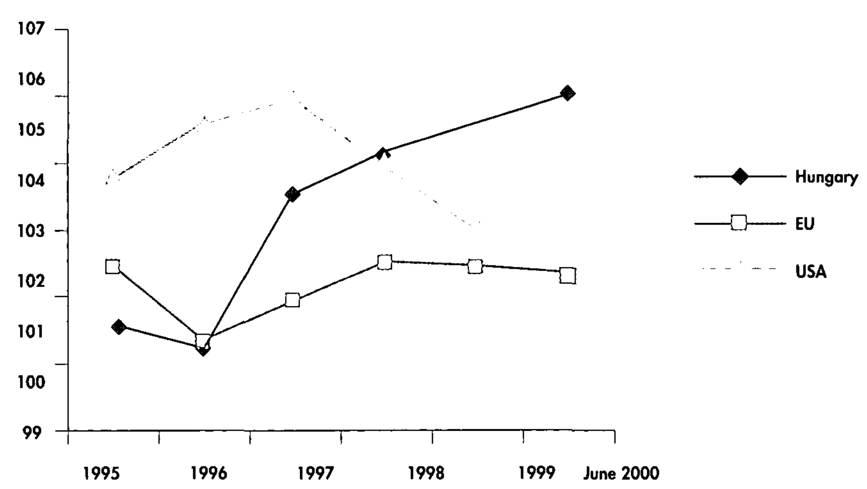
Eva Hegedus



The situation of Hungarian Economy

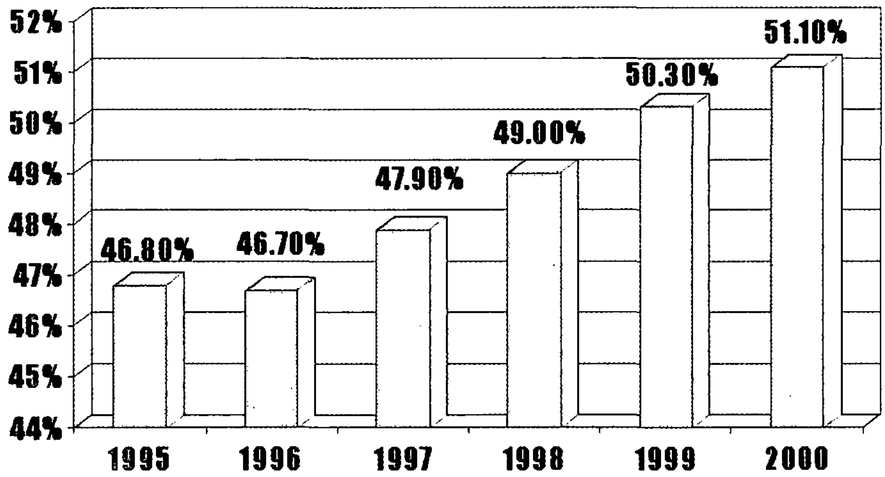


GDP growth in Hungary, USA and in the EU between 1995 and 2000



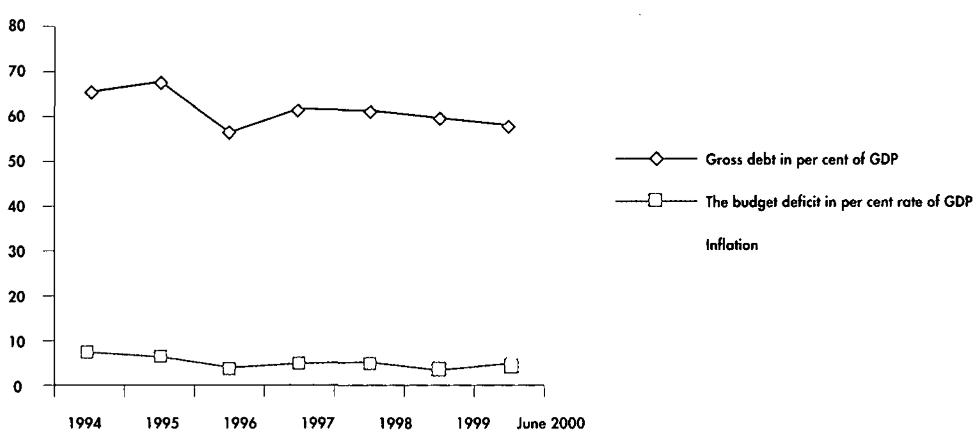
Source: CSO, Budget for 2000, European Economy, Europay

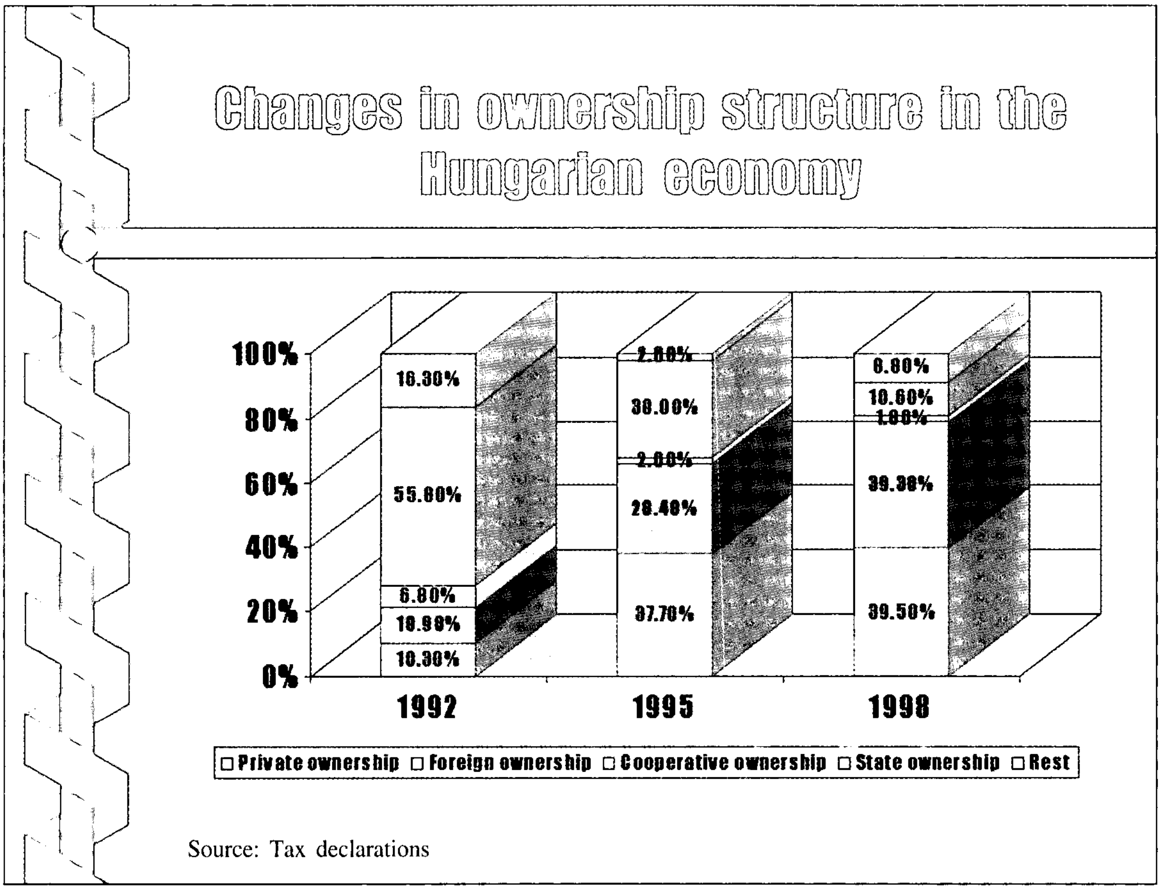
Per capita GDP compared with EU average



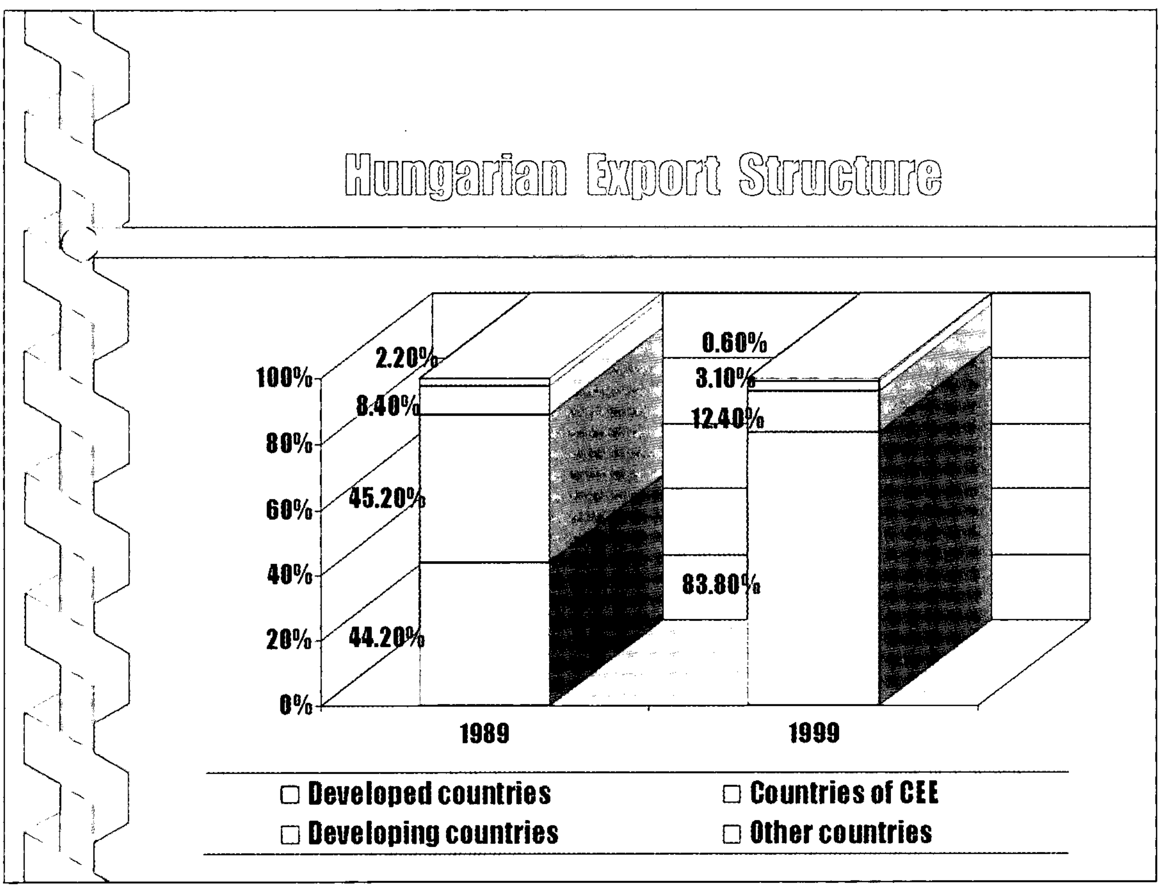
Source: CSO, budget for 2000, European Economy, Europay

Financial indicators in Hungary between 1994 and 2000

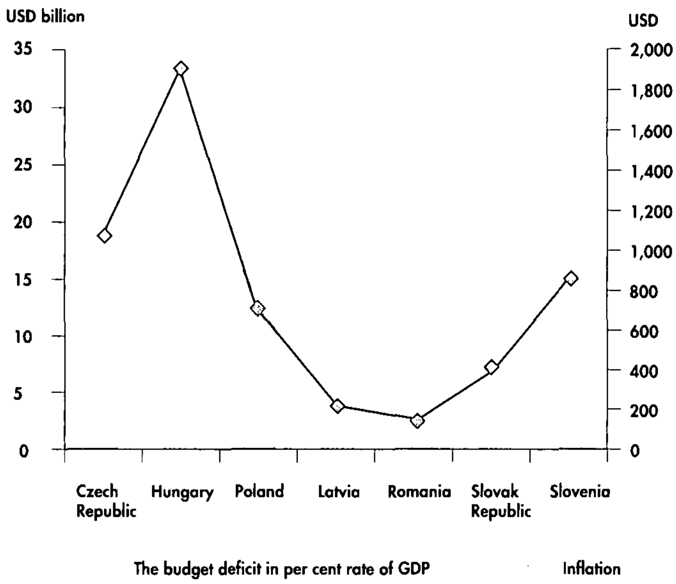




Source: Tax declarations

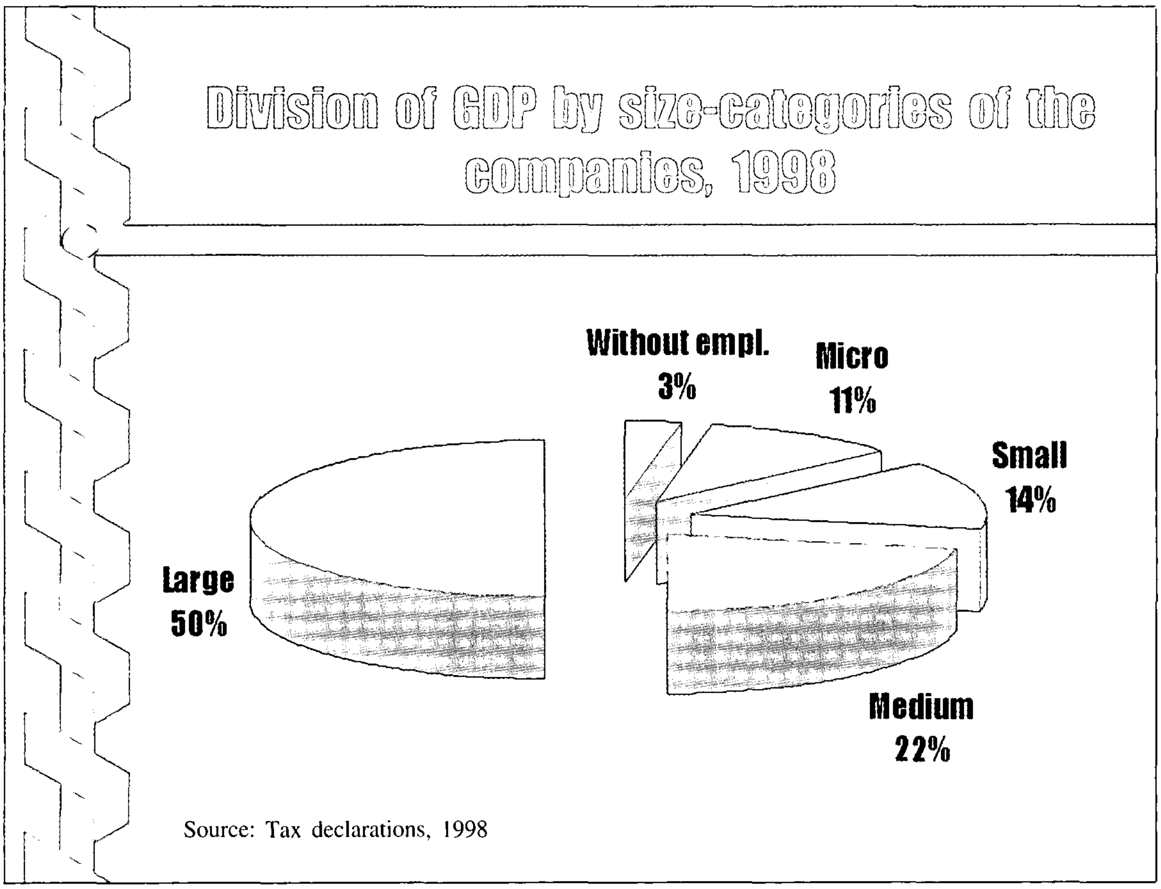


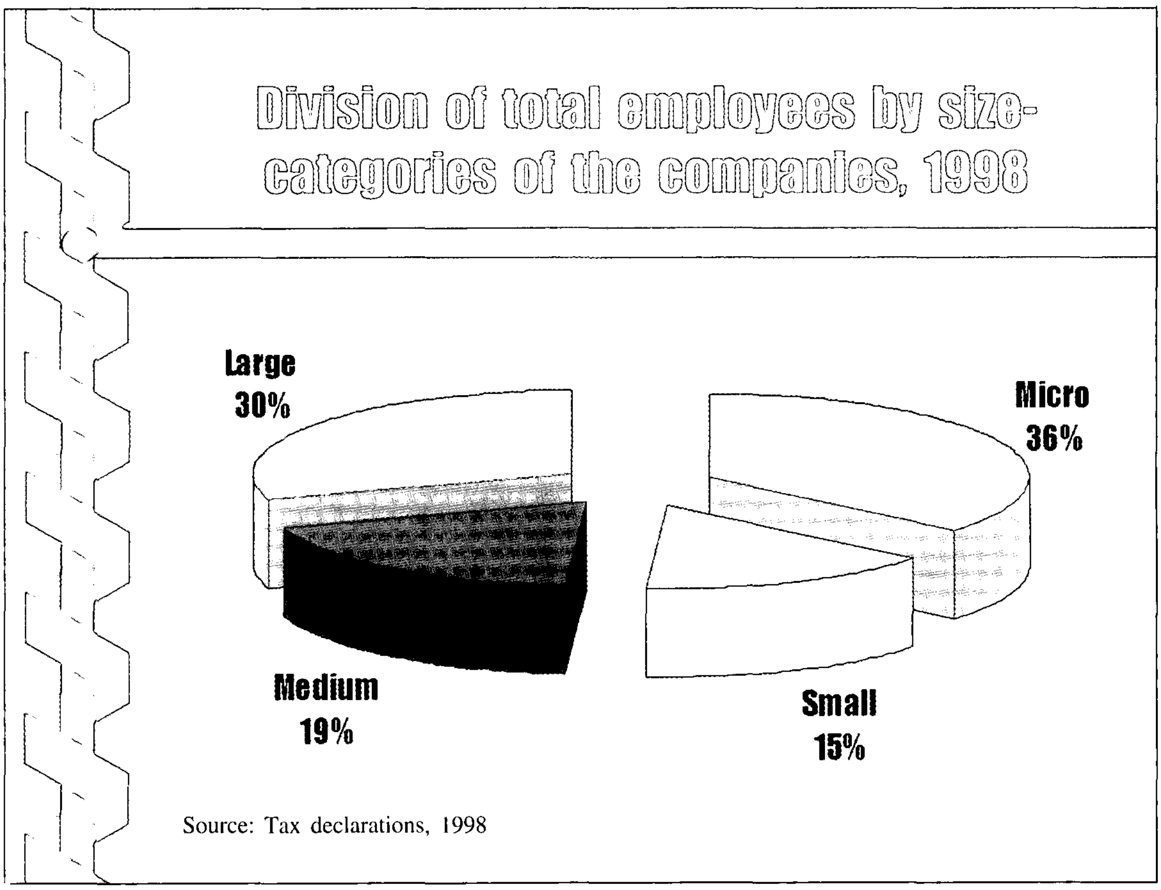
Foreign investments in the Central and Eastern European region (1990-1999)



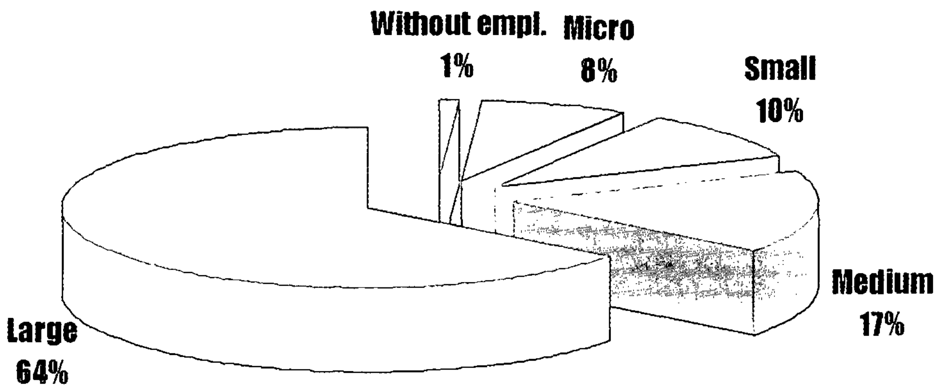
Definition of small business

- SME: total staff below 250 and net annual turnover max. HUF 4000 M or balance sheet total max. HUF 2700 M
- Small enterprise: total staff below 50 and net annual turnover max. HUF 700 M or balance sheet total max. HUF 500 M.
- Micro enterprise: staff below 10.


Division of GDP by size-categories of the companies, 1998
Without empl.
3%
Micro
11%
Small
14%
Large
50%
Medium
22%
Source: Tax declarations, 1998


Division of total employees by size-categories of the companies, 1998
Large
30%
Micro
36%
Medium
19%
Small
15%
Source: Tax declarations, 1998

Division of export turnover by size-categories of the companies, 1998



Source: Tax declarations, 1998

Importance of SMEs

- Employing the majority of workforce
- Meet specific market needs
- Innovative potential

Typical problems of SMEs

- **Weak own financial resources**
- **Low amount of assets**
- **Imperfect managerial skills**

Institutions providing financial support for SMEs

- **Hungarian Foundation for Enterprise Promotion**
- **Credit Guarantee Co.**
- **Rural Credit Guarantee Foundation**
- **Hungarian Export and Import Bank**
- **Hungarian Export Credit Insurance Co.**
- **Hungarian Development Bank Co.**

Hungarian Foundation for Enterprise Promotion

- **Micro Credit:**
  - **staff less than 10 and turnover below 100 M**
  - **max. HUF 3 M**
  - **NBH base interest rate**
  - **0.5-3 years**
  - **min. 20% own source**

Credit Guarantee Co.

- **Supports mainly small enterprises**
- **New guarantee exposure: HUF 30 bn in 1999**
- **90% guarantee if loan size below HUF 10 M**
- **Fast process**
- **Reduced fee (0.5%)**

Rural Credit Guarantee Foundation

- **Created with PHARE aid in 1991**
- **Loans for agricultural activities**
- **70% budget guarantee**
- **Loans of HUF 16 bn guaranteed in 1999**
- **Max. HUF 8 N**
- **Total staff max. 25**

Hungarian Export and Import Bank Co.

- **Refinancing credit extended to commercial banks for export promotion**
- **Customer credit to foreign banks with clients intending to purchase Hungarian goods**
- **Export financing credit extended directly to the clients**

Hungarian Development Bank Co.

- Loans for SMEs to create jobs (refinanced by EC Social foundation)
- Loans for industrial and touristic investments (refinanced by EIB)

Small Enterprise Credit Programme

- Micro Credit (3 M) plus:
  - bank loan up to HUF 7 M
  - guaranteed by Credit Guarantee Co.
  - interest: max. 150% of NBH base rate
  - Interest subsidy (50% of NBH base rate)

Problems of Development of the SME Sector in Poland during the 1990s

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DEVELOPMENT TRENDS OF THE SME SECTOR IN THE YEARS 1990-1997

When observing the development trends of the Polish economy in the years 1990-1997 one can clearly distinguish two subperiods. The first one encompasses the years 1990-1994, when after the introduction of the principles of market economy industrial production in the state-owned enterprises started to abruptly decrease. The ineffective state-owned industry, producing in the era of the centrally managed economy the technologically outdated products, was no longer capable of responding to the competitive challenge after the opening up of the economy and the introduction of the internal convertibility of the domestic currency. There existed yet two other additional factors, which were decisive for the downfall of the state-owned enterprises. The first of these factors was the loss of the traditional sales markets,[1] primarily the eastern ones, where a number of products turned out in Poland had been sold before, such as textiles, clothes, or shoes. The loss of these markets was related to the economic difficulties developing in the USSR, and, following the collapse of the USSR—in the Commonwealth of the Independent States (CIS). The second factor was the radical drop of the volume of governmental orders for the products of arms industry, in connection with the political transformations in the Central-Eastern Europe, leading to dissolution of the Warsaw Pact in 1991. The complete liquidation of a large number of the state enterprises and the decrease of production in the other ones entailed an increase in the unemployment rate from 6.5% in 1990 up to 16.4% in 1993 (16% in 1994). The unemployment rate would certainly have been higher were it not for the fact that a certain group of people having lost their jobs in the public sector acquired in the years 1991-1992 the right

[1]The economic difficulties caused by the severing of the former cooperation links were strongly felt not only by all the European COMECON countries, but also by, for instance, Finland, closely associated with the Soviet economy.

to earlier retirement pays, which, in turn, along with the necessity of paying unemployment benefits, was one of the major causes of the state budget deficit in the 1990s.

The sales of the state-owned and the cooperative enterprises, measured in comparable prices, decreased in 1990 by approximately 15% in relation to the preceding year, and by further 17% between the years 1990 and 1993. Yet, in spite of this decrease of sales of the state-owned and cooperative enterprises, manufacturing production remained in 1993 at more or less the same level as in 1990. This occurred owing to the activity of the small and medium sized private companies,[2] whose sales value in the period 1990-1993 almost doubled. Thus, countering of recession in manufacturing within the other divisions of economy is to a large extent the feat of the private small and medium enterprises (SMEs). It was just mainly owing to the activity of the SMEs, that the gross domestic product (GDP), which decreased in 1991 considerably in comparison with the preceding year, increased in 1993 again to the level of 1990, and then exceeded in 1994 this level by 4%.

The early stage of transformation,[3] taking place in the years 1990-1994, was characterized by the rapid growth of the number and significance of the SMEs, primarily in three domains: trade, construction, and manufacturing. In manufacturing, this growth was limited to a couple of rather more traditional branches, like food processing, garment, wood (especially furniture), printing (package and advertising leaflet printing), and construction materials industries. Of the more technologically advanced domains an exception was constituted by the precision industry, primarily owing to the companies assembling microcomputing equipment from the imported components and subassemblies. The directions of development of the SME sector in the early years of transformation are, of course, not a surprise. The period of real socialist economy left in our country an unfulfilled demand for quite elementary products and services, which started to be first of all satisfied by the private SMEs, more flexible than the large enterprises, which were, at that time, anyway, still largely state-owned. The SMEs searched for and occupied the appropriate market niches, especially there, where the technological processes were not too complicated, the capital necessary for establishment of an enterprise was not high, and the possibility of satisfying local demand made small-scale production profitable.

The early stage of transformation of Polish economy ended more or less in 1994. Starting with this year Polish economy began to grow at a rapid pace. Investment outlays of the private sector outside of agriculture[4] increased from approximately US$ 4.8 billion in 1994 to US$ 12 billion in 1997, namely by the factor of 2.5. The investment outlays borne by the

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[2]For purposes of the present report the small firms will be understood to employ at most 50 persons (excluding owners and members of their families), while the medium-sized enterprise would be the one which employs between 51 and 250 persons.

[3]The statistical data characterising the development of the SME sector in the years 1990-1993 are, regretfully, quite limited, for two reasons. First, the more systematic and methodologically correct study of the SME sector, carried out, in particular, with the representative method, were initiated by the Central Statistical Office (GUS) only in 1993. Second, the classification of the national economy, applied by GUS until 1993 was essentially different from the one introduced at the beginning of 1994, corresponding to the European standards. That is why the statistical data from before 1994 are to an extent incomparable with the ones from the later years.

[4]The data presented in this paper, concerning the SME sector in the years 1994-1998, were elaborated by GUS at the order from the Polish Foundation for Small and Medium Enterprises Promotion and Development, which finances its activity from the funds made available by the European Union (EU). These data were published before in the annual *Reports* of the Foundation concerning the state of the SME sector, and in four publications of RECESS, where they were considered in greater detail than in the *Reports* mentioned. All the information on the SMEs provided in the present paper will not account for the enterprises active in agriculture, forestry, fishing and fishery, and in case of data concerning the functioning SMEs—also in financial intermediation.

SMEs rose from US$ 3.3 billion to almost US$ 7.5 billion, which was caused, in particular, by the intensive inflow of foreign capital. In the new economic conditions the role of the SME sector changed somewhat in comparison with the preceding period. This, however, did not slow down the development of the SME sector, but rather contributed to the change in the directions of expansion of the small and medium enterprises.

The number of the actually functioning, i.e. the so-called active,[5] SMEs increased in the years 1994-1997 by slightly more than 42%. Yet, in particular domains of economic activity the rate of increase of the number of active SMEs differed significantly. It can be generally stated that in the years 1994-1997 the rate of increase of the number of SMEs in the traditional domains of economy was significantly lower, while it was much higher—in relative terms—in the areas with domination of service. Thus, in the period between the years 1994 and 1997 the number of SMEs in manufacturing increased by 23%, and in trade—by slightly more than 31%. These two domains—side by side with construction—were in the period 1990-1993 among the most rapidly developing sectors in Poland as to the number of active SMEs. In distinction from manufacturing and trade, the SMEs in construction have been still developing dynamically after 1994. Their number in the three-year period analysed increased by as much as somewhat more than 70%. The primary cause for this rapid growth was the increasing demand for the construction service consisting in repairs and overhauling of various facilities, both meant for economic activity and for housing, which was on the one hand the result of the enormous repair needs inherited from the period of real socialism, and on the other hand—the effect of a good economic situation starting from 1995, with the related increase of the incomes of the society. In the years 1994-1997 the number of active SMEs in two typically service-oriented sections of the economy, namely in the so-called remaining service activity (the increase of the number of SMEs by approximately 56%), and in the estate and business service (increase by 65%) was growing fast. The development of the latter of the two domains should in particular be emphasised, as it encompasses the firms that provide service to other firms in such areas as technical and legal counselling, marketing, management, and computer service. As it is commonly pointed out by the specialists dealing with the role and significance of the SMEs in the economy, a long-term development—especially of the small enterprises—and a modernization of their way of functioning are not possible without a strong sector of firms providing service to the other ones.

As mentioned already before, the number of the SMEs in manufacturing increased between 1994 and 1997 by 23%, while the number of all the active SMEs in the economy grew at the rate almost twice as high—by 42%. Yet, not all the domains of manufacturing were developing at such a relatively slower rate. And so, for instance, the number of manufacturing enterprises of medium size increased[6] in the period 1994-1997 by approximately 30%, while the number of all the medium-sized firms in the economy increased only by a little

[5]The notion of "active SMEs" is used in order to make distinction with the SMEs registered in the enterprise register maintained by GUS. A part of the registered enterprises (approximately one third) do namely not conduct any proper activity (either ended their activity altogether or never started it after having registered) and have not informed GUS of this fact. That is why the numbers of active and registered enterprises differ considerably, and the rate of increase of the number of registered enterprises does not have to correspond to the real processes taking place in the economy.

[6]One should add at this point, though, that a part of these "new" medium-sized enterprises had been before the large enterprises, which moved over to the medium-sized class by reducing their employment to below 250 persons.

more than 20%. This rapid growth took place, in particular, owing to the inflow of foreign capital to industry. In the group of the smallest industrial enterprises, employing up to five persons, whose number increased in the period analysed by roughly 21%, a relatively low rate of growth—or even an absolute decrease—of the number of firms was observed in the traditional domains of production, like food and beverages, textiles, garments, leather and shoes, wood products (except for furniture), as well as in production of goods of rubber and plastics, and of construction materials. These traditional branches of industry flourished in the initial phase of economic transformation of Polish economy, that is—before the year 1994. Then, on the other hand, in the years 1994-1997 there was a dramatic increase of the number of enterprises being the part suppliers for the automotive and machine-building industries, cooperating with the large companies, mainly those with foreign capital. And so, for instance, the number of enterprises producing parts for mechanical vehicles increased by 135%, and those supplying parts for machines and appliances—by almost 60%. Of the domains classified as high-technology the number of the smallest firms producing medical instruments increased by close to 68%, and of the ones producing microcomputer equipment—by 48%. Regarding other domains of industry, which feature a rapid increase of the number of the smallest enterprises one should mention printing and publishing, as well as the previously very much neglected waste processing, where the number of the smallest firms increased in the period analysed, 1994-1997, by approximately 74%.

The significance of the SME sector for the Polish economy can be easily assessed on the basis of the data concerning employment. The total number of persons employed in the enterprise sector increased in the years 1994-1997 by 5.7%. Yet, while the number of persons employed in large enterprises decreased in this period by 7.2%, it increased in the SMEs by 15.1%. With respect to the latter, the increase of employment in the small firms amounted to 12.1%, in the smallest ones, employing up to 5 persons it was equal 18.4%, and in the medium ones—23.6%. In terms of sections of economy the increase was the quickest in financial intermediation (by more than 88%), this being due, in particular, to the fact that starting with the middle of the 1990s foreign banks and other financial institutions started to set up their branches and offices in Poland on quite a large scale. The increase of employment in the SMEs was also relatively rapid in the sections of transport and communications (more than 24% of increase), estate and business service (more than 23%), and manufacturing (approximately 16.5%). There was, on the other hand, a rather slow increase of employment between the end of 1994 and 1997 in two domains, in which the numbers of SMEs grew dynamically, namely in construction and in the so-called remaining service activity. It must be remembered, though, that construction and services employ a large proportion of seasonal workforce and of part-timers, who are not accounted for in the total number of persons employed as of the end of the year, mentioned before. Besides, construction and service, as well as trade, employ a significant number of persons without any registering (the grey zone of the economy), of whom many are the citizens of other countries, primarily of Ukraine, Belarus, and the Russian Federation.

As can be concluded from the data here presented, concerning employment numbers, the SMEs not only secured in the years 1994-1997 the workplaces for those who lost their jobs due to restructuring or liquidation of the large state-owned enterprises, but also created new jobs for the young, entering the productive age. Due to this, the unemployment rate, amounting in 1993 to as much as 16.4%, dropped by 1997 down to 10.3%. Simultaneously, in the same period, the contribution of the SMEs to the GDP value has been increasing, reaching in 1997 the level of 45.3%. Hence, the gross value added (GVA) produced by the SMEs has been increasing quicker than that produced by other economic agents, including large enterprises. It was exactly owing to the activity of the SMEs that the value of the GDP, calculated in constant prices, was in 1997 higher by more than 26% than in 1990, and was even higher than in 1988, considered to be the best with this respect in the period of real socialist economy.

THE STATE OF THE SME SECTOR IN 1998

In 1998 the economic situation in Poland worsened somewhat in comparison with the three preceding years. The GDP in constant prices increased in 1998 by 4.8%, while in 1995 it increased by 7%, and in the years 1996-1997 by, respectively, 6% and 6.8%. The primary cause of this worsening of the economic situation[7] was undoubtedly the financial crisis in the Russian Federation, which took place in August 1998. As a consequence of this crisis, the official export of goods from Poland to the Russian Federation decreased by at least US$ 450 million in comparison with the preceding year. The losses, however, were much bigger in the so-called unregistered trade with the Russian Federation. The issue is in the purchases of goods in Poland for convertible currencies, made by the citizens of the Russian Federation. The producers and sellers of these goods (food products, beverages, garments, shoes, and furniture) were primarily the small and medium enterprises.

At the end of 1998 the number of active enterprises was equal at least 1,726,073. The number of the small active enterprises was equal 1,709,294, i.e. slightly more than 99% of all the functioning enterprises. There were 13,322 enterprises of medium size (less than 0.8% of the total), and 3,457 large enterprises. Of the total number of active enterprises only 5,781 belonged to the public sector, while 1,720,292—to the private sector. The public sector encompassed in 1998 2,219 small enterprises, 2,284 medium-sized ones, and 1,278 large ones.

The number of active SMEs increased in 1998 by 9%. The rate of increase was the same for the entire population of the active enterprises, which is, however, quite obvious, given the vastly dominating share of the SMEs in the set of all the active enterprises (99.8%). This rate of growth, though, also with respect to the private SMEs, was in 1998 twice lower than in the preceding years, 1996 and 1997, when it amounted to approximately 18%. The number of small active firms increased in 1998 by 9.1%. Here, of course, the rate of growth was as well at half of that from the years 1996 and 1997. Essential decreases of the rate of growth of the numbers of small firms were observed in the majority of domains of economy. Thus, for instance, in trade, the number of small enterprises was increasing in the years 1996-1997 at the rate of approximately 15% a year, while in 1998 this rate dropped to roughly 5%. The number of small construction enterprises increased in 1997 by 38%, while in 1998—only by approximately 10%. There were only two domains of economy, namely manufacturing and communications, where the rate of growth of the number of

[7]There are, however, the economists who put the blame with this respect on the government, conducting in 1998 the policy of cooling down of the economy by limiting the supply of money, which was meant, in particular, to counter the foreign trade deficit. One of the methods of decreasing the supply of money was to be the curbing of the budget deficit. Yet, this policy did not bring the results expected, due, among other, to the volume of credits and loans granted by banks in 1998 the businesses and the private persons.

small firms remained in 1997 and 1998 at similar levels, namely at 10% and 15%, respectively. In the group of the smallest manufacturing firms, employing up to five persons, the tendency observed already before persisted, that is—the one of a quicker increase of the number of businesses in the technologically more advanced branches than in the traditional ones.

The rate of growth of the number of medium sized enterprises decreased almost twice, as well, between 1997 and 1998. In 1997 it was at 8.1%, while in 1998 at the mere 4.3%. Similar regularity was observed in the majority of sections of the economy. Thus, for instance, in manufacturing the rate of growth of the number of medium sized firms decreased between 1997 and 1998 from 10% to 4.7%, in construction—from 4.5% to 1.5%, in trade—from 5.6% to 2.4%, and in transport—from 7.3% to 4.3%.

In 1998 as many as 39.6% of all the small enterprises were trade enterprises, although this share had been systematically decreasing since 1994. The small manufacturing enterprises constituted 13.4% of all the small enterprises, while the third and fourth ranks were occupied by the construction and the estate and business service sections, with similar shares somewhat exceeding 10.5%. In the group of medium sized enterprises the largest share (47.4%) was taken by the manufacturing firms, followed by trade (19.9%), and construction (14%) firms.

At the end of 1998 the enterprise sector employed altogether approximately 9,108,000 persons, of whom roughly 4,270,000 (46.9%) in small enterprises (2,385,000, i.e. 26.2% in the smallest enterprises, employing up to five persons), approximately 1,619,000 (17.8%) in the medium sized enterprises, and approximately 3,219,000 (35.3%) in the large ones. Thus, at the end of 1998 the SMEs secured jobs for 64.7% of all the employees of the enterprises. The analogous share for the end of the preceding year, 1997, was equal 63%, that is—by 1.7 percentage point less. The share of the small enterprises increased between the ends of Decembers of the two years compared by 1.2 percentage point, and of the medium sized firms—by 0.5 point. Private enterprises employed in 1998 approximately 75% of all those working in the enterprises, and if 100% denotes the total number of persons working in the SMEs, private enterprises accounted for more than 91% of it.

At the end of 1998 the number of persons working in the enterprises was by 0.4% lower than on 31 December, 1997. This breakdown in the upward trend of employment in the enterprises, observed since 1994, was brought about by the decrease of the number of persons working in the group of large firms—by 4.7%, which was not quite compensated by the increase of the number of persons employed in the SMEs, amounting to 2.1%. The year 1998 was the first one since a relatively long time, when the rate of growth of employment in the small enterprises exceeded the same rate observed in the medium sized firms. Yet, in both these groups of firms the rate of growth of employment was clearly lower than in 1997. In the group of small enterprises it dropped from 6.3% in 1997 to 2.7% in 1998 (in the smallest enterprises—from 14% to 1.8%), while in the medium sized firms—from 7.2% to 2.1%. Hence, a similar tendency to a decrease in the rate of growth could be observed here as in the case of the number of active SMEs.

In the group of small enterprises the rate of growth of the employment number in 1998 was lower than the respective average (the previously mentioned 2.7%) in manufacturing (2.2%), construction (1.9%), and trade (2%), that is—in the three basic sections providing jobs for roughly 75% of the total number of persons working in small enterprises. In these three sections it is only the lower rate of growth of employment in the small manufacturing firms that can be associated directly with the Russian crisis (the total number of persons employed in the section fell in this case by 3.6%). Regarding trade, the low rate of increase of employment in small firms can also be explained by the development of the supermarket network (employment in the large enterprises of this section increased in 1998 by 10%), established from scratch with an essential contribution of the foreign—especially French and German—capital. A particularly high rate of increase of the number of persons employed in small enterprises in 1998 was observed in financial intermediation (18.4% of increase), owing to the development of the banking and insurance sectors, largely due to the activity of foreign investors.

As far as the medium sized enterprises are concerned, the increase of employment in such sections as manufacturing (by 2.9%), construction (by 2.7%), as well as transport and communications (by 0.8%), was most probably caused by the transfer of some large firms to the class of the medium sized ones, as they reduced their employment to below 250 persons. In all these domains of economy, namely, an essential drop of employment in the group of large enterprises was observed (the biggest one in manufacturing, by 8.5%, owing, in particular, to the restructuring of the collieries). The situation was different in the case of such sections as trade (increase of the number of persons employed in the medium sized firms by 1.7%), financial intermediation (increase by 12.7%), and the estate and business service (increase by 0.7%), where employment was growing not only in the medium, but also in the large firms. Here, beyond any doubt, the increase of the number of persons employed in the medium sized enterprises did not occur owing to the mass migration of the firms, having employed before more than 250 persons, down to this magnitude class.

The data concerning employment numbers, commented upon before, do not account for the unregistered employment, that is—the persons employed in the grey zone of the economy. The respective analyses carried out by GUS indicate that the situation in terms of the share of illegally employed persons in total employment of the small enterprises is the best in transport and manufacturing, where this share was around 5%. In other words, in these domains only every twentieth employee of a small enterprise, including the single-person firms, was in 1998 employed illegally. In construction—every eighth, and in trade—every tenth employee was on the average employed illegally. A much more serious situation existed in the broadly conceived service sphere, except for the financial intermediation. Here, in 1998, every fourth employee of a small enterprise worked illegally, although in this domain, as well, the situation improved in comparison with the year 1995, when every third person working there was employed illegally.

The value added produced by the SMEs in 1997, calculated with due account of the hidden economy, equalled 45.3% of the GDP. In 1998 the share of the SMEs in the GDP was 48.1%. Thus, the contribution of the SMEs to the value of the GDP increased in 1998 relatively significantly, namely by 2.8 percentage points. This occurred mainly owing to the small enterprises, since in 1998 the rate of growth of the GVA produced by the small enterprises was, for the first time since many years, higher than the rate of growth of the value added produced by the medium sized enterprises. The share of the small enterprises in formation of the GDP amounted in 1997 to 36.2% and increased to 38.5% by 1998, that is—by as much as 2.3 percentage points. The contribution from the medium sized enterprises increased, on the other hand, from 9.1% in 1997 to 9.6% a year later, that is—by 0.5 percentage point.

The financial condition of the enterprises belonging to different magnitude classes is analysed in two different ways, depending upon the legal status of the enterprise, i.e., most generally—whether a firm has a legal identity, or is a firm of a natural person.[8] In case of the enterprises without a legal identity (natural persons conducting economic activity and civil partnerships) employing up to five persons,[9] a good measure of their financial standing is the income (sales minus costs) per firm. In 1998 this category, calculated for the entire group of the smallest firms[10] was equal 19,300 Polish zlotys (PLN), meaning a decrease by almost 25% in comparison with the year 1997, when this average income equalled 25,600 PLN. The incomes per firm dropped primarily in the traditional domains of economy. The most pronounced decrease—by approximately 44%—was noted in trade, followed by construction (decrease by more than 16%), and manufacturing (by roughly 14%). Incomes rose, though, in all the service sections—most rapidly in the estate and business service (by almost 36%). Incomes per the smallest firm had been in trade until as late as 1997 the highest among all the sections of economy. High incomes earned in trade attracted to this sphere free capital and the enterprising individuals, with the effect of a gradual decrease of the absolute magnitude of incomes between the year 1995 and 1997. The abrupt breakdown, which took place in 1998 was caused, on the one hand, by the Russian crisis, and on the other hand—by the development of the network of large and medium supermarkets, constructed mainly owing to the inflow of foreign capital. The Russian crisis had the decisive influence upon the drop of incomes achieved in manufacturing. The drop observed in construction was, in turn, the consequence of the decrease of incomes per firm in the category of the smallest enterprises in the two domains of economy, mentioned before, that is—manufacturing and trade, and therefore—the decrease of the investment outlays. The highest incomes per firm in the group of the smallest enterprises were observed in 1998 in the section of estate and business service. This fact can be explained by the relatively high skills of an important part of persons employed there, providing service in, for instance, counselling, marketing, promotion, computer applications, and accounting.

The fundamental information on the financial situation of the enterprises endowed with legal identity[11] is provided by the so-called gross return on sales indicator[12]. In 1998 gross return on sales of these enterprises was 1.9%. Thus, it was lower by more than the factor of two in comparison with the year 1995, the best with this respect, and lower by one third than in 1997. The decrease of the gross return between 1997 and 1998 was the effect

[8]Enterprises not having legal identity (natural persons' businesses and civil partnerships) are allowed to conduct a simplified bookkeeping, and supply GUS with the information on the general magnitude of their revenues and costs only. On the other hand, enterprises endowed with legal identity (state-owned and municipal enterprises, cooperatives, and companies, except for civil partnerships), put together annual balance sheets (not necessarily for the calendar year), and send to GUS, side by side with the balance, the information on the basic revenue and cost items, as well as the so called financial effect (loss or profit).

[9]These enterprises accounted in 1998 for as much as 94.8% of the total population of small enterprises.

[10]The respective calculations relied upon the results of the representative studies of the smallest enterprises, published by GUS, contained in the series of reports bearing the title *Dzialalnosc gospodarcza malych przedsiebiorstw* (*Economic activity of the small enterprises*), plus the year for which a particular study was conducted.

[11]All of the large enterprises had legal identity, along with 97.3% of the medium-sized ones, but only 3.7% of the small ones.

[12]The gross return on sales indicator is the ratio of gross financial effect to total revenue from the entire activity of the enterprise, expressed in percent. In the enterprises endowed with legal identity the difference between the revenues and costs on the entire activity of the enterprise is called the effect on economic activity. This difference, corrected with the balance of extraordinary losses and benefits, is referred to as the gross financial effect.

of the worsening financial situation of the medium-sized and large enterprises, both private and public, while the small firms belonging to both these sectors somewhat improved their gross return indicator. This indicator increased for the small enterprises between 1997 and 1998 from 2.5% to 2.6%. The return indicator in the medium sized enterprises decreased, on the other hand, from 3.4% to 2.5%, while in the large enterprises—from 3.5% to 1.2%. The year 1998 was the first one in the five-year history of systematic analyses of the SME sector, carried out in Poland, in which the small enterprises turned out better than the two other magnitude categories in terms of gross return. In the private sector, though, the medium enterprises, in spite of having suffered a decrease of the return indicator, retained the first rank they occupied in 1997, staying ahead of the small and large companies with respect to the gross return indicator. Still, the differences of values of the gross return indicator between the particular magnitude classes of enterprises in the private sector were relatively small, which seems to indicate the existence of the tendency toward equalization of profitability in various magnitude classes of firms.

The rate of increase of investment outlays in the enterprises slowed down somewhat in 1998 in comparison with 1997. In accordance with the simplified estimates, whose results should be treated with care, investment outlays of the enterprises, expressed in constant prices, increased in 1998 by approximately 19%, while in 1997 they increased by 23%. A decline in the dynamics of growth of investment outlays was observed in all the magnitude classes of enterprises, but the decline was most pronounced in the small firms, since the rate dropped there by half (from approximately 31% in 1997 to roughly 15% in 1998). The decline was moderate in the medium-sized enterprises (from approximately 47% to 39%), and almost insignificant in the large enterprises (from 15% of growth to 14%). A similar trend was observed within the private sector, where the rate of growth of the investment outlays decreased in all the magnitude classes of enterprises, by one third on the average. This decline amounted in the medium private enterprises to one fifth, while in the small and large private enterprises—to almost half of the previous growth rate.

Yet, in spite of this growth decline, the rate of expansion of the investment outlays, estimated in constant prices to be approximately equal 28-29%, remained in 1998 very high. Thus, in the group of medium-sized private enterprises this rate exceeded 43%, in the large private enterprises it attained approximately 32%, and in the small private firms, which definitely lagged behind the medium-sized and large ones in terms of intensity of investing, it was at around 14%. The thus high rate of growth of investment outlays, especially in the case of medium and large firms, would, of course, not be attainable without the inflow of foreign capital.

THE SMEs IN THE REGIONAL SETTING

The SMEs concentrate primarily within the large urban agglomerations, and in the areas with well-developed and differentiated industry. The reasons for the concentration of a large number of the SMEs on such areas are quite obvious. The share of the skilled and enterprising persons is much higher there than in the other regions of the country, and, also, the potential demand for goods and services supplied by the SMEs is higher there in view of, in particular, higher incomes of the population in large towns. Thus, in 1998, 29% of all the economically active SMEs functioned in the Masovian province, whose capital is

Warsaw, and the Silesian province (with capital in Katowice). A relatively small share of the SMEs—the estimated 15% of the entire population—were located in rural areas. Within these areas the basic economic units were very small enterprises, single person or family firms. The development of the SMEs located in rural areas is limited primarily by the low incomes of the population inhabiting these areas. The problem of creation of new jobs outside of agriculture in the countryside is essential in view of the very small average acreage of Polish farms, and the resulting necessity of concentrating agricultural production, along with elimination of the hidden joblessness in the countryside.

The potential of the SME sector in particular provinces is well characterized by the number of the SMEs per 1,000 inhabitants. It can on a very high level of generalization be said that the value of this indicator decreases towards the East, with the line of the river Vistula being the limit, which clearly discriminates with respect to the number of the SMEs per 1,000 inhabitants. Thus, to the East of this divide there are a number of voivodships, like, for instance, the Lublin voivodship, the Subcarpathian voivodship (with capital in Rzeszów), the Warmian-Masurian voivodship (with capital in Olsztyn), or the Podlasie voivodship (Bialystok), where the number of the SMEs per 1,000 inhabitants ranged between 33 and 36. At the same time, in the Masovian province, leading with this respect, the indicator value was 56 per 1,000 inhabitants (while the country-wide average was 45).

In 1998 the SMEs functioning in just two provinces—Masovian and Silesian—accounted for as much as 29% of the total employment in the SME sector, that is—the share was exactly the same as in the number of the SMEs. These two provinces were followed—in terms of the share of employment in the SMEs—by the Greater Polish province (with the capital in Poznan), and the Little Polish province (capital: Cracow). The SMEs located in the four voivodships mentioned (out of the total of 16) provided jobs to almost half of all those working in the SMEs. In spite of the significant percentage share of the persons working in the SMEs in the Masovian or Silesian provinces (56.6% and 53.4%, respectively), the significance of this category of enterprises on the local labour markets of these provinces is far smaller than, for instance, on the labour markets of the Warmian-Masurian, Western Pomeranian (capital: Szczecin), or Pomeranian (Gdansk) provinces. In these voivodships more than 70% working persons are employed in the SMEs, which is to an important extent due to the functioning of a relatively small number of large enterprises in these provinces and the taking over of their role by the medium-sized ones.

In 1998 the biggest increase of the number of persons employed took place in these voivodships, in which the highest number of the SMEs functioned, that is—in the Silesian and Masovian voivodships. This was beyond doubt closely linked with another phenomenon, namely with the concentration of investment outlays in a couple of most economically developed provinces.[13] The SMEs from the area of the Masovian, Silesian, and Greater Polish voivodships spent in 1998 altogether 52% of the total investment value of this group of enterprises. Thus, the division into the better economically developed western Poland and the less developed eastern part is deepening, alas. The too weak institutional support and the limited means disbursed for promotion of small business cause that the number

[13]When analysing the data on the investment outlays for particular provinces one should not forget, though, that an amplifying influence on the degree of differentiation in these outlays is exerted by the assignment of the outlays to the locations of headquarters of the enterprises, and not to the actual locations at which they were spent. It is namely so that numerous enterprises have their official seats in large towns, while production plants, and trade or service outlets, are located in other parts of the country.

of the SMEs is increasing at a declining rate, especially there, where the population has lower professional skills, where there is shortage of capital, and the infrastructure is below the national average.

BARRIERS TO THE DEVELOPMENT OF THE SME SECTOR

In spite of the high rate of growth of the number of SMEs in the years 1990-1997 the SME sector is in fact encountering several obstacles and limitations to its development. They were being overcome due to the advantageous—especially in the years 1995-1997—economic situation. Yet, as mentioned already, the economic situation worsened somewhat in 1998 and there is nothing that would indicate a perspective of immediate improvement. Hence, the barriers and the obstacles encountered by the entrepreneurs, and first of all by the owners of the SMEs, limit now much more strongly the rate of growth of Polish economy and are harder to overcome than in the period 1995-1997.

The numerous survey studies conducted recently[14] indicate the existence of multiple barriers hampering the development of the SME sector. The entrepreneurs mention usually at the first place, as a main obstacle,[15] high taxes, followed by low demand, complicated financial and legal regulations concerning the principles of conduct of business, and lack of cheap credit. The fifth rank is occupied by the disadvantageous policy, conducted by the government with respect to the SMEs, and lack of support from the local authorities. The subsequent obstacles mentioned by almost exactly half of the entrepreneurs are: the unfair—in the opinion of the respondents—competition from the side of the large domestic and foreign firms, lack of information on the influence exerted by the integration of Poland with the EU on the situation of the SMEs, and the difficulties in acquiring valuable, skilled employees.

The barriers mentioned here require a few words of comment, especially as they are essentially mutually interrelated. First, one should pay attention to the connection between such obstacles, listed by the entrepreneurs, as high taxes, complicated regulations, difficulties in acquiring good employees, and the disadvantageous policy of the government. In general, these responses are related to the conviction common among the entrepreneurs, that the rightist coalition government, ruling since the fall of 1997 is under a too strong influence from the trade union "Solidarity", and is guided in its decisions much more by the interest of the blue collar workers employed in the large state-owned enterprises than by the interest of the so-called middle class, to which the owners of the SME belong as well.[16]

[14]See, e.g. the results of the survey study conducted by the Institute of Public Affairs, commissioned by the Polish Foundation for SMEs Promotion and Development, described in the report of W. Kozarek and P. Mielczarek, entitled *Opinie przedsiebiorców sektora MSP o prowadzeniu dzialalnosci gospodarczej* (*Opinions of the entrepreneurs from the SME sector on the conduct of business*, in Polish), Warsaw, 2000. When writing on the barriers to the development of the SME sector, the authors of the previously mentioned *Report on the state of the SMEs in Poland in the years 1998-1999* (as well as of the preceding issue concerning the years 1997-1998), published by the same Foundation, refer to the survey studies carried out, in particular, by the Ministry of Economy, the World Bank, and by the public opinion study centres, Demoskop and CEBOS.

[15]See the report by W. Kozarek and P. Mielczarek, referred to in the preceding footnote, pp. 43 ff.

[16]A kind of test on the popularity of the politicians of various orientations was constituted by the recent presidential elections, which took place on 8 October 2000. The leader of the "Solidarity" trade union, M. Krzaklewski got not quite 16% of vote, while A. Olechowski, perceived as the representative of the middle class—more than 17% of vote.

Consequently, in spite of the efforts undertaken, the scale of the personal income tax (PIT) paid by the natural persons conducting business, has not decreased since 1997, just like the insurance premiums paid by the employers on hired labour, although the scale of corporate tax (CIT)—paid by the enterprises endowed with legal identity—decreased. The complicated tax regulations did not change, neither, and the regulations concerning social insurance have become—after the introduction of the social security reform at the beginning of 1999—even more cumbersome than before. On the top of this, the community of entrepreneurs has been very much stirred recently by the issue of the potential changes in the Labour Code. In the framework of struggle with the increasing unemployment the trade unions aim at a shortening of the legally prescribed working time (down to 40 hours per week), like it happened, for instance, in France. The employers, to the contrary, maintain that such changes will contribute to increased unemployment, and their aim is to establish a Labour Code modelled after that of the United States. They primarily mean the weakening of the Labour Code restrictions concerning the procedures of layoff and employment (the questions of the length of notice, compensation value, etc.). Employers, alas, can count in their efforts only on the centrist Union of Freedom party, whose influence is quite limited. The very strong—now in opposition—Alliance of the Democratic Left (SLD), differing entirely in many basic questions from the ruling rightist coalition, supports the governing coalition, dominated by the trade union "Solidarity", on the issue of taxes[17] and the shortening of the working time.

When speaking of such barriers to the development of the SME sector as low demand or the unfair domestic and foreign competition, the entrepreneurs often refer to the situation existing in trade, where, starting with the middle of the 1990s, an expansion of the supermarkets is observed, established in a vast majority of cases with foreign capital. The assessment of this whole process by the entrepreneurs appears, however, to be highly subjective. Introduction of economic reforms in 1990 entailed the emergence of an enormous number of private shops, most often managed by entire families, rarely hiring outside labour, which led to an extreme dispersion of trade in Poland. This corresponded roughly to the situation existing in the West in the 1950s or 1960s. The margins appropriated by the small firms were, however, high, and the product range narrow, and so the customers positively reacted to the possibility of making their purchases in the newly established supermarkets, offering lower prices and a broader assortment of goods. The owners of the small shops—just like their Western counterparts two decades earlier—try to fight the idea of establishment of the supermarket networks with all the means available, including the administrative interdiction of constructing new large shops in some quarters of towns. In view, though, of lack of social support such initiatives do not bring the effects that would satisfy the petty shopkeepers. The complaints of the entrepreneurs about the unfair competition, on the other hand, have certain rational foundations in case of foreign companies, which make construction of a new factory or purchase of a state enterprise dependent upon obtaining of various privileges, including tax exemptions and reliefs. Yet, the actual facts of granting such privileges become increasingly rare, also in view of the obligations of Poland related to our access to the EU, according to which all the economic agents ought to be treated equally (thus, in particular, no new so-called special economic zones can be

[17]More precisely, the SLD proposes, rather than to just lower the taxes, to introduce various kinds of exemptions for the employers, including investment-related tax reliefs, which, however, would make the entire tax system yet less legible than today.

established). Besides, the inflow of foreign capital—even at the cost of tax reliefs—is beneficial for Poland, since it activates definite areas, creates jobs there, and expands demand, thereby forming additional opportunities for the domestic enterprises, including also the small trade firms.

The here presented list of barriers to the development of the SME sector seems to contain yet two rationally justified items, not yet commented upon in more detail. The first one is the lack of information on the consequences brought for the SME sector by the expected integration of Poland with the EU. Politicians mention various dates of the accession of Poland to the EU, ranging between the beginning of the year 2003 and the year 2005, or even later. Yet, a responsible owner, who plans the development of her/his firm over a longer time period, must have a better knowledge of the conditions, in which the enterprise owned will be functioning in the coming years. The knowledge, however, in this particular domain is very limited and accessible only to a narrow group of economists[18] who work actively on the integration of Poland with the EU. The second of the barriers to the development of the SME sector, mentioned before, and actually existing, is constituted by the difficult access to credit. This particular obstacle became even more hampering in Fall 2000 in connection with the raising of the interest rates, which was a response to the increase of the inflation rate, although the latter had been caused primarily by the external reasons, such as the oil price increase on the world market, and the persisting high exchange rate of the US dollar. It is estimated that owing, in particular, to the elevated interest rates, only 15% of the Polish SMEs do regularly make use of credits.[19] It is exactly the lack of access to inexpensive credits that appears nowadays—side by side with the high taxes and the Labour Code stipulations, disadvantageous for the employers—to be the main obstacle limiting the development of the SME sector under the circumstances of a not too good general economic situation.

The entrepreneurs, who responded to the questions contained in the survey questionnaires, perceived the sources of their difficulties and failures primarily in terms of the external conditions. Yet, a number of reservations can as well be addressed at the entrepreneurs as an entire social group. The fundamental one of those reservations concerns the relatively low level of technical and economic knowledge, characteristic for the typical representatives of the class of entrepreneurs. The consequence is constituted by the relatively low innovativeness, especially of the small enterprises, which is apparent from the results of various studies. At the same time, the number of the so-called business support units, being the non-commercial institutions specialising in provision of service for the SMEs (like business incubators, centres of economic information, of innovation promotion and of technology transfer, as well as counselling) increases more and more slowly,[20] starting with 1996. In 1998 there were approximately 350 such units, that is—by 1.7% more than a year before. The cause for such a low rate of expansion of the network of such units was lack of means, as well as a marginal interest in their activity from the side of the local authorities. In 1998, similarly as in the initial stage of transformation of Polish economy, the

[18]An effort aimed at bridging this information gap resulted in the publication by B. Piasecki, A. Rogut, and D. Smallbone, *Wplyw integracji Polski z Unia Europejska na sektor MSP* (*The influence of integration of Poland with the EU on the SME sector*, in Polish), Polish Foundation for SMEs Promotion and Development, Warsaw, 2000.

[19]See *Raport o stanie sektora MSP w Polsce w latach 1998-1999* (*Report on the state of the SME sector in Poland in the years 1998-1999*), Warsaw, 2000, p.238.

[20]See *Raport o stanie sektora MSP w Polsce w latach 1998-1999* (*Report on the state of the SME sector in Poland in the years 1998-1999*), Warsaw, 2000, pp.210-213.

primary source of financing of the business support units was constituted by the funds originating from the foreign assistance programmes, primarily coming from the European Union. Side by side with the relatively low level of technical knowledge, yet another reproach can be formulated with respect to the group of entrepreneurs in Poland. It is namely the defensive attitude vis à vis reality, reflected through the incapacity, aversion, or apprehension of the entrepreneurs as to the perspective of expanding the scale of their activity. This is confirmed by the average number of persons employed per one SME, which has been persisting at a similar level for many years.[21] In other words, the development of the SME sector in Poland has a somewhat extensive nature and is expressed through the increase of the number of enterprises, with the new ones being characterised by similar features as those existing before, rather than through the development of the enterprises themselves, meaning their technical restructuring linked with expansion of employment. Such a situation gives rise to the apprehension that in case of a further worsening of the general economic situation many of such businesses would not be able to face the challenge.

CONCLUSIONS

Polish society took during the 1990s a crash course in economy. The various processes and trends, which appeared in the West over the last 20-30 years, visited Poland over just one decade. Still in the middle of 1989 Polish economy was a strictly rationed real socialist economy with the functioning system of rationing stamps for purchasing the basic consumption goods. Half a year later the society faced all the good and bad sides of the market economy, with the difficulties in selling the outdated products turned out by the large state-owned firms, followed by the collapse of many such firms, increasing unemployment, and at the same time—a perspective for forging one's fate opening before the enterprising and the independent. A dramatic surge in the number of the SMEs in the initial period of transformation constitutes the proof of the fact that many persons made use of this opportunity. Already by the middle of the 1990s, though, the demand for traditional goods was to a large extent satisfied. This brought a quicker growth of the number of enterprises providing service (including business service) and producing more technologically advanced goods than those supplied by the firms producing traditional commodities. In addition, the process of concentration in trade started, positively assessed by the customers, but bringing the threat of disappearance for many small trade firms of family nature. The tendencies appearing since the middle of the 1990s in industry and trade were initiated and maintained to a large extent owing to the inflow of the foreign capital. Finally, at the end of the 1990s the Russian crisis, and recently also the high prices of oil, caused a worsening of the general economic situation, and therefore also an additional threat to the SMEs, especially those economically weaker and producing outdated goods.

Simultaneously, Polish economy faces at the doorstep of the new century two great challenges. The first of these is to respond to the competition within the uniting Europe in connection with the expected access of Poland to the EU. The second challenge is related to the necessity of securing jobs, especially for the young from the demographic boom of

[21]See J. Chmiel, *Problemy statystycznego pomiaru i analiza tendencji rozwojowych sektora prywatnych przedsiebiorstw w Polsce w latach 1990-1998 (The problems of statistical measurement and the analysis of development trends of the sector of private enterprises in Poland in the years 1990-1998*, in Polish). Raporty CASE, Warsaw, 1999, p.42.

the beginning of the 1980s, entering now the labour market. The experiences from Poland and from other countries demonstrate that the new jobs can virtually solely be created now in the SME sector. Hence, the question arises, whether the Polish SMEs will be able to cope with this task in the conditions of a generally not too good economic situation and under the competitive pressure from the SMEs of the EU countries, which are, in addition, strongly supported by the governments of the EU member countries, respective local authorities, and other institutions established exactly for this purpose. It must be feared that the Polish SMEs might not be able to stand up to the challenge without a much bigger support from the side of the Polish government and the local authorities than that extended until today.

In fact, the support from the Polish central administrations has been until today more of a declarative than real nature. In June 1995 the then leftist government adopted the document expressing the intentions of the state administration with respect to the SME sector. The intentions, though, were never put into practice.[22] The development of the so-called business support units, referred to here before, which was envisaged in the document, along with the formation of the system of SME monitoring, took place independently of the governmental initiatives, almost uniquely owing to the assistance funds offered by the EU. The subsequent programme of support for the SMEs, until the year 2002, was adopted by the government, this time of a rightist character, in May 1999. This new programme assumes three primary goals:[23] increase of innovativeness and technological advancement of the SMEs, increase of exports, and increase of the investment outlays of the SME sector. Still, the means allotted for the three-year implementation of this programme, which was positively assessed by the entrepreneurs, amount to quite a symbolic sum of approximately 60 million US dollars, according to the exchange rate as of the middle of 1999, that is—not quite two times the expected volume of assistance funds in the same period only. Given the enormous scale of problems to be tackled, these means seem to be far too scarce.

When assessing the scale and scope of the governmental support for the SME sector one should, of course, take into account other tasks related to the restructuring of the economy, which are resolved currently. We mean here, in particular, the necessary decrease of employment in coal mining, steel industry, and railways, which is associated with the resulting requirement of paying high compensations to the employees laid off, these compensations meant also to constitute the initial capital for setting up own small firms. Yet, even if we account for these facts, it still appears that the means allotted to the development of the SMEs, disbursed from the state budget, are definitely too small. The high rate of growth of the numbers of the SMEs in the 1990s, which occurred practically without any intervention from the side of the government, had a clearly demobilising influence on the activity of the central and local authorities. It was evidently concluded that a similar autonomous development of the SME sector would also continue in the future. The present problems of the development of the SME sector, though, are qualitatively different than before. Suffice to compare the possibilities open for the SMEs in conditions of unfulfilled demand at the beginning of the 1990s, inherited from the period of real socialism, and the present neces-

[22]See J. Chmiel, *Male i srednie przedsiebiorstwa a rozwój regionów (Small and medium enterprises and the development of regions*, in Polish), ZBSE (RECESS), Warsaw, 1997, pp. 206 ff.

[23]See *Raport o stanie sektora MSP w Polsce w latach 1998-1999 (Report on the state of the SME sector in Poland in the years 1998-1999)*, Warsaw, 2000, pp.113-115.

sity of competing with the Western companies, in conditions of a market practically not protected against foreign competitors by custom duties nor import quota. The increase of the rate of unemployment, observed in Poland since 1998, despite the relatively high growth of industrial production and the GDP, appears as a warning that the question of a more resolute support for the development of the SMEs cannot be neglected any more.

SME Technology Policy in Transitional Economies: From Survival to Prosperity in the Market

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SMEs AND TECHNOLOGY

The importance of small and medium size enterprises (SMEs) is widely recognized. It is frequently discussed as follows: SMEs are important for a national industrial organizational structure because they constitute a part of supporting industries; SMEs are important for international trade because they constitute a crucial part of export industries; SMEs are also important for national socio-economic aspects because they are the source of employment opportunities, economic vitality, etc. In the OECD countries, more than 95% of enterprises are SMEs.

To survive and prosper in the market, SMEs, in any country, must be globally competitive in the age of mega-competition as explained in the next section. Beforehand, SMEs in some countries could compete with domestic competitors only because of the low level of international information and goods trade due to undeveloped international telecommunication and transportation systems. However, SMEs must compete with any agents in the international market in our mega-competition age. Even to survive, they must be globally competitive from the beginning. To enhance competitiveness, technology in a broad sense is an indispensable factor, although many argue much about external issues such as the access to finance and complicated regulations and procedures for SMEs.

Technology is also important when considering a production function. Technology is the only source of output increase without increasing capital or labour as inputs. Wealth is increased by technology.

$\Delta T/T = \Delta Y/Y - \alpha \Delta K/K - \beta \Delta L/L$
ΔT: total factor productivity increase (technology progress)
ΔY: output (value added) increase
ΔK: capital increase
ΔL: labour increase
α, β: coefficients where $\alpha + \beta = 1$.

Technology is also important to think of labour productivity as follows.

$y/y = T/T + \alpha k/k$
where $y = Y/L$ and $k = K/L$.

Thus, a labour productivity increase rate is determined by a technology progress rate and an increase rate of a capital per labour ratio. As far as capital investment in the form of foreign direct investment and others continues, labour productivity increases. However, It will not last long as Paul Krugman warned the East Asian Miracle in his paper.[1]

Good news for a country under industrial development is that it has a great potential to make technology progress. As shown in figure I, the technology progress rate of Japan was high in the early stage of industrial development and it became lower as Japan developed.[2]

TECHNOLOGY POLICY IN THE AGE OF MEGA-COMPETITION[3]

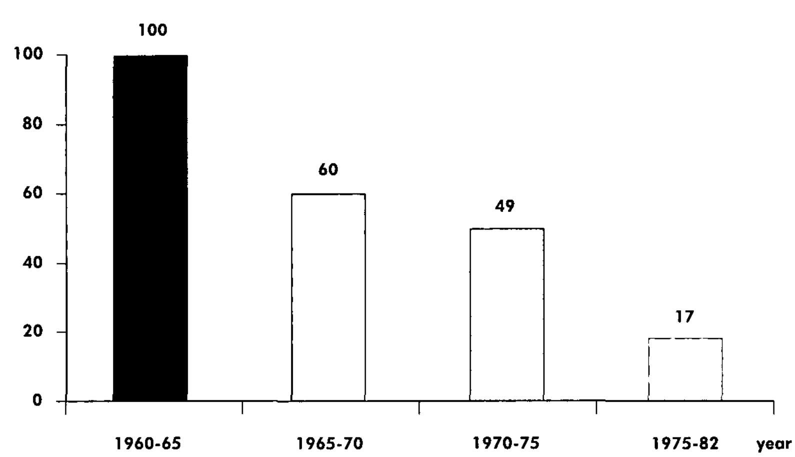
MEGA-COMPETITION AND TECHNOLOGY

As everything changes except changes, a paradigm for technology strategy changes. This section discusses how the paradigm is changing and how both corporate strategy and national strategy are changing or need to change accordingly.

We now live in the age of Mega-competition. Technology has contributed to creating Mega-competition in two ways. One way is that technological revolution or fusion makes an industry to be able to go into another industry and create cross-industry competition. For example, a glass producer becomes a competitor of cable manufactures by the invention of optical fibres. Another is, as stated by many others, that technology development has reduced the cost of and increased the availability of telecommunication and reduced the cost

[1]See Krugman (1994).
[2]Technology strategy changes as a country develops. See Kim and Dahlman (1992) and Chapter 5 of Kondo (1998).
[3]This section is based on Chapter 2 of Kondo (1998).

Figure I. Technology progress rate in Japan



and time of transportation. This change of telecommunication and transportation together with the progress of open economy in the world has created worldwide competition. Thus, a firm in any country in any industry can be a competitor of another firm tomorrow.

Even in former days, there existed competitors that produced competitive goods in other countries. However, the existence of potential competitors did not become competitors because the information on foreign markets or foreign suppliers was not easily available due to the insufficient development of telecommunication and information networks. Another reason was that the time of delivery of goods was uncertain and lengthy due to the insufficient development of transportation.

These days the situation of telecommunication and transport has changed dramatically. Information network is well developed. Information is easily obtained and correspondence is easily done through Internet and other information networks. Small producers can put advertisements in their home pages and buyers including consumers can order goods through Internet. Goods are delivered within 48 hours by international courier companies if they are small.

This change creates a large paradigm shift in which a technology strategy is formulated because it has changed the scheme of international competition. It requires governments to pay more attention to technology policy and firms to pay more attention to technology strategy because the driving force of this change is technology and one of major means to cope with this change is technology. Both governments and firms need to see the course of change of competition environment caused by technology and to figure out how to place themselves in this changing environment.

CHANGES OF NATIONAL STRATEGY

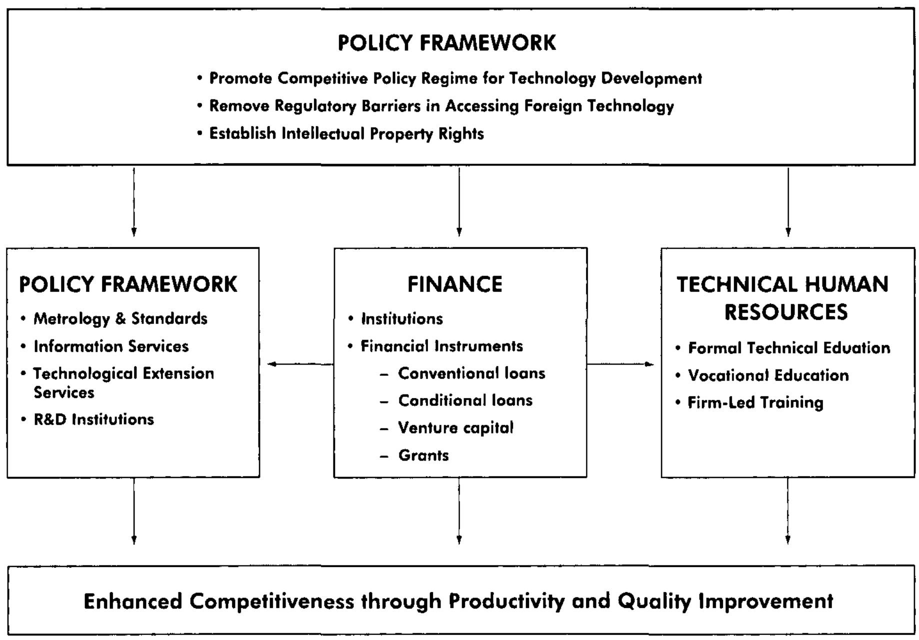
National technology strategy has changed. National technology strategy means the strategy at the national level and is related to government policy. The framework of technology policy defines three policy areas as shown in figure II. The changes are found in three areas. They are from research for research to assistance for industry, from public initiative to private initiative and from general approach to tailored-for-technology approach (see annex).

FROM 'RESEARCH FOR RESEARCH' TO 'ASSISTANCE FOR INDUSTRY'

It is commonly seen that science and technology policy in developing countries places a strong emphasis on R&D. Though R&D is surely needed to assess and assimilate technologies acquired, more resources and policy attention need to be oriented to supporting services such as testing, consulting and training. Upgrading the average level of industrial technology of a country is an acute problem and supporting institutions to improve technological level are not well developed in developing countries.

For R&D, faculty members and researchers many of whom are trained overseas have a stronger linkage to international scientific community than to domestic industry and most research seems to aim at producing papers in academic journals. More resources and attention need to be oriented to industry. A country cannot afford to allow researchers to enjoy a paradise in their circles. Researchers need to contribute to economic development of the country in the age when competition is global and technology is a critical element of competition.

Figure II. Technology development



Another common phenomenon is the emphasis on science. This is partly due to the fact scientists are respected and influential. There is a structural problem in international organizations. In many cases, education departments handle science and technology policy in those organizations. These departments have strong connections with academia and tend to be science-oriented. Science is important for education and a basis for technology development in the long run. However, a country needs more immediate technology development to compete in an international market. Policy emphasis needs to be shifted from science to technology.

Policy emphasis also needs to be shifted in education. Resources need to be shifted from science departments of universities to engineering departments or technology institutes to support technological development of a country. At the same time, basic education and vocational training are important to secure the basic level of industrial technology of a country as seen in East Asian countries rather than higher education until basic education becomes pervasive.

FROM PUBLIC INITIATIVE TO PRIVATE INITIATIVE

In former days, the R&D mission was clear and the public sector took the initiative and conducted R&D itself. However, this mission is now diversified and it is difficult to determine a few missions. The private sector knows industrial needs better. Moreover, most urgently needed technology development is incremental technology development that takes place on shop floors or near shop floors. Thus, the private sector should be a main player of R&D. R&D mode needs to be shifted from technology-push to technology-pull. In order to do so a more vigorous national strategy is needed to develop R&D capability in the private sector because R&D capability is concentrated in the public sector in most developing countries. It is needless to say, however, that a public role is definitely important to assist and complement the private sector R&D and public R&D is surely needed in some areas, such as environment and safety, and in some aspects, such as technology evaluation.

The same can be said about training. Firms know their training needs best. In Japan, in-house training is common and extensive based on a long-term employment practice. Public training may provide generic training but not tailored training for each firm or each industry. Moreover, once a public institute is established, its management is rigid. It is not easy to change trainers and machines for training frequently, though technology changes quickly and firms need to equip with up-to-date technology to compete internationally. Thus, training needs to be shifted from public-led training to firm (or industry)-led training. When training is done in firms, their machines can be used for training and their workers act as trainers.

One training institute in Malaysia provides a good example of industry-led training.[4] Its building is provided by a local government but the institute is essentially managed by managers of large local factories. They decide training curricula. Training equipment is leased, sometimes without charge, from equipment suppliers to factories in that region; and trainers are hired on a term-by-term basis. This institute meets the needs of local industry at an affordable training fee and keeps flexibility of training curricula.

FROM GENERAL APPROACH TO TAILORED-FOR-TECHNOLOGY APPROACH

Changes are occurring in financing, too. Conventional loans are risk aversive and technology assets are not safe collateral. Moreover, traditional financial institutions do not possess proper capabilities to assess technology assets. Thus, new risk financing schemes are emerging. One is a form of venture capital and another is a form of conditional loans. Governments need to assist these new schemes to be developed. It may also needed to establish new financial institutions that are technologically capable and are specially catered for technology-related risk financing.

Education also needs some changes. In the former days one-time education was enough. Knowledge needed after education could be acquired by individual efforts and on the job experiences. However, as technology increases its speed of development and its knowledge content, it requires more systematic continuing education for people to catch up with ever changing technology. Education is changing from one-time education to lifetime continuous learning. A national strategy needs to assist develop the change of a formal education system and informal training or learning institutions.

The ever-changing efforts are also required for firms and governments. The accelerated innovation requires quick response and constant "strategic innovations" for firms and "policy innovations" for governments.

CHANGES OF CORPORATE STRATEGY

Three major changes are found in corporate technology strategy. They are changes from single approach to comprehensive approach, from efficiency to flexibility and from self-reliance to network sourcing.

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[4]See Kondo (1999).

FROM SINGLE APPROACH TO COMPREHENSIVE APPROACH

Mega-competition has changed the mode of competition. Beforehand operational competition was mostly based on price or cost because competitors were basically domestic and product quality was similar. For product variety, old production system was rigid and this kind of system did not allow production of a wide variety of models in a small scale. For timely delivery, old logistics management and transportation did not allow a single-product-management. Thus, competitors pursued competitive advantages through economies of scale or other means to reduce cost.

Now operational competition is based on time, quality and product variety in addition to price. Thanks to the advancement of information network and delivery and transportation network, buyers and consumers can obtain product catalogues quickly and receive products timely. Since customers are accustomed to getting products that they want quickly, they change their tastes for goods quickly and prefer to have differentiated goods from others. Thus, the time required from design to delivery needs to be shortened. Since buyers know that they can save cost by reducing inventory of input materials, they ask suppliers to deliver an exact amount of materials at the exact timing. Thus, time and timing and product variety are important factors of competition. In Mauritius and Cyprus, fashion sensitive fabrics and clothes are sent by air to and from Europe.

For quality, many competitors from the world provide different qualities of goods. Then, buyers and consumers are conscious about product quality. In addition, an international market, especially European market, requires suppliers to be certified as ISO 9000 factories. ISO 9000 is a set of industrial standards for quality assurance systems developed by International Organization for Standards (ISO). Thus, quality is an important factor of competition.

The situation changed for innovative competition, too. Beforehand product development only sufficed in many cases. A new product usually enjoyed its monopoly for a while. However, these days new competitive products quickly appear from some corner of the world and from another industry due to the accelerated pace of innovation and high speed of information diffusion. Thus, a product development cycle of idea creation to market entry needs to be shortened and a total product-delivery system from design to input material procurement and to production and delivery needs to be established to capture profits in a short time and to construct operational competitiveness from the beginning of a new product launch.

FROM EFFICIENCY TO FLEXIBILITY

To support the strategic changes above, an old production paradigm that pursued efficiency needs to change. An old production system consists of single-purpose efficient machines and single-skilled labour available in the market. A new production system needs to be flexible as well as efficient. Versatile flexible machines replace single-purpose high efficient machines. Those machines are computer-controlled and embody a rich technological knowledge and are capable of producing various types of similar products. Economy of scope becomes more important rather than economy of scale.

Workers also need to be flexible. Beforehand single-skilled labour force is enough and efficient to seek economies of scale in producing a limited number of types of products. However, multi-skilled workers are needed to operate flexible multi-task manufacturing machines and to cope with a small-lot wide-variety product production. Now economy of scope is required not only for production systems but also for workers. Skills and knowledge required for these multi-skilled workers are accumulated in firms. Training including on the job training (OJT) and some job rotation are needed to foster these workers. These workers are not readily available in the labour market.

FROM SELF-RELIANCE TO NETWORK SOURCING

The third change in corporate technology strategy is from self-reliance to network sourcing. Technology development activities were mostly conducted in-house in the former days. However, in-house development only is not enough to cope with the accelerated speed of technology development and coming up of new areas. Thus, firms need to seek partners for technology development to complement quantity and quality of engineers. They make strategic alliance with other firms, sometimes even with competitors. They also cooperate with universities and government institutes.[5] They need to compete not as an isolated point but as a node of a network.

Firms also make an international alliance to establish de facto standards of new products. When a firm develops a new generation product, the industrial standards of that product largely determine the competitiveness of that firm. If the specification of the type of a product that firm is developing is adopted as an international standard, that will give a strong competitive advantage to that firm. Otherwise, that firm will lag behind an R&D race of that product and needs to pay a large amount of royalty to the firm whose product specification is adopted as an international standard.

Also for production, firms need to compete as a network. This strategy gives flexibility and agility of new product production as far as partners deliver quality products just in time. Subcontract arrangement based on a long-term relation has been largely seen in the Japanese assembling industries. Work specialization and sharing network is seen in the Italian fashion industry. Today, this kind of production network is worldwide. Some firm has only design and marketing function. They are fabricationless companies.

For firms in developing countries, it is quite advantageous to be in the international production network. They may be original equipment manufacturers (OEMs), subcontractors or subsidiaries. They can access to or are exposed to foreign technology, management skills and marketing information constantly.

CONCLUDING REMARKS

Transitional economies have great potential for technology progress. They have high scientific level and well-educated people. In addition some economies have experiences of market economy. They are only required to change the direction to realize their technological potential. With proper incentive schemes and with initial assistance from the abroad and the governments, they are likely to realize their potential through the own efforts of their enterprises and people in the future not far from now.

[5]See Kondo (1995) for the increase of joint patent application in the 1980s in Japan.

ANNEX PARADIGM SHIFT OF TECHNOLOGY STRATEGY

Corporate Strategy

From Single Approach to Comprehensive Approach

Operational Competition
Cost → Time, Quality And Product Variety + Cost
Innovative Competition
Product Development → Production-Delivery System Development + Product Development

From Efficiency to Flexibility

Production System
Efficient Production System → Flexible Production System
Human Resource
Single Skilled Labour → Multi-Skilled Workers

From Self-Reliance to Network Sourcing

Formation
In-House Efforts Only → Networking
Space
Domestic Network → International Network

National Strategy

From 'Research for Research' to 'Assistance for Industry'

R&D → Supporting Service
R&D for Journals → R&D for Industry
Science → Technology/Engineering
Higher Education → Primary Education and Vocational Training

From Public Initiative to Private Initiative

Public R&D → Private Technology Development
Public-Led Training → Firm/Industry-Led Training

From General Approach to Tailored-For-Technology Approach

Conventional Loans → Venture Capital and Conditional Loans
Conventional Financial Institutions → Technologically Capable Special Financial Institutions
One-Time Education → Life-Time Continuous Learning

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SESSION 5

ROLES OF GOVERNMENT AND PRIVATE SECTOR

The Selection by Market and the Role of Government
Masatake Wada, Japan

Role of Government, Private Sector and Private Organizations
Valentin Pavel, Romania

The Selection by Market and the Role of Government

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INTRODUCTION

I spent three years in Poland from March, 1997 to March, 2000 as an advisor for the Minister of Economy. My task was to advise the Minister on industrial policy making. During my stay in Poland the attitude to industrial policy was not favourable under the Polish macro economic framework. Even this was a difficult period, I have to confess that I enjoyed my job in Poland because I could reconfirm a certain positive role of government for the transitional economic countries.

I worked for many years in the Japanese government and was involved in making and implementing industrial policies. The period of stay in Poland gave me a chance to re-examine the role of government in a free market economy. My conclusion is that government has an important role for the national economy and has to take initiatives sometime, when the private sector has not developed strong enough. Government has to have a clear future vision for the state's economy and to keep a strong will to realize the vision. When the private sector is not strong enough, government should supplement the role of the private sector in the economy and cover the weakness of it. We should not wholly depend or rely on the choice of the market.

The environment for industrial policy is not favourable nowadays. Developed countries, including EU member countries, gradually came to avoid governmental intervention on the economic activities and this is the time when the Central and Eastern European countries are trying to join the EU.

In the early 1990s, Polish government drew up restructuring plans for main industries but the government did not support the implementation of these plans and left it to the self effort of each company and the selection by market mechanism.

The Polish government signed the Association agreement with the EU in 1992. Under this agreement Polish government lost main policy measures to support the restructuring plans of selected important industries because the Agreement prohibited state aid which was thought to have a possibility of distorting market mechanism and free competition. Poland also joined GATT, WTO and OECD. This movement also made Poland give up governmental direct support to specific industrial sectors.

The article in the EU Association Agreement, which prohibits state aid to specific industrial sectors, has been introduced to the newly established Polish domestic law in 2000. This meant that Poland officially abandoned the policy measures to support restructuring and modernizing specific industrial sectors. We can recall policy support to specific industrial sectors had been common even in the Western European countries in the 1970s and 1980s and it is still common among the South East Asian countries.

As for the restructuring plans for the steel and coal industry in Poland, the goal is obviously to strengthen their international competitiveness and to make them self sustainable. However, the policy which has been pursued by the government so far is to accelerate reducing the production capacity, closing inefficient factories, coal mines and reducing redundancy of employment. On the contrary it does not include promoting positive investment for modernization and rationalization of production facility for their future development.

This is very different from the Japanese policies which were taken in 1950s and 1960s. Japanese industrial policies on coal and steel industry were always to stimulate modernization of the industry and to make them competitive in the world market.

As for the coal industry, Japanese government took a so-called "Scrap and Build" policy under which inefficient mines were closed and modernizing investment was focused on potential mines. After the 1970s, the policy was changed to gradually reduce the production of coal and then to take a phasing out policy on coal industry. Now Japan maintains only two coal mines. The policy on the coal industry has been criticized from time to time because government failed to keep the industry competitive and just prolonged its life with a huge public support. But on the other hand we can say the Japanese inefficient coal industry is now almost diminished without any social problems and some areas where coal mines were once located have transformed their economic structure during the long transitional period.

As for the steel industry, Japanese government strongly supported the rationalization and modernization programmes during the 1950s and 1960s and thanks to them, Japanese steel industry had become the most modernized and advanced one in the world market in the second half of 1960s.

In Poland there has been only the policy for phasing out old industries, but no positive and supportive policy for transforming the old industrial structure to a modern one.

After the economic reformation in 1990, the Polish government has adopted a typical classical free market system as its economic framework. The role of government in micro economic activities was reduced drastically. The market environment surrounding state companies was changed from a monopolistic, non-competitive one to a free competition one. They had not been ready to the new circumstances. What happened in Poland after the new liberalizing policy started? What is the result of the market selection and is it a desirable one which the Poles had expected before?

I would like to discuss the changes to the Polish economic structure under the free market economic system for these 10 years from the view point of industrial policy.

CHANGE OF INDUSTRIAL STRUCTURE

First of all, the Polish macro industrial structure has changed since 1990. A shrinking of the share of manufacturing industry and development of trade, finance and insurance and service industries for individuals and businesses have been observed. This change would be natural under the new economic circumstances. The new economy needed development of these industries and there were a lot of business chances in this field. The development of these industries could become good absorbers for the unemployed and also gave a flexibility to the Polish economic structure.

Secondly, in the structure of manufacturing industry, we can see a reshaping of the old structure which had been biased to heavy industry. The capital goods industries, especially industrial machinery industry, had almost collapsed. At the same time, light industry also shrunk greatly due to the liberalization of foreign trade.

In the first two or three years following the reformation, the food processing industry and basic material industries such as the steel, energy and power industry, which were still protected from the outside market, could maintain their position. The daily neccesity goods and durable consumer goods industries began to recover their production because of investment of foreign firms in the Polish market. The change of the industrial structure could be said to be a result of adjustment to the new circumstances of Poland.

There was another type of structural change in the textile industry. Before the economic reformation, the Polish textile industry had a full self-supply structure. They imported cotton and wool as raw materials and spun them to thread, and weave cloth to make clothes and other final textile products. Poland also had a textile machinery industry which could supply the necessary machinery for domestic needs. But now, the fully sustained structure has changed. They import thread and cloth and concentrate their activity on knitting and sewing. The domestic market for clothes has been taken over by cheap imported goods. So Polish apparel manufacturers have to export their products to the EU market. Unfortunately, brand names of Polish apparel manufacturers are not established in the market and they do not have strong sales channels or networks in the market either. This means that they have had to depend on the OEM system under famous foreign apparel companies. As for the textile machinery industry, they have lost their domestic market for spinning and weaving machinery because of reduced activity. The sewing and knitting machinery can not compete against imported ones and are also giving up the domestic market. This means that the Polish textile machinery industry has almost collapsed in these 10 years.

This structural change in the textile industry can be said to be the result of liberalization of foreign trade. This policy forced Polish textile industry to find a new position in the liberalized market.

When we remember about the objectives of Japanese industrial policy in the postwar period, we can say it was perpetual efforts for making an advanced industrial structure, that is a shift from a consumer goods dominated industrial structure to a capital goods oriented industrial structure. We also focused our efforts to foster strong supporting industries such as the metal processing industry and the parts and components industry for machinery industry. Through this effort we could build up today's well-balanced industrial structure. Poland, on the contrary, abandoned the well-established self-supply system and took only the knitting and sewing part out of the whole textile related industrial activities. This is the new division of labour for the Polish textile industry under the free market system. Is this structural change an advancement or a retrograde for the Polish industry?

INDUSTRIAL ORGANIZATION

The industrial organization has also changed greatly. The monopolistic supply system had to be changed and a competition policy was introduced. Before the reformation, competition in the market had been deliberately avoided. Foreign trade was strictly controlled and it was common that manufacturing companies did not produce the same products which other companies produced. This kind of non-competitive condition had been gradually changed during the reforming period in the 1980s. Industrial Associations were resolved and member firms got their independence from the Association's control. Moreover, each factory under the same company also became an independent company. So the market was divided into small pieces and the companies could not gain the scale merit from integration of the market share.

The Polish government introduced the Anti-monopoly Law in February 1990 and established an Office of Competition under this law. It is said that the Polish Competition Law is the most advanced among EU countries.

Now, some people point out one of the most urgent problems which should be solved is the fragmented industrial organization. They are wondering how the fragmented power companies, sugar factories, construction firms could be consolidated for surviving in the future.

The Ministry of Economy tried to accelerate the integration of the fragmented industries, such as the electric power industry, but the attempt was refused in the Ministerial Committee and the future structure of the industry left to market forces. As we can expect, the new industrial organization has been formed by initiatives of foreign companies. Foreign companies started buying the Polish fragmented power companies and are targeting to get some dominant market share in the Polish market.

How to form a desirable industrial organization is one of the most important subjects for industrial policy in order to strengthen international competitive power in the world market. In the case of Poland, the government did not take the initiative and depended on the market choice. It means that foreign companies will decide the future of the Polish industrial organization. In the case of the Polish Government, it could not establish a clear vision for the future industrial organization, it could not be established and their policy floated back and forth. So they could not utilize its privatization process of state companies as a policy measure either.

On the other hand foreign investors have had a clear strategy to gain a substantial market share in Poland. Some domestic capitals are now moving to establish industrial consortia or group holding companies to maintain some market share but the markets of cement, beer, sugar, pharmaceuticals and some chemical products, are already divided and controlled by foreign investors

SELECTED INDUSTRY BY FDI

The macro-economic figures in Poland shows expenditure for consumption is at a very high level and investment expenditure does not seem to be big enough to modernize the nation's economy. Japanese economic reconstruction in the post-war period was carried out through an active modernization investment in industries and the fund for investment was procured through domestic financial market. In the case of Poland, the domestic private financial system is still weak for supporting domestic industry's rationalization plan. Moreover, the Polish government has maintained strict fiscal policy with high interest rate.

Under the policy, many companies had to procure the money for modernization through self-finance. This is one of the main reasons of delay of modernization plans. The government did not support the modernization efforts of individual industries and did not have a strong policy priority for supporting them.

Today it is thought that FDI is the best way to solve the economic problems, such as lack of capital for modernization, obsolete technologies, weakness of marketing activity, old management system, etc. FDI can offer all of the neccesary resources for modern management in a package and the Polish economy came to depend on FDI for their economic modernization. Since 1994, FDI in Poland has grown gradually and for the past two or three years Poland has attracted large foreign investment from Central European countries.

During the early 1990s, FDI in Poland was domimated by small and medium size companies from neighbouring EU countries. But as the economy was stabilized successfully, in order to grasp the domestic market large foreign companies began to invest, at first, in the field of daily neccesary products such as beer, tobacco, food, detergent, confectionery, etc. and then diversified their investment priority to durable consumer products such as automobiles, electronics products, etc.

Foreign investors decided on their investment fields through a world-wide management strategy. Usually foreign investors did not show their interest in capital goods industry like machinery industries. They were not willing to make efforts to foster parts and components industries. They prefer to import components and parts from their mother factories or their own long related companies. The capital goods industries will therefore be left without outside support.

After the change of the administration in 1997, the policy of privatization changed and the process was accelerated in order to alleviate the budgetary deficit. The Polish government strongly needed a new source of income. Since then, Poland has obtained a large amount of foreign capital by inviting foreign investors to large privatization projects. They included telecommunication, large retail banks, national airline, power sector and so on.

The government has been trying to privatize the second largest oil refinery, large steel mills and power companies. However, we have to remember again that the foreign investors' preferential sector is not always the same of Polish desire. The oil refinery has so far not been able to find appropriate investors. In the case of the Huta Katowice steel mill, foreign investors wanted to divide the largest steel mill in Poland into three parts and it was difficult to find an investor for the main part of the company, the steel production division.

The Polish government asked a Canadian consultant to make a modernization plan for the steel industry in 1992 but the implementation of the plan was left in the hands of each company. Without governmental support, modernization plans for gaining international competitiveness had to be delayed. I think Poland missed the chance to foster an internationally competitive steel industry and weakened their negotiation power against foreign investors. When we decide to entrust the future of a nation's industry to foreign investors, we should first assess their managerial strategy in the global market and seek effective negotiations. At the same time we should improve the market position of Polish companies. This is the way to increase negotiation power against the foreign investors.

FOSTERING SMALL AND MEDIUM SIZE ENTERPRISES

Fostering SMEs is now one of the most important policy objectives for almost all countries. In the Central European countries, the role of SMEs is thought of as an important measure for creating new employment, filling the gap which could not be covered by large enterprises and improving the industrial structure which should be more flexible to changes in the economic environment. Moreover, it is also thought that supportive policy for SMEs can be the only industrial policy which will be allowed even under the IMF conditionality.

In Poland we could see an emergence of a huge number of SMEs after the end of the planned economic system. It is known that the majority of the newly born SMEs during the early stage of transition are trade and service companies which had not developed under the former economic system. As for the manufacturing industries, entry barrier to the market is higher than that for trade and service industries. They need a large initial investment and sophisticated technological and managerial skills. The emergence of SMEs had a significant meaning for modernizing the Polish economy and stabilizing the society by giving chances of new jobs to many people. The phenomena of the high rate of emergence of SMEs can be compared with the situation of Japan in the post-war period. A drastic social and economic structural change gives great chances for people to start something new.

Under the planned economy, technologically specialized SMEs had difficulty existing because of the in-house manufacturing system which was prevailing and adopted by large state companies. State manufacturing companies were apt to produce not only final assembled products but also the parts and components by themselves. Moreover, they usually had maintenance and repair factories under them. It meant that free accessible market, essential for the existence of independent SMEs, had not been developed. Even now casting products of parts and components for machinery are still produced mainly by in-house factories of large machinery companies. This market situation is one of the largest barriers for development of technologically specialized SMEs in Poland. If we want to promote development of SMEs in the field of the manufacturing sector, we have to change this enclaved market condition first.

I can also point out another specific market condition for SMEs in Poland. Sometimes, SMEs can be born and grow in a protected local market. The local market sometimes has a special character and preference for select goods. Some products can not be distributed too far and will be consumed in the local market. These naturally protected local markets could be a cradle for local SMEs. After accumulation of power in the market some SMEs can expand their activities to a nationwide market place. However, this growing process of enterprises could not be applicable in the planned economy. The domestic market had been highly standardized and become very equal and common. The government had deliberately eliminated specialities of local markets for these 40 years. The Polish government had also adopted a rapid liberalization policy for international trade and very low tariff rates on components and parts were applied.

I think Polish government has not offered favourable market conditions for SMEs manufactures to grow. Previously, SMEs in Poland were not given time to prepare and improve their competitiveness to cope with large foreign companies and imported goods.

Market conditions are varied in each industry, so we have to think about the characteristic of market condition of each industry and to prepare the most appropriate policy for them. I regret that the current SMEs policy is very horizontal and has missed the differences of the chracteristics of each industry. I don't deny the importance of a horizontal approach for SMEs promotion policy, but I think we can not succeed to foster, for example, a desired supporting industry without a more specific sector approach. I want to stress that the Central European countries have very different market conditions for SMEs from the Western countries and this has to be changed.

R&D AND INNOVATION POLICY

We saw the drastic shrink of R&D expenditure in the Central European countries after the reformation. It is understandable that policy priority of supporting R&D activity is not high when the society and economy is in a turmoil.

But, I have to point out another problem. After the adoption of a free market system for their basic economic framework, governments in many Central European countries thought applied research should be carried out by the private sector and only basic research should be supported by government. Almost all national research institutes that had devoted themselves mainly to applied research, transferring the result of their research work to state companies, have faced critical financial problems. In the case of Hungary and the Czech Republic, many national applied research institutes have been bankrupted and surviving institutes had to change their activities from research to giving certifications and technological analysis services.

I think there is a serious misunderstanding about the role of government in the R&D activity. If the private sector has not developed strong enough in the country, we cannot depend on the private sector for applied research. The role of government is to supplement the weakness of private sectors and if so, government should support the R&D activities of the private sector or conduct applied research by themselves.

There exists a very wide technological gap between Central European countries and Western advanced countries. The most urgent technology policy is how to fill this gap. Introduction of foreign advanced technology is needed and at that time national research institutes could and should become technology transfer centres for domestic private industries. For this purpose they have to keep their technological level high enough to select and digest foreign advanced technologies for the domestic private sector. This is because applied research activities in national research institutes are needed. At the same time we should stimulate and promote private companies' R&D activities but we have to wait until the private sector is able to afford to start R&D efforts.

CONCLUSION

In the early 1990s, it was said that " No policy is the Best industrial policy." After that, some policy revision was made and several sectoral industrial policy programmes were prepared. But basically governmental direct initiatives on specific economic activities has been avoided until now. The free market system is thought to be the most efficient economic system and believed to bring us the most preferable results for the national economy in Central European countries. But I think we have to think about the different development stages of economy and industry in each country. The Ministry of Economy in Poland defined the industrial policy as follows; " The industrial policy is to promote economic development by not denying market mechanism but by utilizing it in an effective way." This approach is really right. We cannot get the desirable goal against the market mechanism in the current economic system. However, I think we can guide and lead the national economy to the desirable direction under effective governmental influence. I know that the environment for governmental initiatives on economic activities has changed compared with the one in 1950's and 1960's, when Japan could recover and develop our national economy under the strong influence of the government industrial policy, but I think we have still some room to allow the government to act more actively.

The main players are obviously private companies in the market mechanism framework. So we should prepare a good facility for them to act freely. But if we understand the real condition of the private sector in Central European countries, should we force them to compete with western large companies in the same playground at this moment? The fair competition advocated by Western advanced countries is not always fair for the companies in Central European countries. Many Central European countries already expressed their hope to join the EU and accepted the conditions which the EU required for member countries. This policy choice by the Central European countries is very different from that of the East Asian countries. The East Asian countries still try to keep the important role of government in the field of economy and industrial development. They have a future vision of industrial development and are making efforts to realize that goal. And more importantly, they recognize their private sector is not strong enough to compete with foreign large companies on the same ground.

I know that the social and historical background cannot be comparable between Asia and the Central Europe. Asian countries seem to try to keep the varieties but European countries, on the contrary, try to get unity among them. Even though, I can say if we decide to entrust every thing to the choice of market, we have to be very careful of the result and make efforts to get as good a result as possible. Through this efforts we can rediscover the real role of government under the transitional period.

Role of Government, Private Sector and Private Organizations

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The government provides many economic functions that affect the way in which exchange and resources allocation are carried out in the economy. Basically, government can provide a legal structure that encourages or discourages economic activities. The government attempts to stabilize the economy by smoothing out the ups and downs in business activity.

During the post-war period the developed capitalist countries started from the mechanism of free market that prevailing functioned spontaneously to a mechanism which functions in a mainly organized manner. Developed capitalist countries achieved an intensive scientific and technical progress with important positive effects on economic efficiency, incomes, and population consumption.

In comparison with good evolution of the developed countries, the European socialist countries experienced economic decline due to the economic system characterized by super-centralized and bureaucratic planning.

After the removal of the monopoly of communist parties' power in European socialist countries, the option of new political forces in these states for their orientation to market economy has been justified also by the necessity of replacing the economic system. This mechanism was almost blocked with a mechanism similar to the one used by the developed capitalist countries.

Many people believe that the only way to attain economic efficiency is through competition. One of the roles of government is to serve as the protector of a competitive economic system.

Through privatization and creation of new enterprises it tends to remove the monopoly of state property and to assure the predominance of private property in all economic branches. The post-socialist transition period is defined as a mixed economic system where the elements of centralized management by the state are mixed with elements of the market economy. Consequently, the functioning mechanism of the economic and social life is much more complex than both the economic system that existed in socialist countries and the economic system existent in developed capitalist countries. In most European ex-socialist countries this situation was not taken into account. It was considered that the transition from planned to market economy should occur through a total liberalization of prices, wages, profits, currency, and external relations. As a result, financial blockage severely influences almost all enterprises in these countries. The way out of this impasse is not possible without reconsideration of the economic system used in the course of transition. It is necessary that such economic system centred upon the market and the economic rules should occur not as a spontaneous process, but as a process with the involvement of the state, economic agents, and all citizens.

PROPERTY RIGHTS AND ENTREPRENEURSHIP

If you were in a country where bank accounts and businesses were periodically expropriated by the government, how willing would you be to leave your money in a savings account or to invest in a business? Certainly you would be less willing than if such things never occurred. Therefore, the more certain private property rights are the more capital accumulation there will be. The property rights and the legal structure in a nation are closely tied to the degree with which individuals use their entrepreneurial skills. Entrepreneurs are the risk takers who seek new ways to do things and create new products.

In ex-socialist countries, privatization is often considered as a fundamental premise for the establishment of a democratic political regime and for the transition to market economy. Privatization cannot be limited only to this role since this process has many implications in the restructuring of the entire economic and social life in each country. Privatization holds the main role in the restructuring of the property system on which socialism was based. The monopoly of state property was set up as a basis of a political system of the proletarian dictatorship. However, this monopoly produced inefficiency in economy, since the enterprises and the citizens themselves have been frustrated by the attribute of property, a fact that made the state or the entire people's property be considered as no one's property. Through privatization process, the transfer of the largest part of state property into private property of citizens is assured, either free of charge or for a payment pursuing that the private property should become predominant in each country's economy.

On one hand, it is necessary to avoid crumbling the object of property among a large number of small enterprises since they cannot carry out an efficient activity and, therefore, cannot be viable. On the other hand, it is necessary that the new subjects of property that came out after privatization should adopt the organizing forms able to favour the extension of economic activities and the achievement of performances.

State property monopoly in ex-socialist countries considerably limited the individual and group economic interests, suppressed personal initiative and responsibility due to the super-centralized management of economic life; it severely influenced the possibilities to satisfy the needs of each individual and of the whole society. By privatization, a favourable ground for individual and group interests is created. These interests strongly stimulate citizens' initiative for successful economic activities they are involved into. However, at the same time, it determines them to assume the responsibility for the effects produced by the respective activities.

In modern market economy the activity is adjusted predominantly consciously by an adequate use of the objective laws by both economic agents and the state. The combination within the economic system of the market with the state's economic role explains, at large extent, the successes recorded by the developed capitalist countries during the post war period.

It has been argued that one way to improve economic growth in any nation is to improve its infrastructure. Each economy's infrastructure consists of its roads, communication system, financial system, and educational and training institutions.

THE INCREASE OF THE ROLE OF THE MARKET AND THE UNDERESTIMATION OF THE STATE'S ROLE

The most important way in which a government influences the economy is through the governing plan. We are living now times when free market economy, globalization, deregulation are words on everyone's lips. The concept of no government intervention is more and more obsolete.

Consider a hypothetical world where there is no government regulation against pollution. You are living in a town that so far has clean air. A steel plant moves into your town. It has paid for the inputs of producing the steel: land, labour, capital, and entrepreneurship. The price it charges for the steel reflects, in this example, only the costs that the steel planned incurred. In the course of production, however, the plant gets one part of an input—smoke dispersal—free by simply taking it. The steel plant does not have to pay the cost of cleaning up smoke; rather, it is the people in the community who pay that cost in the form of dirtier clothes, dirtier cars and houses, and even more respiratory illnesses.

Developed countries such as Japan, United States, United Kingdom, France, etc., are adepts of free market economy with some level of government intervention. Even Adam Smith promoted the idea of British float protection and nowadays governments cannot ignore the necessity of their intervention in economy to protect emerging and strategic industries and lead to economic growth. The government should facilitate conditions in which competition is most efficient and help where is not so efficient. To be efficient a system based on competition needs a well-developed legal system. This legal system must be periodically updated to reality and latest events. The state decision-making persons must have a high morality and implicate themselves in issues regarding the national state interest.

The functioning mechanism of socialist economy was centred on a super-centralized and bureaucratic plan. Within this system, the role of the market and the objective economic laws was considerably limited, in spite of the existent production commodities. Consequently, this economic system led to a deeper blockage, a fact that contributed to the fall of the Soviet type of socialism.

The transition in ex-socialist countries situated on the foreground of replacing the economic system based on the super-centralized plan with an economic system centred on market, which would be similar to the economic system in developed capitalist countries. As a consequence, important steps were achieved in the organization and functioning of other market categories: the labour force market, the capital market, and the monetary market. Along with citizens' assimilation of the necessary knowledge and an adequate conduct for their participation at all markets the increase of the market role in the functioning of our economic life is to be expected.

The markets secure a direct connection between the solicitants of products, services, labour forces, capital, and currency, and those supplying these elements.

Each market is in a permanent interaction between demand and supply, favouring their reciprocal adoption. The disequilibrium between demand and supply, revealed by the market determines the economic agents to act for surpassing it.

Markets substantially contribute to the allotment and efficient use of the available economic resources from the national economy. In this case, the economic agents are continuously preoccupied with increasing the efficiency of economic activities they are involved into.

Parallel with the positive effects the functioning of markets also produce some negative effects: speculation, the tendency of some economic agents to domination, breaking of the legal and moral norms within the relationships between citizens.

Taking into account that the main role of the market within the economic system in developed capitalist countries, I can say that the state's role substantially increased. It tended to amplify both the positive effects of the market and the limitation of the negative ones.

The democratic state should play an active and positive economic role in the conditions of modern market economy.

I consider that the state's role should confine to:

- The adjustments of the frame of the economic activities
- . State's intervention to fix the situations of failure of markets
- Redistribution of incomes

Many laws were elaborated and a series of adequate institutions were founded for functioning of the market economy, assuring thus the possibility that should more and more satisfy their individual and group interests in various economic activities.

In the modern world it is impossible that the state does not make decisions regarding the way in which competition must be organized within the market. At the same time, the state institutions should focus their attention on the elaboration of certain rules regarding the economic competition according to the total purposes of the society. If in the countries with a market economy consolidated long ago, the state plays an important role in competition, such role is also necessary in the course of transition in ex-socialist countries.

It is necessary a sustained preoccupation of the state to stop the decline of production, so that it may balance the ratio between demand and supply. It still does not exist the necessary ground for competition between economic agents that activate in each branch and the consumers are constrained to accept almost any commodities. That is why, it is necessary that the state should involve more substantially by both its economic possibilities and certain programmes not only for the increase of production, but also for its restructuring according to the needs and real possibilities of the country. The state should provide a general climate for an economic activity able to determine companies to continuously deal with improving quality and reducing costs. Without perseverance in this direction products will not become competitive and there is also the risk to lose even important segments of the internal market in favour to foreign commodities.

It is necessary that the state should organize the process of privatization in such a way that its process should lead to both the increase of private sector in the total national economy, and the formation of competitive viable companies. This would secure a favourable ground for the competition in each branch and increase initiative and responsibility of all economic agents.

On one hand, an intensive competition on a healthy economic base on inner market that would allow an increasing number of economic agents to become competitive on the external market. On the other hand, the protection of the branches with strategic importance given by the state (which is accomplished in the developed countries such as Japan, United States, France, etc.) in order to avoid an increasing economic dependence of the country along with integration into the world economic circuit.

ROMANIA

Since December 1989, Romania has undertaken an ambitious programme of transition to a market economy based on private ownership and free competition.

The adoption of a new constitution in 1991, the free parliamentary and presidential elections in 1990, 1992, and 1996 as well as local government elections in 1992 and 1996 have all contributed to an irreversible break from the past. Today, the country is firmly moving towards a fully market economy.

After December 1989 in Romania it was estimated that an economic system based on the market should be secured without any gross intervention of the state in the evolution of national economy. The underestimation of the role played by the state in the modern market economy had negative effects on our transition towards such economy.

The main elements of the reform process have included: prices and foreign trade liberalization, privatization of state-owned properties, development of a free trade and healthy financial system (including banking activities, insurance companies, capital market).

The inadequate involvement of the state favoured the perpetuation and even deepening several disorders within our national economy, the extension of anarchy, and the multiplication of the anti-social facts in all fields of the economy.

The state may—and should—determine the extension of competition of Romanian economy by adopting and using the legislative and institutional frame. It is necessary that through the entire economic legislation and economic institutions, the state should determine all economic agents to deal with the extension of their activity and increase their profits on a healthy base: the increase of labour efficiency and cost reduction, qualitative and sorts commodities structure improvement.

The government has encouraged the development of the private sector. In fact, more than 500,000 private companies have been set up, which now provide about 45% of the gross domestic product (GDP) and employ more than one-third of the active labour force.

Moreover, the private sector accounts for more than 40% of exports, 70% of consumption work, and 45% of services.

Imports and exports were also liberalized and new fiscal and monetary policies were promoted to control the budget deficit and inflation.

Confidence in the national currency—leu, has increased due to the positive real interest rates offered by banks and stabilized exchange rates on the domestic hard currency market.

Romania is also aiming to attract major inputs of foreign capital, technology, and managerial expertise, so as to redefine and improve its competitive advantages. To increase foreign investment, the Romanian government has promoted an active policy of attracting capital through setting up favourable institutional framework and adequate legislation. This legislation provides free access to markets and offers tax incentives in the case of substantial investments in the field of production.

The consolidation of the domestic investment environment is an absolute priority in our policy to attract foreign capital. To this end, it will be important to further liberalize economic activities and remove the obstacles and bureaucratic hurdles that foreign investors still need to overcome when negotiating and operating on the Romanian market.

In this context, essential changes were made so as to comply with the requirements of the Romanian economy's integration into European and Euro-Atlantic political, strategic, and economic institutions.

The state may—and should—provide the necessary connection between the competition in the inner market, and the degree of the competitiveness with which Romania participates at international economic relations.

Acting along the above-mentioned directions, the state might provide a predominantly organized competition for the Romanian economy. It would have favourable effects for both the economic agents with an efficient activity and meeting the demand of population's consumption and the demand of productions means for the economic activity. Without competition we can not get to a modern market economy able to provide an increasing evaluation of the available economic resources and the raising of the population's life standards.

In Romania, the national economy suffers because the state did not get involved as much as needed. Therefore, weak industries were almost killed by the outside competition without some sort of protection, by a controversial privatization of state owned enterprises, and by the lack of legal activity to prevent frauds, bribes, and corruption.

Besides privatization, the restructuring of unprofitable companies is an important task. To this end, the government has issued new regulations aimed at generating a positive cash flow in such companies, reducing and finally eliminating inter-company arrears and developing profitable economic activities without state support.

The main objectives of privatization as part of the overall economic reform programme are:

- to create profitable private companies;
- to raise funds for restructuring and rehabilitating commercial companies;
- to establish the commercial and entrepreneurial management practices to be followed by those companies;
- to provide the background of an efficient capital market; and
- to educate the Romanian public as to the operations of a capital market in a market economy.

Privatization of farming land and other assets in agriculture is an essential element on the general reform programme because agriculture has always been regarded as one of the main sectors of the Romanian economy. In Romania, more than 70% of farmland is now private property. The technical equipment of private farms has also expanded. For instance, they own nearly 50% of the total tractor fleet, up from 4.8% in 1990.

Under a 1990 Land Law, Romanians received the right to claim up to 10 hectares each from land that the communist had confiscated from private owners. However, land restitution has so far been slow.

The government ignored the national interest by borrowing money from international organizations at high interest rates and just waited for foreign investors to come without creating a safe and attractive field for investments.

Even the capital market did not received proper attention. After having been closed by the former regime for more than five decades, the Bucharest Stock Exchange officially reopened on June 1995.

Although, Bucharest Stock Exchange, a self-financing institution, possess modern trading and clearing—settlement systems can be compared with other prestigious stock exchanges from around the world, it struggles with a low capitalization and daily turnover. Big and attractive companies from industries such as banking, telecommunications, airlines, petroleum can not be found between the companies listed at Bucharest Stock Exchange. Moreover, government securities, here including government bonds, T-bills are not traded on this market. Instead of using this safe and cheap market to raise its capital, the government continues to ignore it presence.

Restructuring of companies was given high priority in the government programme. In implementing this objective, the government worked closely with international financial institutions and the European Union to achieve progress in this area:

- the International Monetary Fund (IMF) programme includes, among others, the restructuring objectives of enterprises;
- the World Bank has established upfront conditions regarding enterprise restructuring in order to proceed with its Financial and Enterprise Adjustment Loan (FESAL);
- PHARE has insisted on restructuring. During several months, an institutional framework has been created for to facilitate implementation of a restructuring programme

In order to stimulate enterprise reform, in 1996 the Parliament endorsed the competition law, a law meant to protect, maintain, and stimulate competition, in the context of promoting consumers' interests. The Ministry of Finance is responsible for administration of state monopolies. The prices and tariffs for the products and services of state monopolies are to be supervised by the government and approved by the Office of Competition.

CONCLUSIONS

Starting after 1990, the privatization programme of the Romanian economy has led to an increase in companies' capabilities to meet market economy requirements and adjust their behaviour to the rules of competition.

The Romanian policy-makers and legislators have tried to keep a strict balance between the domestic reality and international practice, the international pressure of the workers and the interests of the foreign business community and the potential strategic investors and, last but not least, between the great variety of privatization techniques and theoretical approaches and the spirit of consistency and continuity.

SESSION 6

EVALUATION OF BILATERAL AND MULTILATERAL COOPERATION

Taking Stock and Challenges Ahead
Rika Ishii, EBRD

The OECD and the Economic Transition in Central and Eastern Europe
André Barsony, OECD

To the International Conference on the 10-Year Review of Transitional Economies and Challenges in the Next Decade
Yo Maruno, UNIDO

Reforming the Private and Financial Sectors in the Transition Economies of CEE and Former Soviet Union
Yasuo Izumi, IBRD

Transition to Market Economy and JICA Cooperation
Yoshiaki Nishimura, Japan

Taking Stock and Challenges Ahead

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Office of the Chief Economist
EBRD

It is a pleasure for me to be given an opportunity to present the EBRD's activities in the 26 countries in eastern Europe and the former Soviet Union. In the past decade, the countries in the region have taken giant steps towards establishing democracies and market economies. Indeed, 11 years after the fall of the Berlin Wall, we can see clear progress in the transition. Practically all the governments in the region have been elected in free or almost free elections. Exceptions such as Belarus simply prove the rule. With the election of a new president in Yugoslavia, one of the last vestiges of communist rule in eastern Europe has been overcome. In the area of economic reforms, there have been substantial advances in trade and price liberalization, privatization and institutional reform. In 20 of the 26 countries, the private sector now accounts for over half of total output. This year, the regional as a whole is projected to grow by almost 5%, which constitutes its highest growth rate since the start of the transition, and the prospects for the years ahead are also good.

However, I do not wish to underestimate the structural problems that still exist in the transition countries. In the advanced countries these concern mainly the restructuring of old industries and agriculture, as well as reform of the tax and social systems. In the less advanced countries, industrial enterprises and banks still require fundamental restructuring, and the effectiveness and reliability of state institutions and of public administration need to be radically improved. Domestic and foreign investors in a number of transition countries rightly complain of the lack of certainty in the legal system, corruption, bureaucracy and arbitrary administrative acts as being the biggest obstacles to investment. For small and medium-sized enterprises in particular, this makes life difficult and spoils their appetite for investment. Therefore, in our view: significant progress has been made but the transition is far from over. And, as the Russian Federation crisis and its impact on the neighbouring economies have shown, set-backs are possible along the way to completing the transition to a free market economy.

Within today's speech, I would like to drawn on the lessons learned from the experience of first ten years of transition and challenges of the next decade. Where appropriate, I would like to present you some of the findings from our Transition Reports, the most recent of which was published just 2 weeks ago. But first, let me briefly describe the EBRD's activities in the region.

EBRD'S ACTIVITIES IN THE REGION

The EBRD is a multinational institution founded in 1991 with the specific aim of assisting the countries of central and eastern Europe and the CIS to develop into market-oriented economies. Specifically, the EBRD seeks to promote the development of the private sector within these economies through its investment operations and through the mobilization of foreign and domestic capital. With a capital base of • 20 billion, it has committed 14.5 billion for 642 projects by the end of June this year. We are active in all countries of operations. It should be highlighted that the majority of investments by the Bank are in the private sector and the Bank uses various instruments from loans—both private and state—to equity investments and guarantees. We have also invested in various sectors. Perhaps the most important aspect with respect to the EBRD's contribution to transition is its role in mobilizing investment capital. Compared to the total EBRD financing of • 14.5 billion as of June 2000, the Bank has mobilized additional resources amounting to • 37.4 billion. The Bank is the largest single direct investor in the region and by the end of this year, will have been associated with almost • 14 billion of FDI representing over 9% of total cumulative FDI into the region between 1991-2000. The EBRD's medium-term business plan calls for investment in our countries of operations totalling more than 3 billion euros a year, and therefore the Bank will remain the largest direct investor in the region for some time.

Now let me turn to the lessons that we have learned from our experience so far.

LESSONS LEARNED

- The first lesson is that building institutions that support markets take much longer than implementing liberalization and privatization. The lack of supporting institutions hampers the functioning of markets. The governments should attach the highest priority to establishing transparent, predictable and fair rules of the game. The series of Transition Reports beginning in 1994 has been providing a detailed assessment of progress in structural reform. These assessments are made for a number of core dimensions of reform that correspond with the main elements of market economy — markets and trade, enterprises and financial institutions. Progress is measured against the standards of industrialized market economies. The measurement scale for the indicators ranges from 1 to 4+, where 1 represents little or no change from a rigidly planned economy and a 4+ represents a standard that would not look out of place in an industrialized market economy. The progress measured for each country this year and the classification system are contained within the handout. It is clear that the development of market supporting institutions—such as governance and enterprise restructuring, competition policy, banking reforms and the development of securities markets and non-bank financial institutions—has lagged behind progress in liberalization and privatization. The points that correspond to countries and years in which progress in liberalization and privatization advanced ahead of institutional performance are mostly below the 45-degree line. Of course, liberalization and privatization are easier to implement than institutional reforms, but it is also clear from the slide that the sequence of reforms has differed sharply across the region. Whereas Hungary has achieved almost perfect balance between progress in liberalization/privatization and institutional reform, in Lithuania, rapid progress in initial liberalization was only followed by institutional reforms in the mid-1990s. In Georgia, institutional reforms failed to follow rapid liberalization in the early years.

- The second lesson is that reform choices matter. There is a growing divergence in progress in reform and economic performance between the front-runners in EU accession and the less advanced countries in the CIS. To some extent this is because countries in eastern Europe had better starting positions. Indeed, the correlation between initial conditions—such as the initial level of development, trade dependence on the CMEA (Council for Mutual Economic Assistance), macroeconomic disequilibria, distance to the EU, natural resources endowments, market memory and state capacity—and progress in reform is positive. It should be noted however, that there are countries that have been much more successful in implementing reforms than initial conditions would otherwise suggest such as in the Baltic States, Kyrgyzstan and Poland. Further, as this slide shows, liberalization of markets and progress in privatization have contributed positively to growth.
- The third lesson is that because reform choices matter, political will and its implementation are decisive. Reforms have tended to progress further where governments have come to power in free and fair elections. However, where democracies are young and weak, states remain at risk from "capture", that is, the efforts of firms to shape and influence the underlying rules of the game (i.e. legislation, laws, rules and decrees). Consequently, the competitive process is distorted, inefficient firms survive artificially and new firms are discouraged from entering in the market. Last year the EBRD has conducted a business survey, together with the World Bank, which has shown that "state capture" by vested interests is a serious problem in some of the countries of the region.

CHALLENGES AHEAD

From these lessons it is clear that the challenges in the years ahead are institution building, consolidating the gains made in economic liberalization, and promoting open, democratic and accountable government. Let me now turn to some specific challenges on each of the major sub-regions.

CEE AND THE BALTICS

Although Central and Eastern Europe and the Baltic states had better initial conditions, they have also made rapid progress in structural reforms. For the four Visegrad countries, Slovenia and the three Baltic states, EU accession is now the main policy goal and the major transition challenge, but an increasingly realistic prospect in the medium-term.

- EU accession will require substantial investment in public infrastructure. In the areas of environment and transport systems alone, investment requirements are expected to reach 2-3% of GDP annually over the next decade. While EU transfers pre- and post-accession may help the financing of these investments, fiscal pressures are likely to arise. Against the background of already large public sectors and high statutory tax rates, the governments will need to cut expenditure—such as public sector wages, social security and welfare services—and enhance the effectiveness of social assistance for example, through the reforms in pension systems.

- Improvements in the implementation capacity of the governments for infrastructure investments are another challenge. Investments in environmental improvements will naturally require municipalities to take a lead and municipalities must strengthen their financial management capabilities. Governments also need to explore the scope of public-private partnerships in the financing and management of utilities.
- EU accession will also eliminate many of the remaining trade and non-trade barriers and expose weaknesses in the corporate sector—particularly in agribusiness, financial services and heavy industry. Managing the painful structural adjustment and the associated labour-shedding in the remaining large-scale enterprises will be a key challenge.

SOUTH-EASTERN EUROPE

Progress in transition in South-Eastern Europe has been considerably held back by the prolonged military conflict in former Yugoslavia. With a new democratically elected government now in place in Yugoslavia, the hope is that this region may finally put the instability of the past decade behind it. However, reform challenges remain more daunting than in Central Eastern Europe.

- Perhaps the most immediate challenge relates to the cementing of a still precarious democracy in Yugoslavia and implementing economic reforms. While the economy is in crisis, subjected to a decade of misrule, conflict and international isolation, prospects for recovery are good. We believe that the international community can have a constructive role in Yugoslavia's economic recovery — first by providing an emergency short-term assistance programme, but also by helping Yugoslavia to design a longer-term growth strategy.
- Foreign investments in the region have remained far less than in Central Eastern Europe—largely reflecting the uncertain political environment but also because of the unfavourable investment climate. It is unlikely that investor confidence will increase rapidly in the short-term. Therefore, the best hopes for economic restructuring lie with the growth of new businesses—as demonstrated by the experience in Poland where the growth of small and medium enterprises (SMEs) became the engine of reform and economic recovery early on in the transition. The governments in the region can make relatively easy improvements in the business environment for start-ups through lowering administrative barriers, streamlining taxation and ensuring equality of treatment in courts.
- Another immediate and critical challenge relates to rebuilding regional links. The revival of intra-regional trade and investment, as well as the creation of expanded markets for local producers will be crucial in increasing the attractiveness of the region to foreign investors. The Stability Pact for South-Eastern Europe will provide between • 1-1.5 billion per annum for regional infrastructure projects. As in the case of EU accession, governments will have to improve their implementation capacities to deal with these large transfers.

THE RUSSIAN FEDERATION AND UKRAINE

The transition process in the Russian Federation and Ukraine has been slower than expected—especially in the area of institutional reforms. Administrative interference at all levels and high-level corruption are seriously undermining the business environment and growth of new businesses. Energy subsidies have also hindered much-needed enterprise restructuring. Nevertheless, developments over the past two years have defied the prophets of doom following the Russian crisis. The Russian Federation has recorded two consecutive years of growth and Ukraine is experiencing its first year of growth ever since the transition process began. Of course, this has been achieved on the back of real exchange rate depreciations and high oil prices (in the case of the Russian Federation). In both countries, this has provided a window of opportunity for new, bold reform programmes to be adopted. However, restructuring challenges remain enormous.

- First, competition needs to work. The loosening of public monopolies in energy and infrastructure are key. Not surprisingly, they feature high on the reform agenda of the present governments in both countries. WTO accession process in the context of the Russian Federation will further remove trade barriers and increase competitive pressure in the economy.
- Second, corporate governance must be improved. The EBRD as an investor, has experienced a number of cases where weak corporate governance undermined investments. A recent case in the Russian Federation has highlighted how both creditor and shareholder rights can been abused. Nevertheless, the threat to the international reputation of the company involved in the case and, by extension, the Russian Federation itself has rectified the situation. Therefore, as large the Russian Federation and Ukrainian corporates look increasingly for private financing including from abroad, changing their corporate practices will become increasingly important. EBRD is supporting public and private policy initiatives such as the planned development of a Corporate Governance Code for the Russian Federation. The recent start by Standard and Poors to rate the corporate governance of the Russian Federation companies can also provide important institutional backing.

  Finally, a social safety net to cushion the impact of redundancies associated with enterprise restructuring must be provided for. Compared to Eastern Europe, social security welfare expenditures in the Russian Federation are small. During 1993-1998, public expenditures in social security and welfare in the Russian Federation averaged only 8% of GDP compared to 13-19% in the Czech Republic, Hungary and Poland. Social reforms are rightly emphasised by the new the Russian Federation reform programme. Given limited public resources, better targeting is needed and for this, great political and administrative skills are required.

SOUTHERN CIS

The countries south of the Russian Federation cover a vast territory from the Black Sea to the Chinese border and have a population of 70 million—as much as Central and Eastern Europe and the Baltics combined. However, their economy constitutes less than 5% of the total regional GDP. Whilst vast natural resource endowments may attract foreign investments, there is a real risk that the economies face problems of economic dualism. At present, markets especially in Central Asia remain highly concentrated and subject to state intervention.

- Commitment to transparent processes involved in awarding contracts to natural resources development. Early privatizations and private sector participations in natural resources have often been undermined by corruption. In order to attract serious foreign investors, many of which, have been discouraged by past experiences, governments must establish clarity in the process.
- Improve the business environment for SME development. In order to achieve more broad-based economic development, administrative barriers should be reduced, tax administration strengthened and access to financing by the SMEs should be improved.

CONCLUSION

The past decade has been one of great achievement. People in the region have demonstrated tremendous resilience and ingenuity in the face of dramatic change. It is clear that whilst there have been set-backs in reforms along the way, the principles of free markets and pluralist democracy have not been fundamentally questioned. There is no turning back. However, challenges ahead are also enormous and the EBRD hopes to continue to contribute to a successful transition through its investment activities.

The OECD and the Economic Transition in Central and Eastern Europe

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It is a pleasure for me to have this opportunity to address this international conference. The organizers have asked me, first, to report on the OECD's efforts to promote the emergence of effective market economies in Central and Eastern Europe and, second, to highlight what further efforts might be needed to support specifically the development of competitive private enterprises.

Since the fall of the Berlin Wall, we have seen an historic and irreversible economic and political transformation of Central and Eastern Europe. In the early 1990s, as their communist regimes collapsed one after the other, the countries of the region faced daunting challenges. There have been remarkable achievements over the last decade. However, progress has been uneven. In some countries, per capita productivity and income have started converging towards average OECD levels. And this is only part of the picture. Production is now much sounder in terms of environmental impact, the quality of goods and services has improved and life expectancy has significantly increased. The foundations of a market economy can be considered as well entrenched. Other countries, however, still face a difficult journey to an effective market economy.

These differences of outcomes can perhaps be explained by the complex interaction between two main factors: the initial economic and political conditions prevailing in individual countries (i.e. the "path dependence") and the quality of the reform effort. Regarding the first factor, OECD work indicates that over the last century GDP per capita in Central and Eastern Europe was at no time ever converging to levels prevailing in Western Europe. The planned economy episode only pushed the region further away from convergence. When the transition started in the early 1990s, there was a common legacy of distortions but there were also considerable variations in the initial conditions. The Czech Republic was among the industrialized European countries before the Second World War. Hungary implemented a number of market-oriented policies for two decades under its communist regime. Poland had a private sector, especially in agriculture. In contrast, Bulgaria and Romania had stiffer communist regimes and inherited more distorted economic structures, institutions and policies. Second, as the transition unfolded, there have also been significant differences in the quality of the institutional and policy reforms implemented by governments.

The accomplishments of the first decade of transition are remarkable. However, as we enter the second decade of Central and Eastern Europe's great transformation, considerable challenges still remain for all transition countries. It might thus be useful to recall that institutions and policies matter in transition.

A DECADE OF OECD ENGAGEMENT IN THE TRANSITION PROCESS

Today, the most important external "anchor" for economic policy in the countries of Central and Eastern Europe is the prospect of accession to the European Union. But it is appropriate, in the 10th year anniversary of transition, to take stock of the OECD's engagement in the transition process. In particular, the OECD Partners in Transition Programme (PIT) played a somewhat similar role of external "anchor" in the uncertain and complex early stages of transition for the countries concerned. In September 2000, Slovakia formally committed itself to the OECD Convention. As a result, the PIT programme has come to a successful conclusion, since the other participants—the Czech Republic, Hungary and Poland—became OECD Members some years ago.

Even if the PIT programme is formally over, the realities of transition are still on the OECD agenda today, not only with respect to the former PIT participants but also with respect to other countries in transition, including the Russian Republic and China as well as through OECD's contribution to the Stability Pact for South Eastern Europe. In fact, OECD engages no less than seventy transition and emerging market economies through different programmes managed by its Centre for Cooperation with Non-Members, all aimed at institutional and policy reform for effective market economies.

In that pivotal year of 1990, OECD members decided that the Organization should engage itself to the maximum of its capacity to assist and support the great transformation already underway in the former Czechoslovak Federation, Hungary and Poland. Within a year, wide-ranging PIT programmes were established with these countries, with the important "anchor" that the ultimate, if undated, target for these programmes was OECD membership. It is, perhaps, one of the "accidents of history" that other transition countries in the region such as Bulgaria, Romania and Slovenia, which launched their efforts somewhat later or from different initial conditions, were not extended similar OECD programmes. The main reason which has some resonance today in the EU context—is that the prospects of OECD enlargement have implications for internal governance of the Organization that are extremely difficult to sort out and resolve. Nevertheless, it should be noted that the OECD's Cooperation Agreement with the Russian Republic stipulates membership as an ultimate shared goal.

A thorough assessment of the PIT programmes, for possible lessons for the future, is far beyond the scope of this statement. The question as to whether there are, in fact, any lessons to be learned is less rhetorical than it might appear. Most of what one can say is provisional. After ten years it is still difficult to draw significant and uncontroversial recommendations which could be easily applied to all economies in transition. However, there are four points that I would like to underline:

First, even with hindsight, the policy advice provided to the transition countries through the PIT programmes was good advice although it must be recognized that in some cases it might have underestimated the difficulties related to the unique initial conditions of transition economies. The starting point was that macroeconomic and structural policy issues are closely linked and that therefore the transition process needed to be seen in the broadest possible context. Of course, the OECD has been only one of several external players providing policy advice; and OECD advice can well be characterized as "mainstream" in that it is largely coherent with the evolving paradigm of transition economics. What distinguishes most OECD policy advice is the related working methods: the comparative analysis of policy experiences and the lack of strict conditionality. These methods encourage a sense of ownership by the country concerned. They also reveal clearly that OECD Members have distinctive blends of institutional and policy frameworks in support of an effective market economy, reflecting their history and culture. Nevertheless, the real credit has to go to the Central and Eastern European governments themselves, who have faced the far more demanding tasks of translating policy advice into politically sustainable programmes and to the people for their courage and patience.

Second, the centrality—and the complexity—of the financial reform in the context of transition should be emphasized. In particular, financial development impinges directly both on the nature of the budget constraints facing enterprises and the governments, and on the evolving nature of corporate governance. In fact, the most difficult issues in the accession of PIT countries to the OECD related to the OECD Codes of Liberalization which cover invisible transactions and capital movements. These discussions forced the pace, to some extent, of domestic policies with regard to the financial system so as to promote the restructuring or the liquidation of firms that fail to add value and the entry of efficient enterprises, as well as to assure financial robustness in the face of inevitable shocks.

Third, and most fundamentally, the PIT programmes provided a critical catalyst to institution building and reform. A number of dimensions could be cited here. A substantial amount of direct assistance was provided to reduce transaction costs in establishing appropriate legal frameworks in key areas. In this respect, the active engagement of the OECD's Fiscal Affairs Committee in helping the transition countries implement fundamental tax reform and improve tax administration needs to be mentioned, as does the work of the Competition Policy Committee with respect to the drafting of basic laws on competition. Also, the SIGMA programme, mainly financed by the European Commission but carried out by OECD, provided critical assistance in the area of efficient public governance. It should be noted that most of these OECD efforts have rapidly gone well beyond the PIT countries and now engage a broad number of transition economies as well as emerging market economies.

Finally, the PIT programmes provided wide access for the participating countries, as observers, to OECD committees. This access has been an efficient vehicle for the training, or re-training of officials in the ways public administrations operate in the context of a market economy. Indeed, one of the most fundamental challenges of transition has been to create a new culture of public service under radically new conditions of real democratic pluralism and electoral contestability. For the officials who participated in the unique specialised networks of OECD Committees, the direct contact with OECD counterparts on both the substance of issues and on the role of policy advisers in the policy process in areas as diverse as trade, financial markets, agriculture, technology, social policy, labour markets and education may have been decisive in the emergence of "public service" ethos and pluralistic know-how in these countries' capitals.

Furthermore, the broad nature of OECD reviews, cutting across a wide range of competencies also meant that these reviews, by themselves, fostered the development of interagency coordination mechanisms that clearly impacted on the overall quality of policy advice transmitted from the bureaucracy to the politicians. It is also important to point out that training of officials through the programmes of the Joint Vienna Institute have been and will continue to be a key aspect of the OECD's support for reform in transition countries.

These are in a nutshell, the main points that can be retained from OECD's engagement in the transition process, which may then be seen as an important and successful element in the overall history of transition. After this overview, I will now turn to one of the key challenges ahead: how to promote the development of competitive enterprises in the overall effort to establish an effective market economy. This is particularly relevant because the world economy is itself going through a great transformation and the transition economies face the challenge of adapting to increasing competition in a globalizing world economy.

A KEY CHALLENGE OF THE NEXT PHASE OF TRANSITION: THE DEVELOPMENT OF COMPETITIVE ENTERPRISES

In most instances, Central and Eastern European countries have successfully liberalized trade, the exchange rate system and a large basket of prices. As a result, the pattern of both domestic and foreign demand revealed itself and relative prices adjusted to this pattern. This was accompanied by stabilization and as a result, inflation is now basically under control in the region. Privatization is well advanced in some countries while others still struggle to implement large-scale privatization. However, liberalization, stabilization and privatization are necessary but not sufficient. To ensure the good functioning of markets and to create the conditions for sustainable economic and social progress, it is essential to link more effectively liberalization, stabilization and privatization to two other areas of institutional and policy reform: *(a)* first, the restructuring or, if necessary, the liquidation of firms that fail to add value to the economy according to market criteria and *(b)* second, the entry of new enterprises which are profitable in competitive markets.

The aim of the next phase of the transition should be to strengthen the market incentives for the further release of real resources from ineffective uses—Schumpeter's "creative destruction"—through the continuing restructuring of enterprises and, if necessary, liquidation. In turn, these real resources are recycled in higher productivity activities. What steps should be taken to underpin the reallocation of real resources to more productive activities? There is a clear need to create a more competitive climate for enterprises and, importantly, to enhance efficiency, transparency and accountability in the allocation of real resources by firms through better corporate governance. Key institutional and policy challenges include:

- strengthening the domestic framework for trade liberalization;
- creating a better environment for the inflow of private capital;
- promoting efficient markets;
- fighting corruption;
- improving the rules of corporate governance; and
- promoting entrepreneurship and SME development.

STRENGTHENING THE DOMESTIC FRAMEWORK FOR TRADE LIBERALIZATION

Trade liberalization has intensified competitive pressures on enterprises in the region through external exposure and has led to the restructuring or liquidation of inefficient enterprises. Importantly, it has also stimulated the reallocation of real resources from unproductive to productive firms. In turn, this has led to the reorientation of the commodity structure and the direction of trade as well as a more efficient use of the country's comparative advantage.

WTO disciplines and regional integration under the auspices of the European Union will continue to play a key role in trade reforms and institution building in Central and Eastern Europe. These "anchors" set liberalization commitments and strict deadlines for implementation for the countries in the region. They also help lock in its achievements. As WTO members, the countries of Central and Eastern Europe accepted significant trade liberalization commitments. They have also been subject to regular monitoring and surveillance. The current trade negotiations at the WTO in Geneva on agriculture and services are of particular importance for the region because they provide new opportunities for trade reorientation and productivity enhancement. The potential to release resources from ineffective uses and for the emergence of competitive enterprises in agriculture and services is strong because these two sectors had been neglected before the transition had started.

Free trade agreements with the European Union—the so-called Europe Agreements—have also played a key role in trade reforms undertaken in Central and Eastern Europe. These Agreements have led to the removal of tariff barriers and continue to steer the rationalization of trade regimes. They also have led to a considerable increase in the volume of mutual trade with EU countries. Today, exports from Central and Eastern European countries are very strongly oriented to EU markets. The share of liberalized imports is also high. Since the Central and Eastern European countries have signed other bilateral and plurilateral agreements guaranteeing preferential trade access, the bulk of industrial imports, corresponding to some 60 to 75% of total trade, enter duty-free to their markets.

While most countries in the region have made substantial progress in establishing a formal legal framework for trade, several continue to face problems in building effective domestic legal institutions capable of ensuring appropriate implementation of trade liberalization commitments. In other words, while the "law on the books" has been adopted, considerable efforts still need to be deployed to ensure the "law in action". Looking ahead, there is a clear need to improve the effectiveness of domestic institutions for trade liberalization and their capacity to enforce the law as well as to enhance the readiness of enterprises to cope with competition and comply with the law and legal decisions. OECD cooperation with countries in the region attaches increasing attention to the legal, regulatory and institutional aspects of trade policy, especially as regards implementation.

CREATING A BETTER ENVIRONMENT FOR THE INFLOW OF PRIVATE CAPITAL

The relationship between foreign direct investment (FDI) and economic growth is twofold: FDI stimulates economic growth, but is also driven by economic growth. Growth is generated by FDI through imported capital, technologies and marketing capabilities. For example, Hungary has had an economic recovery strongly supported by the inflow of FDI. But the reverse causality also seems to exist: foreign investors react positively to the resumption of economic growth. Thus Poland started to receive substantial amounts of foreign capital only after economic growth became robust. Whatever the relative weight of these causalities might be, a comparison of domestic and foreign owned companies indicates the crucial effect that FDI has on the up-grading of the economic structure and technology and, as a result, on productivity and growth. As it was the case in Spain in the 1970s and in Ireland in 1990s, FDI is contributing heavily to economic growth in a number of countries in the region.

FDI regimes and various incentive schemes to foster domestic and foreign investment can influence the relative advantages of a country, region or locality. But links with macroeconomic balances should be kept in mind. The potential scope for active investment promotion schemes is limited by the budgetary situation of the countries in the region. Tight fiscal policies do not allow for much tax breaks and spending on incentives.

Some countries in the region have complex incentive schemes, ranging from tax and customs allowances to R&D and infrastructure-related subsidies. In addition, special incentives are often considered necessary to foster the start-up of new firms and greenfield investments. These may involve import duty allowances for equipment, subsidies for infrastructure, industrial parks, and special economic zones. Regional and labour market policies also have investment promotion components. Nevertheless, the transparency and the stability of investment promotion policies need to be improved. However, it should be underlined that the positive impact of tax breaks and other incentive schemes are not analytically proven. This is probably because the effects of incentives can hardly be separated from other factors determining FDI.

More than tax breaks and other incentive measures, what really matters to foreign investors is the quality of overall economic and social conditions and the assurance that their investment will be protected by a stable, predictable regime based on the rule of law. Against this background, the application of national treatment to foreign controlled enterprises and the elimination of double taxation are essential framework conditions to attract foreign direct investment.

National treatment of foreign controlled enterprises after establishment has become a pervasive principle in OECD countries and prevails also in most of Central and Eastern Europe. This means that laws and policies do not discriminate between domestic and foreign firms. However, various incentive schemes in the region still offer preferential treatment to large investments. This involves a bias in favour of large foreign investors, who are more able to launch large ventures than domestic and foreign SMEs. Small and medium-size firms often cannot meet the minimum investment and employment requirements to become eligible for tax breaks or other investment incentives.

Several OECD instruments contribute to the development of conditions conducive to FDI. First, the OECD Declaration and Decision on International Investment and Multinational Enterprises constitutes a policy commitment to improve the investment climate, encourage the positive contribution multinational enterprises can make to economic and social progress and minimize and resolve difficulties which may arise from their operations. All OECD Members and Argentina, Brazil and Chile have subscribed to the Declaration. Serious consideration is presently given to the possibility to open this OECD instrument to the participation of a larger number of non-Member countries. The OECD undertakes analytical and advisory work with non-Member countries from the region on FDI trends and policies.

Second, FDI would be seriously impeded if there was a danger that the returns on such investment would be taxed twice, both where the money was invested and in the country of residence of the investors. The OECD Model Tax Convention and the world-wide network of tax treaties (over 1500) based upon it, help avoid this danger by providing clear rules for taxing income and capital. Countries in Eastern and Central Europe will continue to contribute to the development and refinement of the OECD Model.

PROMOTING EFFICIENT MARKETS

The essence of an efficient market economy is that enterprises are free to compete and can try to satisfy demand in the best way they can find. There are of course some exceptions to this rule in case of market failure. OECD work on competition law and policy in Central and Eastern Europe is focused on the identification and elimination of laws, rules and policies that unnecessarily prevent enterprises from competing in efficient ways on factor and product markets. In particular, the OECD assists in the design and implementation by national competition authorities of laws that prevent enterprises from engaging in cartels and laws that prevent abusing monopolies to interfere with the market by restricting output or other such harmful conduct.

The OECD competition policy activities in the region have two main targets. First, they focus on rules that directly impose anticompetitive restrictions on entry or expansion (e.g., into a new geographic area, a new product line, or new production or distribution processes.) Since restrictions on exit necessarily operate as impediments to entry, work also addresses government rules or policies that prevent exit or reorganization into a more efficient structure or new line of business. Second, OECD cooperation in the region also deals with the manner in which countries regulate industries in which there is some natural monopoly aspect. This work involves opening up new markets to competition, both by observing that an activity no longer has natural monopoly attributes and by separating potentially competitive sectors from those that are natural monopolies. It also uses competition principles to improve the regulation of natural monopolies.

This competition policy work will continue to be carried out through cooperation with competition authorities in the region, sharing with them the ways in which OECD competition authorities have used "competition advocacy" to bring about reform.

FIGHTING CORRUPTION

The social, political and economic costs of corruption are very high. The economic costs stem from sharp distortions in the allocation of public resources and less competition in markets. First, corruption distorts the allocation of resources by governments not only because contracts do not go to the most efficient competitor but also because it tilts the composition of public spending and regulation towards areas that make it easier to collect bribes. Second, by increasing risks and transaction costs, corruption reduces investment. Third, by allowing the reaping of benefits through criminal means instead of competition, corruption hinders the development of competitive enterprises. For all these reasons, fighting corruption at the national and international levels is a key component of the overall effort to promote an effective government and market economy and the development of competitive enterprises. Notwithstanding progress made, the legal and institutional anti-corruption framework needs to be strengthened in Central and Eastern Europe.

Since its creation in 1992, SIGMA—a joint initiative of the OECD and the European Union—cooperates with the countries in the region to strengthen public institutions in order to reduce incentives for corruption by improving accountability, efficiency and transparency in the public administration.

The OECD Convention on Combating Bribery of Foreign Public Officials in International Business Transactions constitutes a major step forward in the fight against corruption. It is open to accession by any country that is willing and able to assume the obligations of the Convention. Signatories currently include all OECD Members and Argentina, Brazil, Bulgaria and Chile. The overall purpose of the Convention is to prevent bribery in international business transactions by requiring countries to establish the criminal offence of bribing a foreign public official, and to have in place adequate sanctions and reliable means for detecting and enforcing the offence. They also include non-criminal rules for prevention, overall transparency and cooperation between countries. In addition, parties are obliged to deny the tax deductibility of such bribes.

Reducing the supply of bribes requires more than criminalizing the act of bribing a foreign public official. Enterprises themselves must play a role and address the practice internally by changing the corporate culture that enables corruption to continue. To provide businesses with guidance in this regard, the OECD has revised its Guidelines for Multinational Enterprises, which are open to non-Members, to include a new chapter on the measures that should be taken by enterprises to prevent the furnishing as well as the solicitation of bribes. In addition, the provisions in the OECD Principles of Corporate Governance on improving disclosure and transparency in financial as well as other matters acts as a framework for enterprises to discourage bribery. The Anti-Corruption Network for Transition Economies supported by the OECD provides a forum for the exchange of concrete, action-oriented information between anti-corruption practitioners and analysts from Central and Eastern Europe and elsewhere.

Moreover, the Financial Action Task Force on Money Laundering, which includes most OECD Members as well as some key financial centres outside the OECD area, is combating economic crime, *inter alia,* by addressing the illegal laundering of proceeds deriving from corruption.

IMPROVING THE RULES OF CORPORATE GOVERNANCE

While appropriate legal and market disciplines described above as well as improved accounting and auditing standards, go a long way towards making firms more competitive, improved corporate governance can also greatly contribute. Corporate governance is the set of internal rules specifying the distribution of rights and responsibilities among different participants in a company such as the management, the board, the shareholders and other stakeholders. It is through these rules that the objectives of the company are set and means of attaining them and monitoring performance are determined. By enhancing efficiency, transparency and accountability in the allocation of real resources by firms, good corporate governance underpins the emergence of competitive enterprises. By building investor confidence, good corporate governance can contribute also to the inflow of private capital to a country.

Transition economies face particular challenges. Privatization transfers the ownership of enterprises from public to private interests. But privatization also requires a strict definition of property rights and corporate governance rules. If the manager of a privatized company does not have to give any information to his shareholders, if he does not have to answer to any board about his actions, if he can unilaterally alter the property rights of other parties, by shifting assets and cash flows in and out of the company at will, or by issuing new shares, then the company does not really exist as a well-defined property for its shareholders or for its creditors. It does not really represent a stable source of employment for its workers or a source of revenues for tax authorities that often cannot find anybody responsible to pay them.

The need for better corporate governance has been acknowledged world-wide as a key determinant of efficient allocation of real resources, of inflow of private capital and of the development of equity markets. In this respect, the OECD Member countries adopted a set of Corporate Governance Principles to help policy makers and corporations raise their governance standards. Since their adoption in 1999, the OECD Principles of Corporate Governance have become the main point of reference for corporate governance reform in both OECD and non-Member countries. They were also included in the Compendium of 12 global standards for financial stability, compiled by the Financial Stability Forum. As such, the OECD Principles are expected to be used increasingly by international financial institutions, namely the World Bank and the EBRD.

PROMOTING ENTREPRENEURSHIP AND SME DEVELOPMENT

In the early phase of the transition, the creation of small and medium-sized enterprises (SMEs) was mainly driven by individuals facing unemployment. Progress towards privatization was initially built upon the sale of inefficient, state owned enterprises. As a result, large enterprises still tend to dominate markets in transition economies much more than is the case in mature or emerging market economies. Often the large, privatized enterprises were able to defend their dominant position in the market by maintaining a close relationship with the state and thus creating important obstacles to entrepreneurial contenders. At the same time, the development of SMEs has been hampered by a number of factors such as a lack of adequate legal frameworks and effective enforcement which allow enterprises to enforce contracts, collect debts and resolve disputes; overtaxation; heavy administrative burdens; and corruption. In some countries, banks remained more a vehicle for post privatization corporate control than a primary source of finance for SMEs. The development of small and medium-sized enterprises in the next phase of the transition needs to be more fully supported.

While it is well understood that entrepreneurship and SME development lead to employment creation, the role that SMEs play in increasing competition and instilling flexibility in markets is perhaps less apparent. SMEs increase competition by giving consumers a wider choice of goods and services and employees a broader range of job opportunities. They also put new ideas more rapidly to test than large corporations. In OECD countries, SMEs are particularly dynamic: they are first to move in new economic activities and they are also the first to cut capacity in line with declining demand. Market-oriented structural adjustment in an economy is primarily driven by SMEs.

Over the years, governments in Central and Eastern Europe have become increasingly aware of their responsibility to create the conditions necessary to stimulate and support the development of SMEs. The OECD Forum for Entrepreneurship and Enterprise Development is a policy dialogue tool on how to develop enterprises able to compete in effective market economies. It aims to identify a set of "good practice" institutions and policies that improve the environment for entrepreneurship and lead to the creation of new enterprises. The Forum has developed, through policy dialogue, practical approaches to entrepreneurship and SME development which capitalise on extensive OECD analysis and experience. It's work focuses on two main areas: first, the institutional framework, including tax policy for SMEs, institutionalization of SME policy and rule of law and regulation; and second, support services, including financial instruments for start-ups, advisory services and enterprise promotion through business incubators. It is hoped that over the longer term, the exchange of policy experiences in the Forum will lead to significative improvements in the operating environment for SMEs as well as in a more accurate targeting of public policies and support programmes.

CONCLUSION

In conclusion, I would like to underline that productivity growth and competitiveness are no longer elusive objectives for Central and Eastern Europe. As highlighted in my intervention, governments will need however to take a number of important steps to underpin a more competitive institutional and policy framework for enterprises, including better corporate governance and SME development. The OECD stands ready to continue, within the limits of its resources, its cooperation in all these areas of institutional and policy reform. Clearly, for several countries, the prospects for productivity convergence towards Western Europe and higher living standards are real. If this will be confirmed in the years ahead, we will be able to say in full confidence not only that transition in Central and Eastern Europe has proved to be a resounding success for the people in the region but also a source of new hope to people around the world.

To the International Conference on the 10-Year Review of Transitional Economies and Challenges in the Next Decade

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Deputy to the Director-General and Managing Director to the International Conference
UNIDO

On behalf of the United Nations Industrial Development Organization, it is, indeed, an honour for me to address this part of the Conference, which is focusing on bilateral and multilateral cooperation in the transitional economies.

As the name of the Conference makes clear, we are looking back at what has been achieved since the momentous transition to a market economy began in Eastern Europe and the former Soviet Union a decade ago. We are also looking ahead to tackling the formidable challenges the region faces in its efforts to become part of the global economy.

UNIDO is far from a newcomer to Eastern Europe and the former Soviet Union. Even before the winds of political and economic change swept through the region, it pioneered the promotion of investment and the transfer of technology. In 1983, for example, UNIDO opened the first investment promotion office in a CMEA country, in Warsaw. This was followed, in 1988, by the establishment of the UNIDO Centre for International Industrial Cooperation, in Moscow.

Since then, the region has changed dramatically and so has UNIDO. Confronted a donor community that questioned its *raison d'etre,* the Organization faced a major crisis marked, first, by the withdrawal of the United States, in 1996 and, then, by Australia. A year later, Germany and the United Kingdom were on the verge of pulling out but decided to reconsider their positions.

However, with the driving force and vision of a newly elected Director-General, Carlos Magariños, in 1998, UNIDO embarked on a far-reaching transformation. Its cornerstone was the adoption of a business plan with three crucial aims: to build competitive economies, to create productive employment and to ensure a sound environment.

UNIDO believes that these are the elements that affect people's lives most profoundly. And, after all, human well-being must be the ultimate objective driving the forces of production and commerce.

Based on these guiding goals, the Organization has consolidated its expertise into a series of core services. These can be tailored into unique integrated packages to meet client countries' specific industrial needs at policy, institutional and enterprise levels. Since 1998, more than 40 programmes have been developed. Eight of these, with a total value of US$ 15.5 million, have been designed specifically to deliver value-added technical assistance to countries or areas within Eastern Europe and the newly independent states of the former Soviet Union.

Today, the transitional economies face two major challenges, which are closely interrelated: integration into the global economy and economic transformation. For them to benefit from globalization requires the continuation of internal economic transformation. But economic transformation is largely predicated on economic openness and participation in the globalization process.

Despite progress in overcoming these hurdles during the last decade, there are striking disparities between countries in the region, in terms of their pace and depth of integration into the global economy. Per capita income, for example, ranges from a low of some US$ 179, in Tajikistan, to a high of more than US$ 9,000, in Slovenia. Parallel to the economic transformation that has taken place, a range of environmental considerations has emerged creating a further challenge for the manufacturing sector.

Intrinsic to a lasting solution to these problems is the role of industry. Today, UNIDO is in a unique position among the various international development agencies to offer a comprehensive package of industrial services that reinforce one another. From micro-sized projects to interregional initiatives, it is the only such organization able to deliver the entire range of expertise essential for sustainable industrial growth in the global market of the twenty-first century. Combined with a well-established network of contacts in the public and private sectors alike, this builds a distinct value added into the services that UNIDO is able to offer.

The Organization's investment and technology promotion programme exemplifies this value-added approach. Investment today goes beyond mere joint ventures for manufacturing and marketing. It entails sharing technology and adapting it to local conditions so that production meets the standards demanded by international trade.

Responding to that need, UNIDO has coupled its more than 20 years' experience as an honest broker in investment promotion with its expertise in technology and quality management. The result is a new approach to fostering partnerships between investors and project sponsors. Strategic investments, tools and methodologies for project appraisal, modern technologies and internationally recognized quality standards are brought together into integrated packages designed for success in global manufacturing and trade.

Investment and technology are, of course, essential ingredients in the industrial transformation of the transition economies. UNIDO's new integrated approach to assistance in these two key areas is exemplified by its recent initiatives for the Russian Federation.

In Bashkortostan, Komi and Moscow Oblast, individual programmes have been designed, for the first time, to address all major aspects of investment promotion:

- They draw on UNIDO's strengths in research and studies to address the full range of administrative, economic, social and infrastructure hurdles to attracting investors.
- They work with governments and decision-making bodies to overcome bottlenecks to sustainable industrial development.
- They use UNIDO's expertise in funds mobilization to finance ongoing investment promotion programmes.

- They tailor investment opportunities to meet the republics' individual industrial requirements.
- They apply UNIDO's technical and managerial know-how to improve the capacity and performance of investment projects in marketing, accounting, management, certification and after-sales assistance.
- They offer post-promotion support based on UNIDO's experience in industrial clustering, subcontracting and global networking.
- They coordinate foreign investment with strengthening small- and medium-scale enterprises and creating new companies, as well as with building in cleaner production processes and meeting international environmental standards.

To deliver these services directly to investors and project promoters, UNIDO has established 11 Investment and Technology Promotion Offices. As I mentioned earlier, Warsaw was the first such office to be opened in Eastern Europe. Its success in promoting US$ 154 million worth of investments in 1999 alone speaks for its impact. Earlier this year, Bratislava became the latest office in the UNIDO investment chain. These offices are, in turn, backed up by a network of national investment promotion units working closely with UNIDO around the world.

Value-added support of this kind constitutes the building blocks that industries in transitional economies need if they are to develop and prosper in the global market. This is particularly important for small- and medium-sized enterprises in the region.

In the ten years that the transition to a market economy has been underway, the contribution of the private sector to GDP has grown tremendously. Although privatization of state-owned enterprises has proved important in this regard, new businesses-many in the small- and medium-scale sector-have also helped fuel this new-found prosperity.

But these fledgling enterprises require careful nurturing if they are to grow into tomorrow's engines of economic growth. UNIDO has a central role to play in three key areas:

- by providing policy advice and assistance in establishing support institutions for SME development
- by providing a focus for exchange of experience among transition economies on SME policies and programmes and
- by launching innovative partnership programmes with transnational corporations to enhance SME competitiveness as well as supporting SME clusters and local enterprise development initiatives.

To prosper and grow, SMEs need to increase sales, decrease costs and have access to low-cost support services, including information on financing, technology, markets, raw materials and the like. Information and communications technology can have a considerable impact given the requisite support infrastructure. One approach to ensuring success is to use the technique known as technology foresight.

UNIDO has initiated a major programme in this direction, which is currently being tested in Latin America and may soon be adapted to Eastern Europe and the former Soviet Union.

Technology foresight is the analysis of market trends and current technological developments in a coordinated fashion with the aim of assigning priorities and resources to strategic sectors of the economy.

A key aspect of UNIDO's approach to technology foresight is the strengthening of business-to-business e-commerce, with the aim of fully integrating SMEs into domestic and international production processes and supply chains. In this endeavour, UNIDO enjoys a singular advantage since it brings together the interests of the private and state sectors as an honest broker.

By assisting governments and enterprises to build B2B supply chains, the Organization can help SMEs reduce their transaction costs, increase sales and customer services and create new businesses and linkages. As a spin-off, SMEs gain a better understanding of the use and potential for information and communications technology while finding new ways to improve their businesses.

To strengthen access to e-commerce, at the end of this year, the Organization will formally launch a unique Internet-based electronic platform called UNIDO Exchange. It is designed as a one-stop shop for sharing information and fostering business partnerships between enterprises, governmental and non-governmental bodies, R&D institutes and other industrial stakeholders worldwide.

UNIDO is building a further bridge to span the communications gap, having recently joined forces with Ericsson Consulting to study emerging trends in electronic and mobile commerce for SMEs in developing countries and transition economies. The goal is to pinpoint the bottlenecks SMEs face in this respect at policy, institutional and enterprise levels as well as to map out a viable approach for them to take part in e-commerce.

In addition to networking, UNIDO is fostering information technology for the seamless management of industries, from matching supplies of components to production requirements, to operating efficiency on the shop-floor and, onward, to meeting market demands.

Hand-in-hand with the transformation of the manufacturing sector in the region have come new environmental challenges. These include not only the traditional problems associated with industry of air, soil and water pollution. A further dimension has emerged in the form of compliance with European Union and other international conventions on pollution control, which is central to countries applying for EU membership.

UNIDO's approach is, once again, based on giving value added to its services. Rather than just concentrate on costly end-of-pipe solutions to reducing effluent emissions, the Organization has introduced the concept of cleaner production to the manufacturing process. This encompasses control of the entire production cycle from more efficient use of raw materials and energy through reduction of waste to recycling of effluents.

UNIDO has established a growing network of National Cleaner Production Centres, including ones in the Czech Republic and Hungary, which have, so far, provided more than 25,000 entrepreneurs, technicians, government officials, financiers and academics a new window on the latest developments in the field of cleaner technologies. They are enabling small- and medium-sized enterprises to acquire clean technologies that might, otherwise, be beyond their reach. The Centres collaborate with UNIDO's Investment and Technology Promotion Offices to ensure that the industries of tomorrow are the preservers—rather than the polluters—of the environment.

At subregional level, UNIDO's programme for transfer of environmentally sound technology in the Danube River Basin is helping local enterprises to upgrade technology and, thereby, to comply with environmental norms. The Organization is also involved in three other large-scale environmental protection programmes aimed at reducing industrial pollution in the Dniepr River Basin, Tisza River and Caspian Sea.

These represent but a few of the ways UNIDO is building value added into its services to help transition economies meet the challenge of industrialization in the new millennium. With the region's diversity of development levels, the challenge is, indeed, formidable. But UNIDO is confident that, by working with its partners in this way, the industrial challenges of today will become the economic opportunities of tomorrow.

Reforming the Private and Financial Sectors in the Transition Economies of CEE and Former Soviet Union

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CHALLENGES AHEAD

Successful financial and private sector reform is essential for the transition of the formerly communist countries of Europe and Central Asia (ECA) region to well-functioning market economies. Although privatization has progressed rapidly throughout the region, many countries have been less successful in building the institutions needed for a well-functioning market economy. In the real sector, barriers to small- and medium-scale enterprises' (SME) entry and foreign direct investments must be reduced, steps to improve corporate governance must be taken, and bureaucratic interference and corruption must be curtailed. In the financial sector, reforms will have to temper government interventions by creating incentives for prudent banking and other financial intermediation.

THE LEGACY

Under central planning, rather than maximizing profits, enterprises simply had to meet the central planner's physical targets. The plans tended to stress heavy industry and mining, while putting less emphasis on consumer goods and small-scale enterprise. Further, since enterprises were protected from competition and were required to redistribute any profits they made, they had little reason to emphasize quality, variety, customer service, or innovation. Consequently, at the start of the transition process, enterprises were often inefficient, the quality of goods was poor, and managers had not developed the market-oriented skills that they would need.

At the same time, banks were mere accounting agencies, passively gathering household deposits and keeping track of the financial transactions that corresponded to allocations under central planning. Banks did not, as in market systems, allocate resources to the highest rate of return. Instead, they were part of the command economy and had functions similar to those of state treasuries in market economies.

Furthermore, the other components of the financial system, including the payments system itself, were rudimentary. In most countries non-bank finance simply did not exist.

EARLY REFORM STEPS

PRIVATE SECTOR DEVELOPMENT

Not all transition economies followed the same path of reform. While some countries, such as Poland, adopted programmes that quickly liberalized prices and markets and lifted restrictions on small business, others took a more deliberate approach towards reform.

Similarly, although most used several privatization techniques, they relied to different degrees on different methods. Many countries throughout the region used mass privatization programmes, selling large parts of their economies in voucher schemes (e.g., the Czech Republic). Others relied primarily on worker or management buyouts (e.g., the former Yugoslav Republic of Macedonia), selling privatized enterprises to insiders. Other countries relied heavily on cash-based privatization for large enterprises, sometimes encouraging large amounts of foreign direct investment (e.g., Hungary). Finally, several countries used opaque procedures or allowed "spontaneous" privatizations to occur, as insiders plundered assets from formerly state-owned enterprises.

BANKING AND FINANCIAL SECTOR

In all transition economies, at the start of the transition process, large state-owned banks were split up, acquiring regional or functional specialization. At the same time, in many countries new, and often private, banks emerged. This was not enough, however. Building a banking system on market principles required either transforming the state banks into market-based institutions by rehabilitating them or creating a new banking system through the entry of new banks.

Transition economies adopted different combinations of the rehabilitation and the new entry approach. For example, in Estonia and the Russian Federation, a large number of new banks entered the market, and state banks were broken up and privatized, and in some case liquidated. In Hungary and Poland, recapitalization of state banks was chosen and extensive programmes were adopted to develop such banks institutionally and privatize them as soon as possible.

The development of the financial system coincided with a decline in the performance of enterprises. Consequently, banks accumulated significant amounts of non-performing loans.

The role of banks in financing enterprises also declined. Many banks in Central and Eastern Europe and the former Soviet Union (FSU) limited their role to financing trade and some working capital, making only small contributions to investment in enterprises.

In many FSU countries, the flow of resources to enterprises eventually stagnated. Old loans continued to roll over, but few new ones were made, so net transfers to enterprises were small. The privileged access to financing, enjoyed by many large state enterprises, was another barrier to the emergence of new private firms.

CURRENT ISSUES

PRIVATE SECTOR DEVELOPMENT

Most countries have made considerable progress with privatization since the start of the transition. In all but a few countries (e.g., Belarus), the privatization of small enterprises (which are often in the service and trade sectors) is mostly complete or, at least, proceeding rapidly. Although the privatization of large enterprises is proceeding more slowly, most countries in Eastern Europe (e.g., the Czech Republic, Hungary and the Slovakia) have made significant progress. Although progress has been slower in the FSU countries, several have made some progress and many have at least taken significant steps in the process.

Privatization of infrastructure has not developed as quickly. However, over the past year, several countries have made progress with high-profile privatizations. For example, Poland sold a 15% stake in its telecommunications firm, TPSA, in late 1998 and intends to sell an additional 25-35% by the end of year 2000, and Bulgaria completed the sale of 51% of its telecommunications monopoly, BTC.

Although the progress with privatization and liberalization is encouraging, some deep-rooted problems remain. In particular, with a few notable exceptions (e.g., Hungary and Poland) some areas, such as building the institutions of a market economy and improving corporate governance, have not received sufficient emphasis. This has slowed SME development and foreign direct investment throughout the region.

The 1998 crisis in the Russian Federation stressed the importance of institutional reform. Several countries, including successful reformers such as the Czech Republic, Hungary, and Poland, faced sizable investment outflows following the crisis. In the face of continuing volatility in international capital markets, it is, therefore, vital that the transition economies continue with institutional reform to limit their vulnerability to sudden changes in investor confidence.

Another way that countries can limit their vulnerability to sudden outflows of capital is to encourage foreign direct investment. In general, foreign direct investment is less volatile than other forms of foreign investment. Most countries, with the exception of the Russian Federation, did not appear to suffer from large immediate slowdowns in foreign direct investment following the recent crises. Continued privatization in infrastructure, which can attract large amounts of direct investment and boost investor confidence, and continued steps in institution building will help countries attract direct investment.

BANKING

The legal and regulatory framework for the banking sector in most ECA countries remains inadequate, and has led to a generally small and undercapitalized banking sector.

Accounting standards, collateral laws and registries, and bankruptcy legislation have all been slow to develop and difficult to implement. Banks themselves have also been unable to either develop internal capacity for prudent lending or shift from lending to insiders to lending to a broader range of private sector firms.

These weaknesses have been exacerbated in an environment of rapid change and market volatility. Following the implementation of liberal banking policies, a series of banking crises around the region led to a concerted effort by most governments to strengthen their banking sectors.

The more advanced countries (e.g., Hungary and Poland), in particular, have undertaken broad measures to make their banking systems more sound. Many have forced bank restructuring, using a combination of write-offs, purchase or transfer of bad loans, debt-equity swaps, and direct recapitalization to improve the balance sheets of troubled banks. Some countries have or are planning to privatize state banks in an effort to improve efficiency and responsiveness to market forces.

Similarly, in most countries the enforcement of higher capital requirements and capital adequacy ratios has led to the consolidation of smaller and undercapitalized banks into larger, more financially sound institutions.

Nonetheless, the disparity between those countries that have taken serious action in reforming their financial sectors and those that have not yet taken action is widening. The gaps between those countries that have successfully reformed their financial sectors (e.g., Hungary and Poland), those countries that have engaged in partial reform (e.g., Romania), and those countries that have barely started the process (e.g., Belarus and Tajikistan) are continuing to widen.

SECURITIES MARKETS

Securities markets in the transitional economies are still underdeveloped, depriving firms in the region of a major source of capital. While some countries have been successful with reforms (e.g., Hungary and Poland), others have yet to introduce adequate institutional reforms (e.g., Belarus and Tajikistan).

Problems with securities markets across the region include an insufficient legislative and regulatory base, a lack of securities professionals, and a dearth of listed companies, leading to low volumes of trading and illiquidity.

A handful of countries, specifically the Czech Republic, Estonia, Hungary, and Poland, have been able to develop working capital markets and a variety of traded instruments. In these countries, the listing of a small number of "blue-chip firms" undergoing privatization has galvanized nascent stock and bond markets.

THE BANK'S ROLE AND RESPONSE

In June 2000, the Bank had 34 active financial sector and private sector development projects in the Europe and Central Asia region, with a total commitment of US$ 2.9 billion. During FY00[1], three new operations totaling US$ 359.0 million were approved, accounting for about 11.7% of the total regional portfolio.

In Albania, a US$ 6.5 million Financial Sector Institution Building Technical Assistance Project approved in June 2000 aims to strengthen the financial sector, focusing on the banking and insurance industries. Through the project, technical assistance will be offered to the government for furthering the implementation of key areas of its financial sector strategy including the completion of its bank privatization programme (including Savings Bank sell-off), improving financial infrastructure, and privatization of the insurance sector. It also includes some support to improve the capital market legislative and institutional framework.

[1]Fiscal Year 2000: 1 July, 1999-30 June, 2000.

In Bulgaria, a US$ 100 million Financial and Enterprise Sector Adjustment Loan II was approved in December 1999. A key objective is to help the Government privatize state-owned enterprises by end-2000 through a transparent and competitive privatization process. The financial discipline component focuses on reduction and eventual elimination of public sector losses, as well as on the establishment of transparent and efficient liquidation and bankruptcy systems. The support to the banking sector is aimed at achieving privatization of public sector banks, the restructuring of the State Saving Bank, and establishment of a sound legal and regulatory framework and supervision capacity. Another area of emphasis is energy: the Bank has been assisting the Government in the areas of legal framework, tariff reform and the development and rehabilitation of non-nuclear generation and conservation.

In Turkey, a US$ 252.5 million Export Finance Intermediation Loan (EFIL) was approved in July 1999 to support the Turkish exporting sector hurt by the recent global financial crisis. The loan will provide short and medium term financing for the procurement of input goods, equipment and services by private exporters. The inputs could be procured locally or externally on commercially competitive terms and will, therefore, benefit both direct and indirect exporters. The EFIL will also provide financing for the procurement of consulting services and training, for the further institutional strengthening of Turk Eximbank.

Transition to Market Economy and JICA Cooperation

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INTRODUCTION

I don't belong to JICA, but I have been being involved in several projects for technical cooperation conducted in Central-East European countries by the Japanese governmental organizations including JICA. So I have some experiences from practice in the field of technical cooperation there, and I would like to try to explain JICA activities on behalf of JICA objectively. I will mention the following respects.

- Why does JICA wrestle with support for transition to market economy?
- What is JICA's role in cooperation with transitional countries or what has JICA been
- implementing in practice in Central-East European countries?
- What reputation has JICA got as to its activities there, and what are problems?

COMPONENTS OF TRANSITION TO MARKET ECONOMY

Before I explain JICA activities in the Central-East European countries, I must refer to some aspects of the transition to market economy. We can mention at least four components of transition to market economy.

LIBERALIZATION OF INTERNAL AND EXTERNAL ECONOMIC ACTIVITIES

This contains introduction of convertibility of the national currency. The liberalization means, first of all, deregulation of economic activities which were regulated by the state under the socialist regime. That, nevertheless, doesn't admit a lawless situation as a result of the deregulation. In order to make free economic activities suitable for market economy, market-oriented institutions as normative forms or ways of action are indispensable, including sets of rules, moral and a way of thinking. And moreover, organizations such as a government, enterprises and banks etc. should be transformed into those of market economy. And lastly, market-oriented people are essential.

PRIVATIZATION

It is relatively easy to realize legal privatization and transform state enterprises into private corporations. But a problem is whether newly born private owners or managers have capacities of management adequate for market economy or not. From this point of view, it is an urgent and important task to raise due managers or entrepreneurs at the beginning of the transition.

INSTITUTION-BUILDING, AND DEVELOPMENT OF PROPER ORGANIZATIONS AND HUMAN RESOURCES

It is obvious from the above-mentioned that the transition to market economy is a process of institution-building, and creation and development of proper organizations and human resources for market economy, which takes rather long time. People can learn market behaviour from everyday practice, but it is possible as well as necessary to promote the learning process by training, especially at the beginning of such a great transformation.

ECONOMIC DEVELOPMENT

All the transitional economies are low-income economy or (upper-medium-lower) middle-income economy. And therefore the transition to market economy should entail economic development. First, it is necessary for people in the transitional countries to minimize social cost for the transition. Second, the transition to market economy contains their involvement in the world market. And accordingly they have to achieve economic development so that their national economy can survive independently, I mean, on the commercial basis in the world market, but not on the basis of financial aids from the international organizations or other foreign governments. Thirdly, Central and East European countries want to accede to EU, and as a result, they have to reach the level of economic development adequate for the accession within a certain period of time. Eventually many governments of the transitional countries have been being engaged in developmental policies since the early time of the transition (See the appendix). But it is a difficult task for economists in the governments to work out active economic policies such as industrial policies, having accepted market economy as a prerequisite condition, because they didn't have experiences and knowledge for that.

To sum up, I would like to emphasize that people in the transitional countries must learn much in order to build up market-oriented institutions and organizations and to implement market-oriented economic policies.

WHY DO THE JAPANESE GOVERNMENT AND JICA WANT TO SUPPORT THE TRANSITION?

The Japanese government and JICA have their leading ideas to give ODA (Official development Assistance), and according to their documents, the ideas are as follows.

HUMANITARIAN AND MORAL CONSIDERATION

This means assistance to those people suffering from poverty and misery. I don't think this idea is relevant to the transitional countries especially in Central and Eastern Europe.

RECOGNITION OF INTERDEPENDENCE OF NATIONS

National economies of all the countries on the earth including developed, developing and transitional ones are closely interdependent on each other. And the developed economies themselves cannot develop smoothly without economic development of the rest of the world. This recognition leads up to JICA efforts to support introduction and development of market economy.

ENVIRONMENTAL CONSIDERATION

Environmental deterioration due to past developmental policies is serious in the transitional countries, too. And economic development there must go in harmony with environmental preservation.

I think that the second and third recognition gives arguments for JICA assistance to transitional countries. In other words, the Japan government and JICA regard the transition to market economy as a serious challenge for the people of the transitional countries, which needs assistance from the side of the developed economy.

WHAT IS JICA'S ROLE IN COOPERATION WITH TRANSITIONAL COUNTRIES?

JICA was established to have charge of one aspect of ODA, that is to say, of technical cooperation. In other word, tasks of developing local human resources revolve on JICA. The Japanese government has another organization for financial assistance, such as former OECF (The Overseas Economic Cooperation Fund) and now JBIC (Japan Bank for International Cooperation). Therefore JICA is a most suitable organization to assist people of the transitional countries in learning the market economy. It is worth while to point out one fact as a background of the technical cooperation in the economic field. I mean that Japan has many experiences of quick economic development and has many experts involved in the development process.

The technical cooperation is aimed at the transfer of technology and knowledge that can serve socio-economic development of a country. And JICA has a wide range of menu of technical cooperation, but I think what is relevant to the Central-East European countries is limited to the following four forms of JICA activities. I can't show the whole picture but only the outline.

RETRAINING VARIOUS EXPERTS TO RAISE THEIR MARKET-ORIENTED CAPACITIES

A good many of special training courses for Central-East European experts have been being organized by JICA in Japan for 12 years. Various organizations cooperate with JICA for the training; for example, Japan Productivity Center, Economic Planning Agency, Japan Development Bank, International Development Center of Japan, Japan International Cooperation

Center, Local governments, Ministry of Agriculture, Forestry and Fisheries, Ministry of Construction, Ministry of Transport, Energy Conservation Center and so forth.

I can mention the number of the trainees, the term of training courses and their contents. But topics adopted in the training courses range very widely, and it is not an easy task to make a full list of the topics. I would like to compile a list of topics of the courses held in this fiscal year.

The track record of training experts from the European transitional countries in Japan (From 1989 to 1998)

State	*Number of trainees*	*Number of months multiplied by number of trainees*
Albania	78	146.6
Bulgaria	389	442.3
Croatia	22	30.4
Former Czechoslovakia	139	120.5
Czech Republic	117	119.4
Slovakia	215	223.0
Hungary	602	620.7
Poland	653	729.7
Romania	376	451.9
Former Yugoslav Republic of Macedonia	82	143.0

List of Topics of the Training Courses for Central-East European Experts in The Fiscal Year 2000

1. Business management for Bulgaria (27 days; 10 trainees)
2. Business management for Slovakia (26; 10)
3. Business management for Romania (27; 10)
4. Support for economic reform efforts for Romania (29; 6)
5. Designing and improvement of production system (71; 6)
6. Problem solving and improvement by TQM for Polish industries (29; 7)
7. Fisheries development for Albania (14; 13)
8. Productivity management for Hungary, Slovakia and Slovenia (26; 8)
9. Production management for East European countries (40; 9)
10. Macroeconomics (Japanese development) for Central-East European countries (40; 13)
11. Energy efficiency for East European countries (26; 11)
12. Agricultural production and distribution for four countries (48; 11)
13. Development finance for Central-East European countries (22; 12)
14. Seminar on small business policy in Japan for Central-East European countries (25; 11)
15. Industrial pollution control for four countries (52; 9)
16. Industrial policy in Japan for Central-East European countries (30; 12)
17. Environmental administration for Central-East European countries (35; 10)
18. Industrial air pollution control technology Central-East European countries (43;10)
19. Foreign trade promotion for Central-East European countries (27; 11)
20. Management of medical equipment for Bosnia and Herzegovina (48; 9)
21. Business management for Bosnia and Herzegovina (about 30; 6)
22. Small business policy in Japan (about 30; 6)

Incidentally, JICA also has an experience of opening training courses in a Central Asian transitional country, that is, in Uzbekistan. "The Japan course" was set up in the Academy of State and Social Construction under the President of the Republic of Uzbekistan for three years. Its main contents were introduction and explanation of experiences of the Japanese economic development (See the appendix). The trainees and participants are from central and local governments and from the private sector. The number of the total participants was about 500. The lectures were given by Japanese short-term experts (professors, government officials, businessmen) dispatched by JICA. After closing the course the notes for lectures were translated into Russian and distributed to relevant ministries and 63 universities and colleges and so forth.

In addition to training courses, JICA has organized many seminars of the similar contents in transitional countries in connection with other forms of technical cooperation. For example, JICA held a seminar on Technique of macroeconomic forecasting, meeting a request from the Polish Ministry of economy.

SUPPORT FOR THE FORMATION OF KEY GOVERNMENT POLICIES ON INDUSTRY

In Poland, three long term experts were dispatched to the Polish Ministry of Economy as an in-house advisor so as to help experts of the Ministry in working out industrial policies in the three fields; *(a)* SME promotion policy; *(b)* Regional development policy; *(c)* Technical innovation policy. The Ministry and JICA wanted to devise proper policies for reinforcement of competitiveness of Polish industries. But their activities were limited to these three policy fields, and they could not touch upon industrial policies directly, such as sector approach policy and export promotion with financial and fiscal subsidies. Because EU doesn't like European transitional countries to implement other fields except the above-mentioned three.

The long-term experts as an in-house advisor in the Ministry of Economy, first of all, learned the real situation in Polish economy, and considered their own experiences in Japan, and then they synthesized the both factors and gave advice, when Polish experts worked out economic policies. And they organized about forty seminars or workshops in connection with policy making in and around the Ministry.

It was frequently said by Polish experts of the Ministry that their advice and proposals were utilized effectively. But in what meanings were they utilized? According to my interview study in the Ministry, there are four cases of the utilization.

- Experts in the ministry could get acquainted with new knowledge or know-how in the filed of their tasks. They could extend their knowledge about what is done in the market economy.
- Information given by JICA experts was effective or useful as reference, when Polish economists consider their own concepts of economic policies and institutions.
- Information given by JICA experts was effective or useful, because they could serve as strong arguments for the policies which Polish experts proposed to the government or the parliament.
- Proposals and suggestions given by Japanese experts were adopted in the governmental documents after certain modifications. I can show examples in Poland below.

Examples;

"Program for supporting development of regional Institutions acting to promote technology transfer" (approved by the Council of Ministers in March 1997)

"Assumption of Long-term Industrial Policy till 2000" (approved by Economic Committee of the Ministers Council, in June 1997)

"Economic Activity Law" (its draft accepted by the Council of Ministers and sent to the Parliament)

"The Medium-term Concept of the Country's Economic Development till 2002" (its draft sent to the Council of Ministers)

"Assumptions of Government Policy towards Small and Medium Enterprises in the years 1998-2001"

I think that the above cases of utilization of knowledge given by the Japanese experts can be extended to other knowledge acquired by the participants in the training courses to some degree.

Except the above-mentioned cooperation, two long-term experts were dispatched to the Polish Ministry of Finance. They helped the Ministry to issue foreign bond. And moreover, Technology Information System was set up through JICA cooperation. This organization is to coordinate matching of suppliers and demanders of technology.

JICA is now conducting a new project of the same essence in Bulgaria. One expert was dispatched already, and two will be done within two months to the Bulgarian Ministry of Economy. The main policy fields are *(a)* SME promotion policy, *(b)* Export promotion policy, (c) Reinforcement of international competitiveness of the Bulgarian industry. Here again, it is probable that developments of the export promotion policy will be restricted to marketing and advertisement, because Bulgaria has started the negotiation of EU accession and has to follow the EU standard.

Incidentally, in Uzbekistan, one long-term in-house advisor was dispatched to the Cabinet office, whose activities have got a good reputation and he is required to defer his stay in Tashkent for one year.

TRANSFER AND DIFFUSION OF KNOW-HOW OF ENTERPRISE MANAGEMENT IN TRANSITIONAL COUNTRY

JICA has promoted organization of Productivity Centres by dispatching specialists in Hungary, Poland and Bulgaria. For example, in Hungary, Japanese long-term experts exercised leadership for establishing the Hungarian Productivity Centre. The centre has already conducted inspection and training in more than 200 companies and proposed improvements of management during 5 years. The centre organized open seminars, and more than two thousand people took part in them. It is very interesting that many of the customer companies are joint ventures or foreign companies; a typical case is Audi, a famous carmaker, which requested HPC to train one hundred managers of the middle class. Western companies trust effects of Japanese methods to raise productivity, and the cost of training by the local agency is low, and moreover it can avoid problems of language. But I must underline the fact that those who have learned there are Hungarian. Now the stress of HPC activities is moving to development of small and medium size enterprises.

In Bulgaria, the Bulgarian Quality and Productivity Centre was built up through JICA assistance about four years ago, but it worked only for about 40 companies.

In Poland, the vice premier and the Minister of Finance at that time, Mr. Balcerowvicz made an official request to JICA to cooperate in establishing the Polish Productivity Centre. It was in August 1990.

I can mention another form of transfer of know-how organized by JICA in the field of enterprise management. JICA dispatched a long-term expert as an in-house advisor from 1995 to 1996 to a Hungarian producer of car seats, IMAG, which was a state enterprise at that time. The expert inspected the production line, and proposed its improvements. And he taught the IMAG managers how to produce prototype products and trial products and how to make a decision on investment, and proposed a direction of R&D. This company was privatized later successfully and now it supplies products to Hungarian Suzuki (a carmaker from Japan). The managers say that what they learned from the Japanese experts in terms of Japanese culture and a Japanese way of thinking is very useful for them to do business with the Suzuki company.

JICA has another example in Poland. One of the long-term experts dispatched to the Polish Ministry of Economy applies HOPP Program (Human-Oriented Program for Productivity Improvement) to a tool section of the URSUS factory. The managers of the section could learn the Japanese management system and succeeded in separating it from the URSUS and privatizing it as an independent SME.

DEVELOPMENT STUDY

The last form of JICA activities which is relevant to Central-East European countries is "Development study". Study teams are dispatched to provide assistance in formulating development plans for the public sector and other basic areas of infrastructure. The team studies projects or programmes proposed by its partner government from technical and financial viewpoints and gives proposals or suggestions.

For example, in Poland, JICA conducted three studies of this kind; the study on the comprehensive traffic plan (from 1991 to 1992), the study on the privatization of the Polish national railway (PKP) (from 1996 to 1997), the study on the master plan for energy saving (from 1997 to 1999). In Hungary, one is the study on the energy saving plan and the other is the study of the productivity improvement and environmental preservation in the Borsod power station.

Here I explain only one case briefly. It is the study on the privatization of the Polish national railway (PKP). The study was implemented from 1996 to 1997 and the study team proposed a basic scheme for it. The proposal consists of the following three points.

- The national railway company should be divided into two parts, namely the part of infrastructure and the part of management of running the transport, and then privatized.
- The latter part should be divided into 8 companies, that is, three passenger traffic companies, two freight transport companies and two other related companies.
- A holding company should be established to manage all the companies.

And the proposal contains procedures of the process of corporatization and privatization, which has four stages from 1997 to 2005 and further.

In this proposal, the JICA team tries to draw attention of the Polish government of the danger of overall dependence on private fund to privatize and modernize the railway business and it suggested alternative ideas. The Polish government accepted basic ideas of the JICA proposal, and it has been advancing preparation for it step by step, and now the government has made another request to JICA to conduct a study for the next stage.

All the activities were implemented on the basis of requests of the partner governments. And many of necessary equipment for the implementation of the above-mentioned cooperation were granted by JICA.

CONCLUSIONS

As I mentioned above, so far as Central-East European countries are concerned, JICA concentrates on the technical cooperation to develop local human resources as actors in the market economy. JICA believe that the technical cooperation must lead up to promoting market-oriented institutions and organizations, and to formation of economic development policies on the basis of market economy. Since most of the actors in the economy didn't have adequate knowledge, know-how and experiences of market economy, especially on the first stage of the transition, it seems to me that this type of technical cooperation is of a great significance. I can say, therefore, that JICA makes much of what is missing or undervalued in the radical liberalistic approach. I think that JICA activities hit the mark in this respect.

The technical cooperation conducted by JICA up to now, generally speaking, has a good reputation from its partners in Central-East European countries. For example, it is said in the Prime Minister's Office in Hungary that the JICA technical cooperation is No.1 in terms of quality and quantity among the OECD member countries. So far as training courses are concerned, it is said on the partner side that the number of trainees is very big and the term of training is relatively long and the contents of training courses are rich and comprehensive. As regards the support for formation of key governmental policies on industry, it is sufficient to introduce one story. After having heard the effects of JICA cooperation for formation of key industrial policies directly from the Polish Ministry of Economy, the Bulgarian government made a formal request to JICA to apply the same scheme to Bulgaria.

With regard to transfer and diffusion of know-how of enterprise management, the cooperation with HPC has been relatively successful and the shift of its activities towards SME seems to be appropriate from the viewpoint of economic development. The assistance of long-term experts to managers of state enterprises in rationalizing management was effective itself, but it could only show a model or a good example, and consequently, the efforts at diffusion of the experiences were necessary, but they seem to be unsatisfactory.

Lastly the development study could raise realistic proposals and suggestions to reform the public sector and there are several cases in which proposals were accepted in the governmental plans. But at the same time, there is a difficult case such as the Borsod power plant in Hungary. The study was done when the plant was state-owned, and the results of the study were accepted by the Hungarian government. But then it was privatized and the private power station didn't accept the proposal for it. That is, maybe, because of financial difficulties.

As I mentioned above, there are four forms of JICA technical cooperation up to now which are relevant to Central-East European countries, but in my view, there is one remarkable common feature; the knowledge transferred from JICA experts could be utilized by partner experts in the following ways. *(a)* as a chance for partner experts to expand knowledge or know-how about what is done in the market economy, *(b)* as useful references for working out concepts of economic policies and institutions, *(c)* as strong arguments for policy proposals to the government or parliament, *(d)* as proposals and suggestions adopted in the governmental documents after certain modifications, and/or *(e)* as effective tools for improving enterprise management in practice. I am sure it is possible for partner experts to utilize the knowledge in one way or another, if they want to. It seems to me that especially long-term in-house advisors could get very good reputation from their partners and have strong influences over them.

But in my view, there is a serious shortcoming in the JICA technical cooperation. It consists in the fact that it is, in principle, separated from materialistic cooperation such as financial assistance. I think if it entailed the materialistic cooperation and if it had a close interconnection with the latter, the JICA technical cooperation could have much stronger impacts on partner experts.

Last but not least, I would like to refer to some economic problems. I think there are some fields of which JICA should make much. As I mentioned above, the transitional countries should survive in the world market without chronic financial aids from the international financial organizations and foreign governments, that is, on the commercial basis. But the perspective of economic independence is still unclear for almost all the transitional countries with some exceptions. Therefore the reinforcement of competitiveness of their industries and export-lead development are a crucial task for them, and accordingly they need promotion of export, development of industries of comparative advantage and infant industries, and promotion of SME. SME development can contribute to formation of supporting-industry attracting FDI, mitigation of unemployment, and sometimes, to regional development, too.

And what is more, Central-East European countries want to accede to EU, and therefore, they will have to reach the due level of economic development in a relatively short period of time. From this viewpoint, too, they have to pursue reinforcement of industrial competitiveness. But here I would like to draw your attention to existence of a very complicated problem. It consists in the fact that because they want to acquire membership of EU, they have to develop their economy quickly, on one hand, but that at the same time, they have to follow various EU standards of economic policies and institutions, on the other hand. Nevertheless the application of the EU standards to the countries restricts their latitude of economic policies only to the narrow sphere EU approves. Usually EU permits transitional EU applicants to implement three fields of economic policies, namely, SME promotion, technical development and regional development. EU dislikes them to do sector approach of industrial policy, export promotion with financial and fiscal subsidies, and development of economic special zones. Because of that, the scope of economic policies on which Japanese experts work is limited very much, although they can serve transitional countries with its much wider policy menu. But here arises a question, whether the narrowed economic policies are rational or sufficient for their economic development or not. I am afraid that the application of the EU standards of economic policies to, for example, South-East European countries is not right. I think this question should be examined cautiously from the economic point of view.

APPENDIX

Examples of Active Economic Policies in Some Transitional Countries

Here I don't try to produce a full list of active economic policies. I only show one or two examples in Poland, in Hungary and in Bulgaria.

In Poland: "Industrial Policy Program 1995-1997; International competitiveness of Polish industry" (adopted by the Economic Committee of the Council of Ministers December 19, 1994)

In Hungary, "National Revival Program (Nemzeti megújhoddás programja)" (1990) "Hungary medium-term Economic Policy Priorities" (1997) "Szécsenyii Plan" (draft, 2000)

In Bulgaria, "Program of the Government of the Republic of Bulgaria 1997-2001" (2000). (In the Chapter VI: Financial and Economic Reform in Bulgaria, 1. financial stabilization, 2. structural reform, 3. industrial policy, 4. trade policy, 5. revival of the Bulgarian agriculture, 6. Bulgarian tourist industry, 7. Bulgarian infrastructure) "Strategy for the Development of Industry in the Republic of Bulgaria 2000-2006"

The curriculum of the Japan course in Uzbekistan

First seminar (03.14-03.19, 1997)

"Japan and Uzbekistan"
- Theory of Japanese economic development
- Monetary policy
- Economic statistics compilation and its utilization for policy determination

Second seminar (09.18-09.25, 1997)

"Public Administration and National Public Service System in Japan"
- Administration system
- Public service system and personnel management
- Process of public administration and human resources development systems modernization
- Human resource development

First Intensive course of lectures (11.13-11.24, 1997)

"Industrial Policy and Human Resources Development"
- Industrial policy after the world war II
- Industrial policy development process
- Financing for policies implementation

Third seminar (03.18-03.30, 1998)

"Japanese Enterprises and Their Human Resources Development"
- Japanese method of management at enterprises in transition
- Productivity increase movement in Japan
- Personnel training in the company "Matsushita- Panasonic"

Fourth seminar (09.23-10.09, 1998)

"Improvement of the Service Quality"
- From Planning to market economy
- Service in the Japanese postal service
- What are administration services?
- Private sector services (tourism)

Second intensive course of lectures (11.19-11.26, 1998)

"Analysis of the Uzbek Economy"
- Development of ASEAN countries
- Economic situation with CIS countries and economic analysis of Uzbekistan
- Present situation with investments from Japanese enterprises

Fifth seminar (02.26-03.03, 1999)
"Agricultural and Monetary Policy in Japan"
- Productivity improvement in agriculture
- System of agriculture financing in Japan
- Irrigation system and water control
- Monetary policy in Japan

Sixth seminar (10.04-10.11, 1999)
"Social Infrastructure Improvement in Japan"
- Pension system
- Medical insurance
- Employment insurance system
- Public health and medical service
- Environmental protection policy
- Labour policy

Third intensive course of lectures (11.08-11.12, 1999)
"National Public Service system"
- Public service system and personnel training
- Administration and personnel assignment systems
- Service conditions: salary, service benefits, etc.

Fourth intensive course of lectures (12.07-12.16, 1999)
"Economic Development of South-East Asian Countries"
- Economic development of South-East Asian countries

Seventh seminar (01.31-02.04, 2000)
"National Land and Regional Development"
- Land development
- Environment policy
- Regional development financing
- Regional development policy

SUMMARY

Review of the Vienna Conference
Noriyuki Yonemura, Japan

Review of the Vienna Conference

Noriyuki Yonemura
Senior Vice President, Fuji Xerox Co. Ltd and
Member of the Organizing Committee
Japan

OVERVIEW

On behalf of the co-organizers, I would like to thank all of the participants for their contributions to this conference, not only for preparing the papers in advance but also actively participating in the discussions.

It was a good opportunity to discuss common subjects regarding the competitiveness of transitional economies with the participants from government, academia, industry and international organizations.

Strengthening their competitiveness is a relevant subject confronting transitional economies. However, six sub-themes were too ambitious for a day and a half conference. Little time was left for discussion of the important subjects.

I truly appreciate the tremendous effort by the co-organizers, JICA, JETRO, WIIW, and BANK AUSTRIA to make the conference possible as well as successful.

This was the first trial of this conference, which was initiated jointly by Japanese organizations. Participants expressed their eagerness for us to keep the momentum going. So, we will try to continue this activity in cooperation with relevant organizations both in Japan and overseas.

COMMENTS ON THE DISCUSSION SUBJECTS

It was made clear that since the start of market-oriented economic reforms a decade ago the development gaps among the transitional economies have widened. As a result, the issues that need to be tackled differ among the transitional economies as well.

As Prof. Sato noted, we must recognize that transitional economies are facing two challenges. One is catching up and the other is transferring to the market economy. In this respect, it is doubtful whether urgent accession to EU would really be effective, where the rules and regulation for developed countries apply.

Government's role is always a controversial issue. From the viewpoint of the experiences of Asian economic development, the role of government is important at the stage of catching up. However, this topic will need further discussion for it to be fully understood by CEECs.

Moreover, after joining EU, CEECs will experience a stronger role of the government. In this session, we didn't discuss the role of private organizations in economic development, so we must cover it next time.

FDI is an important driving force to promote economic growth and restructuring in the CEECs. Here again, however, the issues are different depending on the success of attracting FDI.

Furthermore, not only the positive impact but also the negative impact on the national and regional economies must be discussed. Some countries are concerned about the continued flow of FDI in the future.

Promotion of SME is a common and important subject in the CEECs. We should study further what the most relevant policies and measures are for the promotion of SME considering the situation of individual countries. Japan can make a great contribution in this field.

Evaluating privatization is a difficult task. We should develop appropriate measurements to evaluate the success of privatization and apply them. Partnership with the private sector is very important for attaining the economic growth, particularly in the fields of IT, the environment, and corporate governance, since the relevant technology and experience lie in the private sector.

It is interesting that the issue of corporate governance was raised by the participants. I wonder whether the problems to be covered in CEECs are the same ones being discussed in the US and Europe. Anyway, it is worthwhile studying this aspects further.

Participation of international organizations such as EBRD, OECD, UNIDO, and ERBD was extremely valuable. We need to have more opportunities to discuss about the strategy of international organizations towards the transitional economies and explore the joint programmes with these organizations in future.

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