# Transition report

# Part III

## International issues

# 7. Openness to trade and foreign investment in transition

This chapter describes the role that trade and foreign direct investment (FDI) may play within the transition, and the implications this carries for policy. Subsequent chapters then comment on the extent to which the institutional and policy framework has promoted this role or its deficiencies have hampered it. The focus is not on a description of patterns of trade and FDI, which has been provided in greater depth by other publications.[1]

Many countries worldwide have embraced an outward-oriented approach to economic development, particularly since the early 1980s. The evidence on global integration is impressive. While world incomes grew in real terms by one-third from 1982 to 1992, the volume of world trade rose twice as fast, by 65 per cent, further augmenting a process of trade expansion which had been especially rapid in the 1950s and 1960s. FDI, once it had recovered from the 1981-82 recession, grew even more rapidly at almost 30 per cent per year for the remainder of the decade. The number of countries that have participated significantly in these developments has expanded well beyond the OECD area. One Latin American and six Asian developing countries were among the world's top 20 exporters in 1992. Developments regarding FDI have been similar, though more recent. In the period 1986-89, 90 per cent of FDI flows still took place within the OECD area; but FDI into developing countries had risen to approximately US$ 56 billion, or over a third of the total, by 1993.

Overcoming protectionist pressures which emerged from time to time, the broadening of the world economy during the 1980s was fuelled by the progressive reduction and elimination of barriers to trade, to investment and to financial services – no doubt in an interplay with technological developments. A major contribution of the 1980s and early 1990s is the worldwide convergence on these policies. Underpinning liberalisation there has been a remarkable shift in attitudes. Where market integration had been seen as a threat to a nation's control over its development path, the stress is now on greater individual freedom and competition, and the dynamism and efficiency that derives from them. Similarly, in many developing countries foreign capital had earlier been viewed with suspicion, which led to a preference for sovereign debt as a means of complementing domestic savings. The conviction has now taken hold – and has been translated into more welcoming policies – that foreign investment provides potential benefits that go well beyond its financial contribution, and that the debt crisis has demonstrated that borrowing carries risks.

Wrapped in the cocoon of central planning, the CMEA (Council for Mutual Economic Assistance) area hardly participated in this process of worldwide economic integration. Joining the world economy along the liberal guidelines of the 1980s has become one of the principal features of the transition process. The "late entry" carried a cost in terms of a profound need for adjustment and in the destruction of existing commercial links – sometimes perhaps more comprehensively than warranted by economic fundamentals. Nevertheless, there is a widespread understanding that progressive integration into the world economy is both a component of economic transition and a crucial factor in bringing it about.

Liberal trade and FDI are carriers of economic benefits that are supportive of growth and may be of particular relevance for the dynamics of transition. They contribute to both macroeconomic demand and supply. As microeconomic phenomena, they can constitute "packages" that transfer goods and knowledge and cause, potentially, a host of behavioural and institutional adjustments. Principal benefits associated with trade and FDI are described and illustrated in Box 7.1. While the macroeconomic contributions have doubtless played a role in recent developments in eastern Europe and the former Soviet Union, the effects at the micro-level are particularly interesting. As argued in Chapter 1, institution-building and behavioural change are at the heart of the process of transition and are often embodied in FDI. Many potential benefits are not captured by the profit and loss statements of the investing or trading enterprises and thus represent, from an economic viewpoint, positive externalities.

Externalities are a recognised form of market failure; crudely speaking, an externality may be defined by effects arising from the activity of an economic agent (household or firm) which do not accrue to that agent. "Positive" externalities represent benefits to others and "negative" externalities costs. Generally policy should be designed to encourage activities that generate positive and discourage those that generate negative externalities. Since the social benefits of building institutions and acquiring new technologies and management methods are likely to be much higher than the private benefits, private enterprise

[1] See UNECE (1994) and EBRD (1993) for a thorough description of patterns of trade; UNCTAD-PTNC (1994) forthcoming, and Meyer (1994) for a detailed discussion of recent FDI patterns.

may be expected to underinvest in these activities. Many governments in eastern Europe and the former Soviet Union have consequently resorted to special incentives as a means of attracting FDI. On the other hand, the enhanced competition resulting from open trade is sometimes viewed as a drawback since, ostensibly, it does not allow infant or currently ailing industries to realise their long-run potential. The market failure here is said to derive from the existence of learning effects together with deficient capital markets which cannot finance the learning period. Some cases of reversal of the initial import liberalisation in the region – discussed in Section 8.3 – appear to reflect this rationale.

Should governments attempt to "steer" trade and FDI so as to maximise its benefits? The case for and against these policies is taken up again below in their respective context, but some general points can be made here. Some of the effects of trade and FDI derive from the volume of activity: their aggregate demand and supply effects, probably the impact on institution-building, etc. These do not tend to cause much controversy. However, depending on the sector and form of activity, FDI and trade are unevenly endowed with some of the other potential benefits (or perceived drawbacks). The answer by governments – not at all limited to the transition economies – has been to design selective and often highly discretionary policies to promote or restrict trade and FDI. While perhaps justifiable in theory, there is reason for caution since in practice market failure tends to be at least evenly matched by government failure, not only in eastern Europe and the former Soviet Union but worldwide. Three sources of government failure are of particular relevance here:

- **Low administrative capacity:** Markets may need to be strengthened in the transition economies, but so do governments. Policies that selectively support or discourage economic activities are hard to design, and even harder to implement if costly mistakes and distorting side-effects are to be avoided. Where various administrative layers are involved, and bureaucrats are still imbued with the *dirigisme* of previous times, managerial problems and corruption may be hard to avoid.

- **Information deficiencies:** Some market failures are caused by imperfect information. As should be expected, this is true in particular regarding transactions that lie in the future. But there is often no reason to assume that civil servants – whose financial incentives are rarely linked to the outcome of their decisions – should be better prepared for the task of predicting future demand for processes and products, or generally the development of the competitiveness of a particular industrial sector, than private enterprise managers would be.

- **Political economy constraints:** Government might be able but not willing to intervene "correctly". The distributive effect of discretionary government interventions turns them into a focus for lobbying activities. Governments have to be strong, or democratic processes well balanced, to prevent unwarranted biases. Or else they have to be weak, in the sense of having their hands tied in international treaties or by other means, which in turn limits their discretionary powers.

There are, of course, circumstances in which government intervention to overcome market failure is warranted, even necessary, and in which experience has proven it to be effective. But these tend generally to be cases in which intervention does not target individual companies or industries, but rather establishes rules of the game (such as in the financial and insurance sectors to overcome information failure and the risk of financial sector collapse) or augments the economy's general receptiveness to change and ability to amplify spillovers and externalities (such as in promoting general education and research). [2]

The position taken here is that, in the area of foreign trade and FDI, it is generally unwise for governments in eastern Europe and the former Soviet Union to attempt to "pick winners". The policy regime should allow a country's comparative advantage to determine patterns of investment and trade, while strengthening its ability to *acquire* comparative advantage through learning effects and spillovers from trade and FDI. As a general rule, selective interventions into the market mechanism should be avoided, predictability increased so as to reduce uncertainty [3] – itself a cause of distortions – and policies designed to augment human capital and build appropriate institutions.

Part of this debate could become obsolete in the future, since governments – especially in central Europe – may gradually give up degrees of freedom in industrial policy. While the traditional discussion of policies towards trade

[2] In some cases in East Asia, a lowering of factor costs (capital) through government intervention, as well as persuasion to coordinate expectations of industry around particular development paths, have been successfully employed in economic policy; however, success can be ascribed in the first instance to a low incidence of government failure, a condition less likely to be met in the transition economies.

[3] There can be trade-offs between uncertainty and other distortions, namely when liberalisation is perceived to be politically unsustainable; a credible commitment to step-wise liberalisation less subject to pressure for reversals may then be the best course of action. This issue is taken up again in Section 8.3 in the context of foreign trade policies.

and FDI has focused on border measures which have been termed "shallow integration", new developments within the world trading system point to a progressive move towards "deep integration", in particular within regional trading blocks. [4] Deep integration refers to the harmonisation of national legislation, taxes and industrial policies that affect international competitiveness and the movement of capital and labour as well as of goods and services. The most advanced example of this phenomenon is the creation of the European Union's single market. NAFTA's provisions regarding labour and environmental legislation have also been well publicised. At the multilateral level, the results of the Uruguay Round extend international rule-making to trade in services and intellectual property and trade-related investment measures.[5]

In the context of the transition economies, the trade provisions of the Europe Agreements concluded between six eastern European countries and the EU already constrain government discretion significantly in the area of trade policy. In addition, however, they contain far-reaching provisions (and assistance) for a rapid harmonisation of competition policy and legislation, subsidisation policies and other elements of the "acquis communautaire" as a basis for subsequent membership. Some degree of "deep integration" in the same areas might also be forced upon other countries of the region to reduce their vulnerability to contingent protection measures in the EU, their largest export market. [6] The analysis of trade policy is taken further in Chapter 8 and FDI is discussed in greater detail in Chapter 9.

## *Box 7.1*
## Potential benefits of foreign trade and investment

### *Macroeconomic level*

**Aggregate demand:** Both trade and FDI may enable the greater utilisation of production capacity by dampening a fall or boosting an increase in aggregate demand. This effect has been in evidence in eastern Europe and the Baltic states (but not in the CIS), whose exports to the West expanded significantly, while the early transition was characterised by macroeconomic austerity and a sudden loss of traditional export markets in the former CMEA area. [7] Beyond this cushioning function, exports have been successfully used by East Asian economies, and more recently by countries such as Chile and Costa Rica, to provide a dynamic source of economic growth and to enable the realisation of economies of scale.

**Aggregate supply:** A dynamic tradables sector can increase the level of resources available for growth by raising an economy's external debt-carrying capacity and by attracting FDI, i.e. hard currency earnings can be leveraged. FDI itself directly adds to available savings. [8] At the same time, trade and FDI facilitate the modernisation of production facilities through the import of capital equipment.

### *Microeconomic level*

**Relative prices and competition:** Through relatively free international trade – including a high degree of currency convertibility – a country can "import" a set of relative prices that makes economic sense and inject a degree of competition into an economy dominated by monopolies. For small economies in particular, this makes foreign trade an effective complement to privatisation. This impact on production incentives and market structure was consciously used by governments, in particular in central-eastern Europe and the Baltic states, as a driving force behind their "big bang" policies of market-based restructuring. Irrespective of its other merits, which have been widely discussed, [9] the fact that this policy is relatively easy to administer has proven to be an advantage given that not only markets, but also bureaucracies face a difficult task of adjustment. FDI can play an important complementary role in this process – especially in the non-tradable sectors – by overcoming barriers to market entry facing new local firms, which may encounter credit or management limitations. As described in UNCTAD-PTNC's *World Investment Report 1994*, the benefits in terms of price decreases, quality of output and higher productivity can be profound, particularly in service sectors that had been neglected under

4 See Lawrence (1991).

5 As well as agriculture and textiles which had been excluded previously: GATT began in 1947 as a negotiating forum for industrial tariffs.

6 Market access conditions on Western markets are discussed in Section 8.4.

7 See Section 8.1 for information on recent trade flows in the region.

8 See Section 9.1 for information on FDI flows by country. Domestic savings, household savings in particular, have suffered during the early economic transition. The savings rate out of disposable income, even in a country as advanced in the transition as Estonia, is less than 4 per cent. This has been attributed to the fall in purchasing power that many households have experienced, and to improved consumption choices - the transition from a regime of forced savings (for lack of buying options) to one of market-based, decentralised savings decisions.

9 See Balcerowicz (1993) for a spirited defence of the "big bang" approach.

central planning. Thus advertising agencies have reportedly been induced to offer lower prices and better services by the entry of Western companies such as Young & Rubicam, McCann-Erickson and others. [10] Similarly Ceska Pojistovna, the former monopoly provider of insurance in the Czech Republic, has lost 20 per cent of its market share as a result of market entry by foreign providers. [11] On the other hand, FDI has also had competition-reducing effects in cases in which multinational enterprises have demanded protection from imports as a prior condition for investing and governments have been willing to oblige.

**Institutions:** Markets rely on appropriate legal and financial systems as well as supportive administrations to reduce transaction costs. The exposure to market-based transactions and the demands of trading partners and foreign investors can give impetus to the transformation of the inadequate institutional frameworks inherited from central planning so as to ensure better conformity with the requirements of the market. Foreign investment laws have often been the first steps in the development of a transparent and predictable legal basis for contractual relationships, providing a core around which other basic laws evolve. This has been the case, for instance, in the Baltic states, Bulgaria, Romania and the Russian Federation. [12] The ability of the local financial system to conduct market-based transactions has been strengthened, in some cases through direct investments by Western commercial banks and in others through the learning effects (and the income) that derived from short-term foreign trade finance. [13] Lastly, investor surveys provide evidence of a gradual conversion of government and local administrations towards more "market-friendly" modes of interaction in repeated contacts, [14] while trade agreements – notably the Europe Agreements – have severely curtailed administrative discretion in foreign trade. [15]

**Knowledge and technology transfer:** FDI has sometimes been credited with the ability to diffuse Western technology, know-how, management and marketing skills (and channels) as well as with the capacity to demonstrate standards of quality, safety and environmental acceptability prevailing on international markets. The switch during market-oriented transition from a sellers' to a buyers' market forces changes in business culture and demands an array of new skills, in particular for success on export markets. Many of these skills are best promoted by constant exposure and learning-by-doing. From the perspective of the host country, foreign investment enterprises would ideally serve as incubators for these skills and the acquisition of technology, i.e. a certain degree of personnel rotation – while less appreciated by the investing enterprise – may be beneficial for the process of transition. Experiences with technology transfer by foreign investment enterprises in developing countries have been rather mixed, given the interest that multinational enterprises tend to have in maintaining control over proprietary technology. Nevertheless, there have been positive examples. In the case of Renault's investment in Slovenia, for instance, a series of technology transfer contracts were signed between Renault's major European component suppliers and Slovene companies to help them upgrade the quality of their products.[16] Among other examples, training programmes for the local labour force feature prominently in Fiat's investment in Poland.[17]

**Privatisation:** The different components of the FDI "package", in particular the capital contribution and the ability to turn around uncompetitive enterprises, have been targeted by privatisation programmes in various countries. This strategy has been successful in Hungary, where, in 1990, 95 per cent of the revenues of the state property agency came from foreign investors, with the share declining to around 40 per cent in the first half of 1993. [18] However, massive participation of FDI in the privatisation of state assets has also proved controversial where the dearth of domestic investible funds was viewed as giving an unfair advantage to foreigners, and transactions have been perceived to take place at fire-sale prices or to be linked to corruption. The perception of a sell-out has at times been reinforced by the job-losses during the initial restructuring, and by the closing of whole lines of production as part of multinational enterprises' strategies of regional consolidation of their value chains. For instance, General Electric closed the production of vacuum equipment, electronic components, floppy disks and magnetic tape at its Hungarian affiliate, Tungsram, some of which were apparently considered profitable operations by that affiliate. [19]

10 UNCTAD-PTNC (1994 forthcoming), p.110.

11 UNCTAD-PTNC (1994 forthcoming), p.110; the Report cites the case of Poland.

12 See also Section 9.2 on legal frameworks for FDI and Chapter 5 on the evolution of legal systems in the countries in transition. International financial institutions that promote foreign investment in the region have also assisted the process of institutional reform; thus, apart from project-related assistance, the EBRD has elaborated a model law for secured transactions which has been used in Hungary and Poland and is being discussed in other countries.

13 The limitations of financial institutions in the countries in transition in the area of trade finance are discussed in Section 8.5.

14 See Genco, Taurelli and Viezzoli (1993).

15 However, the Europe Agreements have stopped short of eliminating administrative interference to the extent that multiple non-tariff barriers to market access remain that make it necessary, e.g., to assign licences to exporters.

16 UNCTAD-PTNC (1994 forthcoming), p.103.

17 They are also a regular feature of other EBRD-supported projects in the region; more general information is hard to obtain.

18 Lane ( 1994). In Poland, 45 per cent of total FDI between 1988 and 1992 was linked to the privatisation process. Even in the Czech Republic, which has applied preferential conditions for citizens in the privatisation process, 87 per cent of FDI during the same period was related to privatisation.

19 UNCTAD-PTNC (1994 forthcoming), p.106.

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# 8. Trade policy reform

This chapter analyses the evolution of trade policy in eastern Europe and the former Soviet Union and briefly reviews access conditions to Western markets. There has been a remarkable degree of liberalisation (in both East and West), but many discretionary interventions remain and there have been some setbacks in the reform process. The chapter goes on to discuss deficiencies in trade finance which were partly responsible for the disruption of pre-existing commercial links.

## 8.1 A summary of developments

The evolution of cross-border trade in eastern Europe and the former Soviet Union has been one of the more drastic reflections of systemic change in the region. Trade flows are captured in Tables 8.1 and 8.2.[1] Developments, set out more fully in the EBRD's *Annual Economic Outlook* 1993,[2] have been far from uniform:

- Trade among the former CMEA partners and among the republics of the former Soviet Union shrank by half or more between 1989 and 1993.

- At the same time, the fast-reformers in eastern Europe and the Baltic states achieved a rapid reorientation of trade flows towards the Western market economies, according to OECD statistics, while the Western trade of the other transition economies stagnated. The European Union market has clearly dominated as a destination for these "new" exports (Chart 8.1).

- Apart from the geographical distribution of trade, its product composition has also changed, since capital goods and other so-called "soft" goods (i.e. manufactured goods of a quality that could not hold its own in hard currency trade) have been the principal victims of the intra-regional trade collapse.

- Although deliveries from the region have grown dynamically in recent years, total extra-regional merchandise exports from eastern Europe and the former Soviet Union in 1993 did not surpass those of the Republic of Korea alone.

A multitude of factors explain these developments, many of which are quite specific to the individual economies and will not be taken up here. Nevertheless, it is clear that the nature and depth of reforms as well as various transitory impediments to international trade can explain overall trends and some of the variation across countries. Above all, the opening of trade and exchange regimes – to be discussed more fully in the following – was a forceful and often consciously used means of disrupting the economic coordination mechanisms of central planning. Other, less welcome, causes of trade destruction are discussed in Section 8.5 below.

## 8.2 Trade policy reform

As reported in the transition indicators (Appendix 2.1), reform programmes have gone far in dismantling explicit quantitative restrictions on imports and exports and in introducing liberal tariff regimes. As a result of liberalisation, the international competitiveness of enterprises producing tradable goods has become important in determining the pattern of cross-border trade. Some of the former intra-regional trade had no economic justification in a market environment, while trade with OECD and other countries had been artificially suppressed under central planning. By applying competitive pressure, liberalisation reshaped these trade flows. To a large – though hard to quantify – extent, the disappearance of some commercial transactions and the surge of new ones thus testifies to the more appropriate use of the region's resources.

Trade regimes in eastern Europe and the former Soviet Union are described in Table 8.3. Direct controls on imports – the mainstay of the previous import regimes – have generally been abolished. In eastern Europe, explicit restrictions of any importance remain only in some of the more advanced transition economies – the Czech Republic, Hungary, Poland, the Slovak Republic and Slovenia. Even in these countries, quotas appear to be limited to products that also carry the label of "sensitive" in the West and tend to be severely restricted there. However, the table does not include restrictions as a result of contingent protection measures, which are discussed below for Hungary. In all other countries of the region, including those of the CIS in which this can be established with some confidence, explicit quantitative restrictions on imports have been eliminated even in agricultural trade, though some licensing appears to have been maintained. It should be noted, however, that over 70 per cent of intra-CIS trade in 1992-93 was conducted on the basis of bilateral agreements on strategic supplies at regulated prices, which often diverged widely

1 Information on trade flows can differ substantially between national sources and the "mirror" statistics of the trading partners. This is best documented by Bulgaria, for which OECD statistics (Table 8.2) show substantial success in raising exports to the West, while a decline was registered in national sources. Large inconsistencies in statistics are also evident when one compares trade between eastern Europe and the countries in the former Soviet Union as reported independently by these two sets of countries (compare the upper and lower parts of Table 8.1).

2 See UNECE (1994) for a more recent and complete discussion of developments in foreign trade.

**Table 8.1 Foreign trade performance of countries in transition (based on data reported by these countries)**

| Eastern Europe [1] | Growth in US dollar values (in per cent) | | | | | Value (in US$ billion) | |
|---|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1993[2] | 1988 | 1992 |
| **Exports (total) to:** | -3.2 | -2.8 | -6.9 | -4.8 | -2.1 | 63.9 | 53.3 |
| Eastern Europe [3] | -8.4 | -25.6 | -20.1 | -9.7[4] | -13.1[4] | 6.1 | 3.0 |
| Former Soviet Union [3] | -9.3 | -16.1 | -25.1 | -31.7[4] | 16.0[4] | 13.9 | 5.4 |
| Developed market economies | 6.5 | 9.9 | 6.6 | 0.4 | -2.2 | 27.9 | 34.9 |
| Developing countries | -12.5 | -12.6 | -11.8 | 8.1 | 9.0 | 8.4 | 6.1 |
| **Imports (total) from:** | -2.2 | 4.6 | -4.1 | 1.1 | 14.4 | 61.1 | 60.6 |
| Eastern Europe [3] | -8.9 | -17.3 | -25.8 | -4.4[3] | -10.5[4] | 5.2 | 2.8 |
| Former Soviet Union [3] | -12.5 | -10.8 | -9.3 | -6.5[3] | 1.3[4] | 13.3 | 8.8 |
| Developed market economies | 4.8 | 19.1 | 7.8 | 9.2 | 20.7 | 27.0 | 39.6 |
| Developing countries | 5.5 | 6.7 | -9.2 | -22.1 | 18.4 | 7.28 | 5.8 |

| Former Soviet Union /Russian Federation [5] | Growth in US dollar values (in per cent) | | | | | Value (in US$ billion) | |
|---|---|---|---|---|---|---|---|
| | 1989 | 1990 | 1991 | 1992 | 1993 | 1988 | 1992 |
| **Exports (total) to:** | 0.4 | -5.2 | -24.6 | -25.2 | 1.4 | 79.6 | 42.4 |
| Transition economies [6] | -8.7 | -24.3 | -35.0 | -25.8 | -12.6 | 39.0 | 13.0 |
| Eastern Europe [3] | -11.1 | -26.9 | -40.8 | -32.7 | -7.9 | 30.1 | 7.8 |
| Developed market economies | 7.8 | -12.6 | -16.2 | -20.3 | 4.6 | 30.4 | 24.6 |
| Developing countries | 2.0 | -9.5 | -29.0 | -44.0 | 23.1 | 13.1 | 4.8 |
| **Imports (total) from:** | 12 | -0.1 | -35.9 | -21.3 | -27.1 | 65.5 | 37.0 |
| Transition economies [6] | -4.5 | -10.6 | -43.4 | -42.8 | -14.7 | 31.8 | 8.8 |
| Eastern Europe [3] | -5.7 | -12.1 | -51.6 | -49.7 | -46.1 | 27.3 | 5.5 |
| Developed market economies | 21.1 | 5.6 | -31.0 | -13.0 | -36.9 | 30.1 | 23.1 |
| Developing countries | 26.0 | 3.8 | -35.8 | -2.6 | -4.5 | 6.4 | 5.2 |

Source: UNECE "Economic Survey of Europe", various issues; IMF.

1 Eastern Europe includes Albania, Bulgaria, the Czech and Slovak Republics, Hungary, Poland, Romania, former Yugoslavia and the German Democratic Republic through 1990. Data exclude "new" foreign trade (i.e. trade among the successor states of the CSFR and Yugoslavia).

2 From Jan-Sept 1992 to Jan-Sept 1993.

3 Definitionally the value of exports (imports) from eastern Europe to the former Soviet Union is the same as imports (exports) into the former Soviet Union from eastern Europe (except for CIF/FOB – valuation differences). The fact that there are inconsistencies in Table 8.1 in this respect is due to measurement and reporting errors.

4 Data excludes former Yugoslavia and Albania.

5 Before 1991 Soviet Union, thereafter Russian Federation.

6 In this context the concept "transition economies" comprises east European countries (including former Yugoslavia), the former Soviet Union, the Asian centrally planned economies (including China) and Cuba.

**Table 8.2 Foreign trade between countries in transition the OECD area (based on data reported by OECD countries)**

| Exports to OECD countries | Growth in US dollar values (in per cent) | | | | Value (in US$ billion) | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1989 | 1993 |
| **Eastern Europe-6** | **23** | **15** | **19** | **2** | **19.0** | **32.3** |
| Bulgaria | 26 | 27 | 28 | 78 | 0.8 | 2.9 |
| Former Czechoslovakia | 20 | 35 | 40 | 1 | 4.1 | 9.3 |
| Hungary | 29 | 17 | 9 | -10 | 4.4 | 6.6 |
| Poland | 48 | 11 | 13 | -2 | 6.0 | 10.9 |
| Romania | -25 | -15 | 4 | 7 | 3.7 | 2.6 |
| **Former Soviet Union** | **24** | **2** | **-2** | **11** | **25.1** | **34.2** |
| Baltics | na | na | na | 52 | na | 2.4 |
| Newly Independent States | na | na | na | 9 | na | 31.8 |
| **Former Yugoslavia** | **27** | **-7** | **-19** | **-21** | **9.6** | **7.3** |

| Imports from OECD countries | Growth in US dollar values (in per cent) | | | | Value (in US$ billion) | |
|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 | 1989 | 1993 |
| **Eastern Europe-6** | **23** | **34** | **27** | **7** | **18.0** | **40.1** |
| Bulgaria | -34 | 6 | 13 | 6 | 2.4 | 2.0 |
| Former Czechoslovakia | 35 | 29 | 72 | 2 | 3.6 | 11.0 |
| Hungary | 18 | 22 | 18 | 9 | 4.6 | 8.5 |
| Poland | 26 | 63 | 8 | 9 | 6.1 | 15.0 |
| Romania | 106 | -5 | 38 | 11 | 1.2 | 3.5 |
| **Former Soviet Union** | **-3** | **5** | **-6** | **8** | **28.1** | **29.0** |
| Baltics | na | na | na | 52 | na | 2.1 |
| Newly Independent States | na | na | na | 6 | na | 27.0 |
| **Former Yugoslavia** | **45** | **-24** | **-18** | **-1** | **9.6** | **8.6** |

Note: 1993 data do not include trade with Belgium/Luxembourg, Denmark and Ireland.

Source: Monthly statistics of Foreign Trade (Series A), OECD.

from world prices. Given the continuing predominance of state enterprises in some of these countries – see Chapter 3 – as well as restrictions on currency convertibility, the import regime is not always transparent or well described by tariffs or explicit quotas.

It is striking that, within very few years of the beginning of the economic transition, import regimes have become highly liberal by international standards in most countries of the region. Estonia and, it appears, Ukraine have almost no import tariffs at present. In fact, out of the 16 countries where average tariffs have been established or can be inferred from the table, in 10 countries it is lower than the current OECD average of 6.3 per cent.[3] It is less than twice the OECD average in most of the remaining six countries, with the exception apparently of Moldova.[4] This latter group includes some of the larger countries of the region, notably Russia, Poland and Romania. In addition, there is in most countries a relatively limited variance of duties across products.

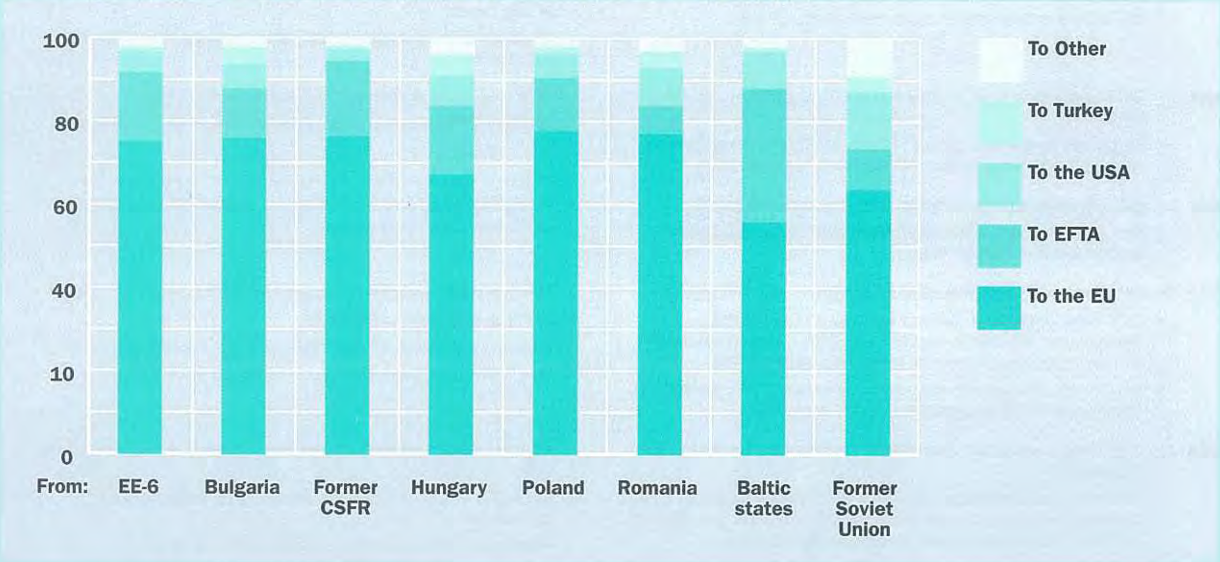
On the export side, the situation differs considerably among countries but tends to be much more restrictive. In eastern Europe, certain restrictions in the form of duties, quotas or licences remain in place in Bulgaria, Latvia, Lithuania, Romania and Slovenia. Some degree of intervention is also reported for Albania, the Czech Republic and the Slovak Republic. It is noteworthy that export restrictions (or rather the "management" of exports) have been introduced in some cases because of market access restrictions in the West – the table mentions Bulgaria, the Czech Republic and the Slovak Republic, though other countries exporting textiles and food are likely to have similar regimes.

In the countries of the CIS, highly restrictive export regimes continue to be the rule, with Kyrgyzstan the only notable exception. Export duties or currency surrender requirements at below-market exchange rates cover many product groups, while quotas are applied to raw materials, foodstuffs and other strategic exports. In some cases

3 For industrial products only; the average tariff is to be reduced to 3.9 per cent under the Uruguay Round agreement by January 1995. The corresponding current value for developing countries is 6.8 per cent (source: GATT). By way of contrast, average import tariffs of large Latin American countries in the heyday of the import substitution philosophy in the 1960s could range up to 150 per cent.

4 There are, however, severe limitations on the accuracy of such data for many countries of the former Soviet Union.

**Chart 8.1 Distribution of exports by OECD destinations in 1993**
*(in per cent of total exports, from each identified origin, to the OECD area)*




Note: 1993 data do not include trade with Belgium/Luxembourg, Denmark and Ireland.

Sources: Monthly statistics of Foreign Trade (Series A), OECD.

obstacles to exports might be regarded as defensive measures to counter arbitrage resulting from the subsidisation of raw materials, undervalued exchange rates, and the widespread practice of illegally acquiring state enterprise property for sale abroad. Other reasons have included dumping accusations by Western companies (in the aluminium industry). Generally, however, export curbs are inimical to the development of rational trade patterns and they foster bureaucratic control. Their elimination is likely to hinge on the general progress of reforms.

## 8.3 Setbacks in the liberalisation process

The initial sweeping liberalisation has in some countries given way to a partial reconsideration of tariff regimes and quotas, resulting in the – still limited – reintroduction of both broad and selective forms of import protection. One of the main features of existing trade laws on the import side is the considerable amount of discretion they leave to the authorities. No country of the region except for the Czech Republic and the Slovak Republic is fully subject to GATT disciplines, and several governments have made use of that discretion.

Various countries, most notably Poland, Bulgaria and Russia, have raised average MFN[5] tariff levels, passing through frequent suspensions and reintroductions of import surcharges and the enactment of new general tariff schedules. The trend appears to be towards higher rates on competing imports of final goods, while imported inputs remain much less affected. This conforms with worldwide patterns of protection, which is enjoyed particularly at the final stages of assembly. A further pattern that emerges is the discriminatory favouring of large foreign investments by protective barriers, often as a result of intense lobbying and as a precondition for the investment to take place (see Section 9.4). Quotas have also reappeared, again most notably as part of packages to attract foreign investors. Lastly, well founded or not and modelled on current Western practice, in certain instances – particularly in

[5] MFN (most-favoured-nation) status, a GATT principle, ensures that a particular exporting country will not be treated worse than others (this does not apply, however, within free trade agreements or to preferences for developing countries – the GSP). MFN does not have to be granted by or to non-signatories of the GATT; however, its application tends to be broader than the GATT membership. Tariff rates are generally substantially lower with MFN than without it.

# Table 8.3 Foreign trade agreements and trade regimes of each country in transition

## Eastern Europe and the Baltic states

### Major trade agreements

**Relations with GATT, EU, EFTA, other OECD, intra-regional**
(Agreements are described in Box 8.1)

| | | |
|---|---|---|
| **Albania** | • GATT observer status, working party on accession (1992).<br>• EC Trade and Cooperation agreement (Sept. 1993). | • EFTA Declaration on Cooperation Dec. 1992, Free Trade Agreement in negotiation.<br>• All other OECD countries except Japan have granted MFN and/or GSP status. |
| **Bulgaria** | • GATT working party on accession (1986), expected to be concluded in 1994.<br>• EU Europe Agreement signed* March 1993, Interim Agreement covering trade components entered into force Jan. 1994. | • EFTA Free Trade Agreement in force since July 1993.<br>• All other OECD countries have granted MFN and/or GSP status. |
| **Croatia** | • GATT observer status, working party on accession (1993).<br>• Terms of EC Cooperation Agreements with Yugoslavia (1980) applied to Croatia as of 1991. | • MFN/GSP status granted by Japan in 1993.[1] Information on other OECD countries not available. |
| **Czech Republic** | • GATT original contracting party as successor to CSFR (1948).<br>• EU Europe Agreement signed* with CSFR in Dec. 1991, renegotiated with Czech Republic Oct. 1993. Interim Agreement covering trade components in force since March 1992.<br>• EFTA Free Trade Agreement in force since July 1992, protocol on succession of CSFR agreement signed April 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since May 1993.<br>• Customs Union with Slovak Republic in force since Jan. 1993.<br>• Free Trade Agreement with Slovenia signed Dec. 1993. |
| **Estonia** | • GATT observer status (June 1992), working party on accession (March 1994).<br>• EC Trade and Cooperation Agreement in force since March 1993. EU Free Trade Agreement signed July 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement.<br>• EFTA Declaration on Co-operation Dec. 1991; bilateral Free Trade Agreements in force with Finland (Dec. 92), Norway (Aug. 93), Sweden (July 92) and Switzerland (Apr. 93). | • All other OECD countries except Japan[1] have granted MFN and/or GSP.<br>• Baltic FTA in force since April 1994, but agricultural trade unresolved.<br>• Free Trade Agreement with Slovenia signed May 1994.<br>N.B. MFN agreement with Russia not yet implemented. |
| **FYR Macedonia** | • GATT observer status.<br>• Terms of EC Cooperation agreements with Yugoslavia in 1980 applied as of 1991. | • Japan has granted MFN/GSP status since April 1993.[1] Information on other OECD countries not available. |
| **Hungary** | • GATT contracting party (1973); working party on re-negotiation of accession terms formed.<br>• EU Europe Agreement in force (i.e. fully ratified) since Feb. 1994, Interim Agreements covering trade component in force since March 1992. | • EFTA Free Trade agreement in force since Oct. 1993.<br>• All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since March 1993.<br>• Free Trade Agreement with Slovenia in force since July 1994 (tariffs phased out by 2001). |
| **Latvia** | • GATT observer status (Oct. 1992), working party on accession (1993).<br>• EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement signed in June 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement.<br>• EFTA Declaration on Co-operation Dec. 1991, bilateral Free Trade Agreements in force with Finland (May 93), Norway (Aug. 93), Sweden (July 92) and Switzerland (Apr. 93). | • All other OECD countries except Japan[1] have granted MFN and/or GSP.<br>• Baltic FTA in force since April 1994, but agricultural trade unresolved.<br>N.B. MFN agreement with Russia not yet implemented. |
| **Lithuania** | • GATT observer status (Oct. 1992); working party on accession (1993).<br>• EC Trade and Cooperation Agreement in force since Feb. 1993. EU Free Trade Agreement signed in June 1994 to enter into force by Jan. 1995. Exploratory talks on Association Agreement.<br>• EFTA Declaration on Co-operation Dec. 1991, bilateral Free Trade Agreements in force with Finland (Jan. 93), Norway (Aug. 93), Sweden (Aug. 92) and Switzerland (Apr. 93). | • All other OECD countries except Japan[1] have granted MFN and/or GSP status.<br>• Baltic FTA in force since April 1994, but agricultural trade unresolved.<br>N.B. MFN agreement with Russia not yet implemented. |
| **Poland** | • GATT contracting party (1967), working party on re-negotiation of accession terms.<br>• EU Europe Agreement in force (i.e. fully ratified) since Feb. 1994. Interim Agreements covering trade components in force since March 1992. | • EFTA Free Trade Agreement in force since Sept. 1994 (applied since Nov. 1993).<br>• All other OECD countries have granted MFN/GSP status.<br>• CEFTA in force since March 1993. |
| **Romania** | • GATT contracting party (1971), working party on re-negotiation of accession terms.<br>• EU Europe Agreement signed* Feb. 1993. Interim Agreement covering trade components in force since May 1993. | • EFTA Free Trade Agreement in force since May 1993.<br>• All other OECD countries have granted MFN and/or GSP status. |
| **Slovak Republic** | • GATT original contracting party as successor to CSFR (1948).<br>• EU Europe Agreement with CSFR signed* Dec. 1991, renegotiated for Slovakia October 1993, Interim Agreement covering trade components in force since March 1992.<br>• EFTA Free Trade Agreement entered into force July 1992 for CSFR, protocol on succession of that treaty signed April 1993. | • All other OECD countries have granted MFN and/or GSP status.<br>• CEFTA in force since March 1993.<br>• Customs Union with Czech Republic since Jan. 1993.<br>• Free trade agreement with Slovenia signed Dec. 1993 (virtually free trade planned for 1996). |
| **Slovenia** | • GATT working party on accession (1992).<br>• EC Trade and Co-operation Agreement (April 1993), EC Commission expected to receive mandate for negotiation of Association Agreement soon.<br>• EFTA negotiations on Free Trade Agreement. | • Japan has granted MFN/GSP status since April 1993; no information available on other OECD countries.<br>• Free Trade Agreements signed with Czech Republic (Dec. 1993), Slovak Republic (Dec. 1993), Hungary (April 1994) (tariffs to be phased out by 2001) and Estonia (May 1994). |

1 Japan was to offer MFN status upon the acceptance of previous agreements. In practice Japan has granted MFN/GSP status to countries if they are deemed to have succeeded the trade agreement from the previous entity such as Yugoslavia and the USSR. However, some countries are not deemed to have succeeded these agreements and thus MFN/GSP status is not applied in practice.

## Trade regime

| Tariff and non-tariff import barriers** | Export quotas and other export barriers | Exchange regime*** |
|---|---|---|
| Four rates of import tariffs from 0-30% ad valorem, excluding temporary surcharge of 5%. No quantitative restrictions. | Only eight product groups subject to export licences. Temporary export tax on six unprocessed natural-resource-based products (introduced March 1993). | Restrictions on current account, heavy controls on capital account. Floating rate. |
| Average tariff from 13% (1989) to 11% (1991) to 16% (1992). 22% average tariff on industrial goods reported in 1994. Minimum prices for tyres and steel pipes. Restrictive import licences for a limited number of products. Some tariff quotas on processed foods and agricultural products. | Export taxes on 30 items, mainly foodstuffs, have replaced most export quotas. Export quotas on six primary commodities. Occasional export bans on agricultural products. Registration and licensing restrictions still operative. | Few restrictions on current account, heavy controls on capital account. Floating rate. |
| 10% import tax introduced in autumn 1993 as part of macroeconomic stabilisation programme. No quantitative restrictions. | High degree of liberalisation, most exports tariff free. | Few restrictions on current account, some controls on capital account. Floating rate with CB intervention. |
| Average weighted tariff 5.7% in 1993 (based on 1990 CSFR imports). Quantitative import restrictions on some agricultural products, textiles, clothing, steel and coal; licences for oil, gas and weapons. | 20% of exports required licensing in 1992. Export tax of 100% applies only to antiques and art works. Export licensing for livestock and plants, some natural resources, and products such as textiles and steel which are subject to quotas in other countries. | Current account convertibility for enterprises, some capital controls. Peg to DEM/USD. Special clearing account with Slovak Republic. |
| Only 14% of imports are subject to duties (10% duty for furs, sea and road vehicles), average weighted tariff 1.4% (1993). Licences for alcohol and tobacco. No quantitative restrictions. Import subsidies abolished beginning of 1992. | Minimal export barriers. 100% export tax on antiques and art works. Quotas removed except for export ban on gravel and specialised clay. Most licensing requirements removed Oct. 1991. No export subsidies. | Full current account, virtual capital account convertibility. Currency board with rate fixed to DEM. |
| Average tariff of 4.7% in 1993. Quotas on only 4% of imports (mostly agriculture, imposed seasonally). Over 90% of imports free of licensing requirements. | Export quotas removed in Jan. 1994. Over 90% of exports free of licensing requirements. | Few restrictions on current account (tourism), controls on capital account. Floating rate. |
| About 10% of imports subject to quota or licensing restrictions, with number increasing in 1994. Average unweighted tariff changed from 13% (1989) to 11% (1991) to 16% (1992); further increase in 1994 (on imports by individuals). | Exports of fuels, wheat and industrial raw materials subject to licences (a little less than 25% of total exports). 80% of the agricultural budget in 1993 devoted to export subsidies. In 1992, these amounted to an estimated 13% of export value. | Current account convertibility (except tourism). Some restrictions remain on capital account. Peg to USD/ECU basket. |
| Basic tariff 15% (as of March 1994), but many exceptions at 0.5% (raw materials, food products); some high agricultural tariffs. Import licensing and quotas for military products and tobacco. No import subsidies. | Export taxes on raw materials, precious metals and antiques. Few quantitative restrictions, mostly for health and national security reasons. No export subsidies. | Full current and capital account convertibility. Informal peg to SDR. |
| Import tariffs 5-15%; higher for food products, alcohol, tobacco and about a dozen manufactured goods (carrying tariffs up to 25%). No quotas since Oct. 1993 except for health and safety reasons. | Some export taxes on raw materials and foodstuffs. No export subsidies. Some quantitative restrictions. Export licensing system abolished in July 1993. | Full current and (virtually) capital account convertibility. Currency board, with rate fixed to USD. |
| Average weighted tariff 11% on industrial products and 18% on agricultural goods (1993) (after a 9.4% overall average in 1991). Most quantitative restrictions eliminated in 1990. Quotas on wheat, cars, alcohol, cigars, cigarettes, engine oil and petrol. | Minimal export restrictions. Most export subsidies were eliminated in 1990. | Largely current account convertibility, limits on residents' capital account transactions. Pre-announced crawling peg regime. |
| Most licensing requirements eliminated in May 1992. Weighted average tariff 11.7% (1993), maximum rate 40%. Restrictions only for arms, drugs and items affecting national health. 30% anti-dumping duty on alcohol, vehicles, TVs and video recorders imposed between May-Oct. 1993. | Export quotas on raw materials for conservation reasons and drugs for price support reasons. Occasional export bans on food, fruits and wood products. Reduced export licensing requirements since June 1993. | Virtual current account convertibility (except tourism), but capital controls. Floating exchange rate. |
| A 10% surcharge on imports established in March 1994 was removed in August. Average weighted tariff in 1993 was 5.7% (based on 1990 CSFR imports). Quantitative import restrictions on some agricultural products, textiles, clothing, steel and coal; import licences for oil, gas and weapons. | Export licensing for livestock and plants, some natural resources, and products such as textiles and steel which are subject to quotas in other countries. | Current account convertibility for enterprises, some capital controls. Peg to DEM/USD. Special clearing account with Czech Republic. |
| Generally tariff free. Where tariffs are applied, rates range up to maximum 25%. Customs formality tax of 1%. Some quotas on agricultural and textile products (98% of products free of quotas). | Temporary export duties of 10-25% on raw materials. Permit for export of "susceptible goods". | Full current account convertibility, some restrictions on capital account. Floating exchange rate. |

* Signed but not yet in force.

** Average tariff rates are from a variety of different sources using divergent methodologies and should be viewed as indicative only.

*** Treatment of profit and capital repatriation by foreign investors is described in Table 9.3.

## Commonwealth of Independent States

### Major trade agreements

**Relations with GATT, EU, EFTA, other OECD, intra-regional**
(Agreements are described in Box 8.1)

**Armenia**
- GATT observer status (July 1992).
- EC Trade and Cooperation Agreement signed Dec. 1989 with USSR, still in force.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.

**Azerbaijan**
- GATT observer status (1993).
- EC Trade and Cooperation Agreement (Dec. 1989) with USSR still in force, but not signed by Azerbaijan.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

**Belarus**
- GATT observer status, working party for accession (1993).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. Negotiating an EU Partnership and Cooperation Agreement.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Union treaty with Russia (Jan. 1994), aiming for economic union.
- Free trade agreement with Ukraine

**Georgia**
- GATT no official status.
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force.
- Other OECD countries, except Japan[1] and the US, have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union signed with CIS countries (Sept. 1993). Bilateral barter and inter-governmental agreements in place with CIS countries.

**Kazakhstan**
- GATT observer status (Oct. 1992).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. EU Partnership and Cooperation Agreement initialed May 1994.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Single Economic Space with Kyrgyzstan and Uzbekistan in force since Jan. 1994.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

**Kyrgyzstan**
- GATT observer status (1993).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. EU Partnership and cooperation Agreement initialed May 1994.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Single Economic Space with Kazakhstan and Uzbekistan in force since Jan. 1994.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

**Moldova**
- GATT observer status; working party on accession (1993).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force. Negotiating an EU Partnership and Cooperation Agreement.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral inter-governmental barter agreements in place with CIS countries.
- Free Trade Agreements with Czech Republic, Hungary, Poland, Romania, Slovak Republic, Ukraine.

**Russia**
- GATT observer status (1990); working party on accession (June 1993), memorandum on trade policies presented in Feb. 1994.
- EU Partnership and Cooperation Agreement signed June 1994; free trade talks only in 1998.
- All other OECD countries have granted MFN and/or GSP status.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Union Treaty with Belarus aimed at establishing economic union (signed Jan. 1994)

**Tajikistan**
- GATT observer status.
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements in place with CIS countries.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

**Turkmenistan**
- GATT observer status (July 1992).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis. The US has not granted MFN/GSP, but a bilateral trade agreement was signed in 1992.
- Economic Union with CIS countries signed Dec. 1993. Bilateral barter and inter-governmental agreements with CIS countries.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

**Ukraine**
- GATT observer status (July 1992), working party on accession (1993).
- EU Partnership and Cooperation Agreement signed June 1994.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries (Sept. 1993) not signed by Ukraine, but associate statue since April 1994. Bilateral barter and state order agreements in place with CIS countries.
- Free Trade Agreements with Belarus and Moldova.

**Uzbekistan**
- GATT observer status (June 1994).
- EC Trade and Cooperation Agreement signed with USSR Dec. 1989, still in force, but not signed by Uzbekistan.
- Other OECD countries have granted MFN and/or GSP status, some on an exceptional, temporary or de facto basis.
- Economic Union with CIS countries signed Sept. 1993. Bilateral barter and inter-governmental agreements with CIS countries and some former CMEA partners.
- Single Economic Space with Kazakhstan and Kyrgyzstan in force since Jan. 1994.
- Member of Economic Cooperation Organisation established by Turkey, Iran and Pakistan (ECO).

[1]Japan was to offer MFN status upon the acceptance of previous agreements. In practice Japan has granted MFN/GSP status to countries if they are deemed to have succeeded the trade agreement from the previous entity such as Yugoslavia and the USSR. However, some countries are not deemed to have succeeded these agreements and thus MFN/GSP status is not applied in practice.

Table 8.3 Foreign trade agreements and trade regimes of each country in transition

## Trade regime

| Tariff and non-tariff import barriers** | Export quotas and other export barriers | Exchange regime, other aspects*** |
|---|---|---|
| Most goods tariff-free, except raw materials, equipment and some consumer-goods. Maximum duty 20%. 10% general import tariff for non FSU countries. No quantitative restriction except for health, national security or environmental reasons. | No significant export taxes. Export licences for nine product groups. No quantitative restrictions. | Restrictions on current and capital account convertibility. 50% export surrender requirement at official rate. Floating rate. |
| Tariffs on imports from non-FSU countries eliminated Aug. 1992. As of 1993, licences only required for military supplies. Import duties may be rendered ineffective by limited border controls. | Strategic exports, mostly raw materials, sold through bilateral state trading agreements at fixed prices. Extensive export quotas, licences and taxes. | Restrictions on current and capital account convertibility. Export surrender requirement at official exchange rate, set on basis of commercial bank rates. Strategic exports valued at domestic prices, creating multiple implicit exchange rates. |
| Import tariffs 10-20%, higher rates for a few products introduced in Oct. 1993, but FSU countries exempt. Import subsidies abolished in Aug. 1993. Few quantitative or licensing restrictions, mostly for health and national security. | Export taxes of 2-30% since April 1992. 10% surcharge on convertible currency exports and barter outside the FSU since Jan. 1993. Quota and licensing system for 11 product categories, mainly energy, raw materials, and foodstuffs. Quantitative restrictions substantially reduced early 1994. | Interim currency, with restrictions on current and capital account convertibility. Floating rate with heavy CB intervention. New rouble zone planned with Russia and Tajikistan. |
| 2% uniform duty on all imports except food items. Import licences generally not required. No significant import quotas. | 8% tax on non-FSU exports. Significant licensing requirements. | Interim currency, heavily restricted convertibility. Rate floating within these parameters. 32% export surrender requirement at official rate implemented in June 1993. 20% customs duty on barter arrangements. |
| Trade system streamlined in May 1994. Import tariffs from 0-50%, generally 5%. Rates vary between individuals and enterprises as well as between goods. FSU countries exempt. Importers have to be licensed. Few quantitative restrictions, mostly for health and national security. | Exporters outside state-order system have to be licensed. Export taxes on many products, avg[?]. 18% in 1992, but substantially cut in 1994. Restrictions on 29 products to non-FSU and 59 products to the FSU (mostly strategic commodities) in 1993. Plans to liberalise (auction off quotas) at end-1994. No export subsidies. | Current account convertibility for enterprises, restrictions on capital account. Floating rate, but intervention. 50% surrender requirement to inter-bank market. Small trading amounts ($1,000 for exports and $10,000 for imports) exempt from all tariffs. |
| Substantial liberalisation of import restrictions in early 1994. No specific tariffs. | Export licensing requirements have been eliminated. No export quotas, taxes or subsidies since December 1993, with the exception of nine groups of goods (incl. grains and live animals), which are subject to export taxes of 30%. State-order system has been replaced by voluntary supply contracts. | Current account convertibility for enterprises, restrictions on capital account. Floating rate, but intervention. |
| New import tariff schedule adopted Nov. 1993 which reduces average tariff to about 30%, few commodities at maximum rate of 100%. Few licences, mainly for health, national security, environment reasons. | Soviet era export taxes abolished Nov. 1993. 5% surcharge on certain exports to the FSU. Licensing requirements for 77 export categories. Export quotas on leather, energy products and cereals. No export subsidies. | Largely current account convertibility, some capital restrictions. 35% export surrender requirement, but market-based floating rate. Barter trade disallowed with convertible currency countries. |
| Relatively free of quotas and licensing requirements. Weighted average tariff raised to 14% in July 1994. Excise duties of 10-400% on some products. Import subsidies phased out by early 1994 (1992: 17.5% of GDP). | Wide range of tariff and non-tariff restrictions. Export of strategic goods, mainly raw materials, only by registered exporters. Introduction of 'commodity passports' in 1994 to limit capital flight. Quotas on most energy and raw material products (2/3 of total exports in 1993). Scope of quota and licensing systems reduced in early 1994, but scrapping postponed to 1995. | Largely current account convertibility (capital restrictions), floating rate. 50% export surrender requirement to inter-bank market. New rouble zone planned with Belarus and Tajikistan. |
| Command system continues to dominate production and trade. Duties 5-100% in rouble terms, lower if paid in hard currency at official exchange rate. | Centralised state trading still prevalent. | Rouble remains official currency. 30% export surrender requirement. New rouble zone planned with Russia and Belarus. |
| Centralised state trading continues to be prevalent. 1981 USSR customs code still in force. Imports from FSU countries exempt of duties. | State-trading prevalent. Quantitative restrictions for main exports (natural gas, oil and cotton) and subsidised goods. Export taxes of 10-50%. Licensing requirements for non-FSU exports, but liberal rules for obtaining licences. | Current account convertibility with various restrictions. Capital controls. 50% export surrender requirement at official rate. Multiple exchange rates for different transactions. |
| Foreign trade recentralised late 1993, leaving most transactions (both within and outside CIS) subject to bilateral agreements and state order system. Few tariff rates since Jan. 1993, ranging from 0-10%, with a limited number of goods (incl. textiles, cars) facing tariffs up to 50%. No significant quotas. | Foreign trade recentralised late 1993, leaving most transactions (both within and outside CIS) subject to bilateral agreements and state order system (explicit exports quotas and licences for virtually all products since March 1994). Export duties within state orders largely eliminated. No export subsidies. | Interim currency with heavy restrictions on convertibility. Floating with intervention. 50% export surrender requirement at official exchange rate (effectively a 30% tax). Multiple exchange rates are to be gradually united. Much of foreign trade "underground". |
| Up to 40% duties on imports from non-FSU countries in 1993; all suspended in early 1994 until mid-1995. Few quantitative restrictions except for health and national security reasons. Import subsidies on commodities acquired through barter. | Export taxes on 65 product groups from 5-50%. Licensing arrangements reduced to 26 strategic products in early 1994. FSU trade on hard currency basis since May 1994. No export subsidies. | Interim currency with convertibility restrictions, managed float. State foreign trade monopoly lifted in March 1994. 30% export surrender requirement at rate set by the central bank. |

* Signed but not yet in force.

** Average tariff rates are from a variety of different sources using divergent methodologies and should be viewed as indicative only.

*** Treatment of profit and capital repatriation by foreign investors is described in Table 9.3.

### *Box 8.1*
### Glossary of principal trade agreements

*Europe Agreements*

Europe Agreements (EAs) aim to further the integration of east European countries into the EU by lowering barriers to trade, establishing a framework for political dialogue, harmonising legislation, cooperating on science and technology, and providing for technical cooperation. EAs have been concluded with Bulgaria, the Czech Republic, Hungary, Poland, Romania and the Slovak Republic. The most important aspect of the agreements is the establishment of free trade in industrial goods over 10 years asymmetrically – with the EC reducing protectionist measures faster. Remaining trade barriers applied by the Community on industrial imports will be abolished by January 1995,[6] except for textiles (1997). Further concessions on trade in agricultural products are applied on a reciprocal basis. The EAs include standstill clauses prohibiting the introduction of new trade restrictions, safeguard clauses, anti-dumping provisions, and definition of originating products (rules of origin). The east European countries are, however, allowed to derogate exceptionally from the standstill clause in order to protect, under strict conditions, infant industries and sectors under restructuring. Harmonisation of legal and institutional provisions governing competition and state subsidies is emerging as a key element of the EAs in the wake of the elimination of import tariffs and quotas (as a means of pre-empting other forms of non-tariff protection). Association Councils (ministerial level) monitor the implementation of the treaty provisions. The prospect of eventual EU membership of the EA countries (without specification of dates) has been made explicit following the Copenhagen Summit of the European Council.

*EC and Baltic States: Free Trade Agreement*

The Free Trade Agreements between the EC (and member states) and the three Baltic states were signed in July 1994. All three agreements are expected to enter into force on 1 January 1995. The goal is free trade, but the timetable for the lifting of trade restrictions is not the same for the three countries: whereas free trade will be immediately and mutually established with Estonia for all industrial products (including textiles, and ECSC and Euratom products), the opening of markets will be asymmetrical and gradual in the cases of Lithuania and Latvia, which will benefit from transition periods of six and four years respectively for industrial products (whereas the EU will open its market immediately for most products while maintaining duties on some sensitive products for two to four years). Trade in textiles will be ruled by specific provisions. Other provisions cover cumulation of rules of origin, payments, competition rules, monopolies, customs cooperation, and approximation of laws on trade and customs matters, etc.

*Partnership and cooperation agreement between the EC and CIS countries*

Partnership and Cooperation Agreements (PCAs) constitute a new form of agreement, announced by the EU in October 1992, to be negotiated with former Soviet states that are not on track for EU membership. PCAs have been signed with Ukraine and Russia, and initialed with Kyrgyzstan and Kazakhstan. The agreement essentially contains provisions concerning the following: political dialogue; improved market access on the basis of mutual most-favoured nation (MFN) treatment; improvements on quantitative restrictions, safeguards and anti-dumping procedures; asymmetric market opening measures such as the inclusion of imports from the CIS countries into the Generalised System of Preferences (GSP); the right of establishment for companies; capital transfer; intellectual property; economic cooperation and institutional framework. Specific agreements on nuclear products have been requested with each partner, depending on the situation.

*EFTA Free Trade Agreements*

EFTA's free trade agreements (covering the same transition countries as the Europe Agreements, plus the Baltic states) aim at abolishing all customs duties, quantitative restrictions and measures having equivalent effect in trade between the partners. These measures are asymmetric in the sense that the EFTA countries will abolish all customs duties upon entry into force except for some sensitive products, while the partner countries will abolish their customs duties over a transitional period. The agreements also set up provisions in areas such as intellectual property, public procurement, competition and state aid. Evolutionary clauses on investments and services are included in most agreements. A separate evolutionary clause provides for the development of relations in areas related to trade not covered by the agreements.

6 1996 in the case of Bulgaria and Romania.

*Central European Free Trade Agreement (CEFTA)*

This agreement was signed by the then Czech and Slovak Federal Republic, Hungary and Poland on 21 December 1992 and entered into force on 1 March 1993. Symmetric trade liberalisation covers all industrial and agricultural are products. All trade barriers applied to industrial products are to be dismantled gradually but at the latest by 1 January 2001. Individual articles of the CEFTA follow the EFTA model, whereas their rubrics (industrial, agricultural and general provisions) follow the EC association agreement model. Industrial products: for "List A" products, the customs duties are eliminated at the time of entry into force of the agreement; for "List B" products, customs duties will be eliminated by 1 January 1997; for "List C", which contains sensitive products such as metallurgic, vehicle manufacturing, textile and apparel products, by 1 January 2001. Agricultural concessions include a 20 per cent customs duty reduction over two years and 50 per cent reduction over five years, both up to the limit of quantitative quotas, as well as a customs duty reduction of 50 per cent over five years, without quantity limits. Other provisions concern: rules of origin, internal taxation, state monopolies, state aid, government procurement, intellectual property and dumping. Exceptions similar to GATT rules are provided. The implementation of the Agreement is supervised and administered by a Joint Committee.

*Baltic Free Trade Agreement*

The treaty to establish a free trade area encompassing Lithuania, Latvia and Estonia was signed in September 1993, and came into force in April 1994. The three countries agreed to eliminate most barriers to trade in industrial goods falling within Chapters 25 to 97 of the Harmonised Commodity Description and Coding System. Extension to trade in agricultural goods is expected at a later date. The Agreement is by its substance similar to those which the three countries had concluded with EFTA countries. At least for an initial period, some restrictions on exports of raw materials will be maintained by all three countries (in Latvia and Lithuania through export tariffs, in Estonia through quotas). Other provisions concern rules of origin (cumulation of rules of origin which will enable the transit of goods to the Scandinavian countries without tariffs), customs cooperation, competition and state monopolies.

*CIS – Economic Union*

A Union agreement was signed on 24 September 1993, by all CIS countries except Ukraine (which has associate status). The treaty aims at establishing free movement of goods, services, capital and labour; coordinated financial and credit, budgetary, tax, pricing, foreign trade, customs and monetary policies; harmonised economic legislation; a common statistical base; and coordination of social policies. The Union intends to create a customs and monetary union in an unspecified future. The Council of Heads of States and the Council of Heads of Governments make decisions by consensus. Separate agreements will determine the procedures for the setting up, functioning and financing of institutions of the Economic Union. Disputes are settled through the Economic Court of the CIS, unless the contracting parties have agreed otherwise. Steps towards the creation of a set of common institutions and of a payments union were taken at the Moscow Summit of September 1994, but the substance of the Treaty still awaits implementation.

*Single Economic Space (Central Asia)*

The treaty (between Kazakhstan, Uzbekistan and Kyrgyzstan) entered into force in February 1994 and will be implemented over an unspecified period. It envisages the establishment of an economic space where goods, services, capital and labour move freely (as of July 1994, customs duties had already been eliminated and a payments clearing system was being established). It also aims at the harmonisation of policies on credit, prices and taxes. Mutual convertibility of national currencies is to be achieved. The treaties contain a clause on non-discrimination on the grounds of nationality in employment.

*Economic Cooperation Organisation (ECO)*

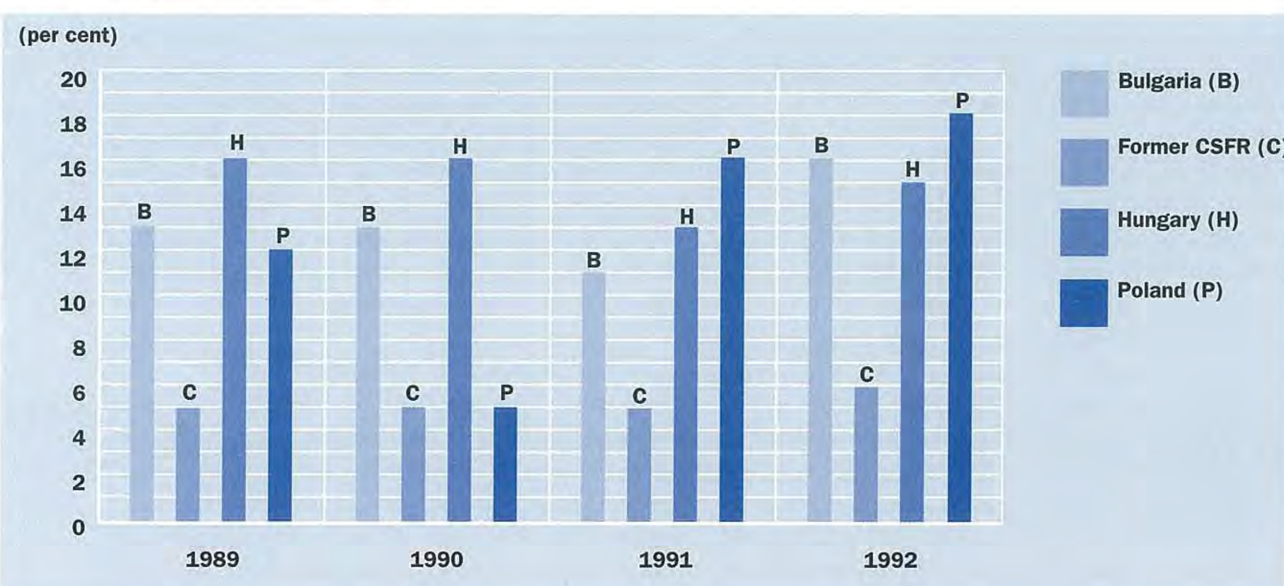
ECO, which had been dormant for 27 years, was reactivated in June 1990 by its member states: Turkey, Iran and Pakistan. In November 1992, Kazakhstan, Uzbekistan, Turkmenistan, Kyrgyzstan, Tajikistan and Azerbaijan were admitted, together with Afghanistan. A 10 per cent preferential decrease of tariffs among members was agreed to in March 1992, and the articles of a regional investment and development bank were initialed in November 1992. In January 1993 ECO agreed on further tariff reductions and devised measures to attract foreign investment. In 1994 the creation of a customs union was proposed.

Hungary – recourse has been taken to anti-dumping measures and countervailing duties, predominantly against imports from former CMEA trading partners (see Chart 8.2 and Box 8.2).

The renewed recourse to active tariff and quota policies should be seen in the context of macroeconomic policies and of the impact on domestic production of the initially radical reforms. Whereas foreign competition was at first welcomed to introduce world market relative prices, limit monopoly pricing, and provide for the backlog of consumer demand, industrial policy considerations are beginning to assume more importance in the trade policies of transition economies. Generally speaking, restrictive trade intervention raises domestic prices and thus the revenue available for wages and profits in import-competing sectors. This comes first of all at the expense of consumers and of the users of imported inputs into production. While this may be sufficiently well known, other implications are not. Three issues should be separated: the average level of protection, the discriminatory granting of higher or lower rates, and the frequency and discretionary nature of modifications.

*Increases in the average level of import duties* – in the form of temporary surcharges or as a result of comprehensive revisions of tariff schedules – have been justified by governments on two counts: by a general lack of competitiveness of domestic industry that squeezes production – with social consequences – and by the need for increased fiscal revenues.[7] The first argument implies, in effect, that the prevailing exchange rate overvalues the domestic currency. This may be one of the root causes of the recent adverse developments in exports and continuing rise in imports of Hungary and Poland. Their real effective exchange rates appreciated by 31 per cent and 77 per cent, respectively, between 1990 and 1993.[8] Import barriers are not an appropriate instrument to deal with this problem. Subject to conditions on factor markets, they tend to raise the production cost of exports (which cannot increase in price correspondingly since they are "unprotected" on their markets). A combination of cautious monetary and aggregate demand management and a responsive exchange rate policy avoids this bias and should be the preferred approach. However, the second argument may justify the temporary recourse to tariffs if this is required to improve macroeconomic stability until less distorting fiscal instruments can be brought into play.

**Chart 8.2 Average tariff levels**
*(in per cent, unweighted)*




Source: Koteva and Ferreira (1993).

7 See Chapter 6 on the fiscal role of trade taxes. A further argument has been that the countries' initial opening up has not led to a comparable response by trading partners.

8 Source: Institute of International Finance, *Monthly Economic Review(s)*, August 1994 (Hungary and Poland). The real effective exchange rate is the trade-weighted relative price of a basket of domestic and foreign goods.

*Box 8.2*

**Cases of trade policy reversals**

Increases in nominal tariffs mirrored the extent of the initial liberalisation. The Polish and Russian cases are particularly revealing in this respect. After liberalisation and tariff suspensions in 1990, Poland's average tariff fell from 18.3 to 5.5 per cent. In the first half of 1991, however, after the zloty had appreciated significantly against other currencies, the government raised the average tariff to 16 per cent (weighted average 9.4 per cent). In autumn 1991, further tariff revisions took place, and early in 1992 all tariff suspensions were ended. As a result, average weighted tariffs rose to 11 per cent on industrial goods and 18 per cent on agricultural goods according to some estimates.[9]

Russia launched trade policy reform in 1991 with the scrapping of most non-tariff barriers.[10] A presidential decree in January 1992 then abolished the USSR's import tariff schedule, which was not replaced until July by a new schedule – in force for only two months – with a prevailing tariff rate of 5 per cent. Beginning in September 1992, general tariff rates were raised to 15 per cent in a regime that survived until April of the following year. This regime was, however, highly inconsistent at least until February 1993, since imports remained free from the 28 per cent value added tax as well as from excise taxes – effectively discriminating against local goods. Even after February and until November 1993, the basis on which the value added tax was assessed was lower for imports than for local goods.[11] It was not until March 1994 that excise taxes began to be fully assessed on imports. The April 1993 tariff revision actually decreased the average tariff by two percentage points to 13 per cent, while substantially increasing the variability of tariff rates. However, the main purpose of the revision seems to have been to raise revenues, and there does not appear to have been a clear pattern of higher protection. In contrast, the most recent revision of the import tariff schedule, which came in force in July 1994, has had an explicit protective orientation. The average tariff rate increased to 15.5 per cent (14.1 per cent if weighted), with a maximum rate of 100 per cent. It appears that the major increases occurred in those sectors with the strongest lobbying power, with a clear hierarchy of defence, micro-electronic, aerospace, motor vehicle and agricultural producers.[12] The Russian government has, however, assured that it will announce in October 1994 a gradual reduction in import tariffs according to a pre-set three-year to five-year timetable.[13]

In Hungary, which had implemented more moderate tariff decreases in the early transition, recourse was more often taken to non-tariff measures. In almost all cases, the main targets were exports from former CMEA partners. Steps undertaken in the period 1992 to mid-1993 were as follows. The Hungarian Cement Industry Association requested and received (in March 1993) the imposition of quotas for various categories of cement on imports from the Czech Republic, Slovak Republic, Romania, and all countries of the former Soviet Union. In October 1992, the Iron and Steel Industry Association initiated a market protection procedure; quotas were introduced on imports from the Czech and Slovak Republics, Romania, the Ukraine and the Russian Federation in July 1993, for a one-year period. At the request of a foreign-owned producer, import quotas on paper products became effective for one year from November 1992, excluding imports from EFTA and the EU because of the prevailing trade agreements. The Hungarian Chemical Industry Association managed to obtain import quotas on various base chemicals from the CIS countries, the Czech Republic, Slovak Republic and Romania beginning in January 1993; a measure later extended to Austria. A preliminary examination was carried out regarding imports of refrigerator compressors, but resolved in negotiations. Lastly, market protection procedures were initiated in March 1993, against imports of PVC powder from outside the EU.

9 Sources are GATT (1992), and Inotai and Sass (1994). These sources might not be fully comparable.

10 The following is based on Drebentsov (1994).

11 The customs value – pre-tax – was the basis for imports, while retail prices – including the tax – were the basis for domestically produced goods.

12 V. Drebentsov, (1994), p.10.

13 Note that Russian borders, in particular with the CIS area – which has not followed Russia in its tariff policy – remain highly permeable. The effective implementation of tariffs is therefore very constrained.

*The discriminatory granting of higher or lower rates of protection* to particular sectors does not respond primarily to macroeconomic disequilibria, even though the tendency to make recourse to it may be reinforced by an overvalued exchange rate or sluggish domestic demand. The public justification tends to combine the need to mitigate the social implications of sudden adjustment (caused by the production effect of superior competition) with the venerable rationale of the "infant industry" argument: the initial liberalisation is said to have put undue pressure on certain activities that could be viable in the longer term, once equipment has been modernised, management has progressed on the learning curve, and other adjustments to market-based exchanges have taken place in the economy as a whole. While the argument may have a conceptual justification, attempts to "pick winners" through discretionary intervention have in many cases ended in costly failure even in less well established economic environments and with more experienced administrations. The difficulty for bureaucrats of predicting the competitiveness of a sector several years into the future is accompanied by political economy problems. The existence of discriminatory protection in some sectors signals to economic agents that financial rents are subject to negotiation, and that political positioning and effective lobbying can substitute for economic adjustment. In the extreme, the "soft budget constraint" may be simply replaced by the "rent-seeking society" as the primary enemy of market-oriented adjustment.

A better case could be made for the non-discretionary protection of "senile industries" if radical liberalisation makes excessive demands on the economies' ability to adjust. A possible strategy would have been: first, to convert all the inherited barriers to trade into explicit equivalent tariffs; second, immediately to reduce exceptionally high rates; and third, phase down the remaining tariffs over say, 10 years to a level characteristic of relatively open trading members of the OECD. Such a process would enable industries with no long-term future to contract slowly as others grow and, as long as the scheduled tariff reduction were credible, would not distort the allocation of resources. Labour retained in the short run would otherwise have been unemployed in many cases, while investment will only be made in industries enjoying temporary protection if, like replacing failed light bulbs, it has a very quick payback relative to the expected viable life of the enterprise.

*The discretion and frequency of trade interventions* is the third issue of relevance here. Trade restrictions have been subject to frequent changes and have tended to be responsive to circumstances, including balance of payments developments, social pressure, and lobbying efforts by industry groups and foreign investors. This generates two problems: it reinforces the political economy drawbacks mentioned above by signalling even more forcefully the opportunities to capture trade policy for commercial purposes and it raises the general level of uncertainty in the economy. The latter is particularly damaging to investment, since the inability to predict government policy in the trade – and other – fields increases risk. An important corollary is that there can be a trade-off between uncertainty and the drawbacks of temporary protection: where quick liberalisation appears *ex ante* unsustainable for political or other reasons, proceeding more slowly but in some predictable and committed fashion may carry less economic cost and be more conducive to investment in long-term viable sectors. Government credibility is weakened (uncertainty therefore increased) when protective policies that are specifically announced as "temporary" fail to be so. A useful means of reducing discretion and increasing the domestic credibility of liberalisation is to anchor trade policy in international commitments. The GATT provides one such anchor, but regional trade agreements such as the Europe Agreements may at times be more demanding and therefore useful in stabilising expectations.

## 8.4 Access to Western markets

For an outward-oriented reform strategy to be successful, exports have to enjoy access to their major markets. Through the example it provides – trade policies are the foreign emissaries of the market economy – the openness of Western import regimes can also be politically and psychologically significant in helping governments in the region hold the course on liberalisation. Anything other than liberal trade exposes Western governments to charges of hypocrisy, and stifles their own growth potential as well as that of the transition economies.

The conclusion of the Uruguay Round is a promising sign; however, most countries of the region are not yet members of the GATT[14] and therefore do not enjoy automatic MFN status. As a result, they have to rely on less predictable and sometimes more selective concessions for access to OECD markets. Additionally, there is a threat of increasing recourse to more subtle forms of protection, such as anti-dumping (including for ostensibly social and environmental reasons), countervailing duties and safeguard action, as exporters of the transition economies gain market share in the West. While their use may sometimes be justified, these measures are pernicious in that they punish success. The mere threat of limited market access may generate sufficient uncertainty so as to reduce investment in competitive sectors. This can stifle the necessary reallocation of resources away from the industries excessively promoted under central planning.

The response by Western governments to the challenges of the import growth from eastern Europe and the former Soviet Union has not been without its merits. As reported in Table 8.3 (and Box 8.2) most OECD countries have granted trade concessions to the transition economies. Of particular importance have been the swift promotion of six central and south-eastern European countries[15] to the top of the trade preferences pyramid[16] of the European Union in the Europe

[14] Whereas the CSFR joined in 1948 as a founding member, Hungary and Poland joined later on special terms reflecting their status as state trading economies. They are presently renegotiating their terms of accession, while most other countries in transition have initiated negotiations on accession.

[15] Bulgaria, Czech Republic, Hungary, Poland, Romania and Slovak Republic. Others, such as the Baltic states and Slovenia, may follow soon.

[16] A thorough discussion of EU trade preferences is contained in Möbius (1994).

**Table 8.4 Non-tariff barriers against imports from transition economies (in per cent)** [1]

| | European Union | | | | United States | | | | Austria | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | Trade Coverage [2] | | Frequency [3] | | Trade Coverage [2] | | Frequency [3] | | Trade Coverage [2] | | Frequency [3] | |
| | 1989 | 1993 | 1989 | 1993 | 1989 | 1993 | 1989 | 1993 | 1989 | 1993 | 1989 | 1993 |
| Bulgaria | 40.3 | 35.2 | 734 | 647 | 0.0 | 0.0 | 1 | 0 | 29.4 | 32.1 | 26 | 36 |
| CSFR | 29.9 | 25.1 | 2321 | 2043 | 17.4 | 3.2 | 29 | 12 | 13.1 | 17.0 | 126 | 249 |
| Hungary | 36.1 | 30.0 | 2179 | 1897 | 16.3 | 10.1 | 82 | 39 | 17.6 | 23.5 | 204 | 240 |
| Poland | 27.5 | 16.6 | 1927 | 1605 | 24.1 | 15.8 | 170 | 126 | 9.1 | 12.9 | 69 | 90 |
| Romania | 37.7 | 36.2 | 1268 | 1211 | 31.0 | 21.1 | 94 | 109 | 16.8 | 23.9 | 46 | 57 |
| Former USSR | 8.7 | 8.7 | 565 | 728 | 0.7 | 0.7 | 2 | 2 | 0.5 | 1.1 | 21 | 28 |

Source: UNCTAD Database on Trade Measures.

1 Refers to the so-called "narrow" group of non-tariff barriers which includes quantitative restrictions (including prohibitions, quotas, non-automatic licensing, "voluntary" export restraints, restraints under MFA and other textile agreements), surcharges, variable levies, price surveillance, minimum pricing and "voluntary" price restraints.

2 "Trade coverage" measures imports under 8-digit tariff lines in which restrictions are encountered as a share of total imports. The base year for trade weights is 1989.

3 "Frequency" measures the number of 8-digit tariff lines with restrictions.

**Table 8.5 The importance to transition economies of the sensitive sectors**

| Share of particular items in each identified country-origins 1993 exports to the EU (in per cent) | | | | | | Share of particular items in each identified country-origins non FSU 1990 exports (in per cent) | | | |
|---|---|---|---|---|---|---|---|---|---|
| From: | CSFR | Hungary | Poland | Romania | Bulgaria | Turkmenistan | Uzbekistan | Russia | Former Soviet Union weighted total |
| Iron and Steel | 11 | 4 | 12 | 7 | 7 | 0 | 0 | 3 | 4.8 |
| Chemicals | 8 | 9 | 6 | 4 | 7 | 5 | 5 | 4 | 5 |
| Footwear, textiles and apparel | 17 | 23 | 21 | 49 | 38 | 66 | 57 | 1 | 2.2 |
| Food and agriculture | 4 | 18 | 11 | 5 | 18 | 4 | 2 | 2 | 2.2 |
| **Total** | **40** | **54** | **50** | **65** | **70** | **75** | **64** | **10** | **14.3** |

Sources: Deutsches Institut für Wirtschaftsforschung, Wochenbericht 23/94, GATT, International Trade Statistics, 1993.

Agreements, and the Free Trade Agreements implemented with EFTA. Nevertheless, progress in eliminating non-tariff barriers (NTBs) to trade has so far been less impressive than these agreements may suggest.

Table 8.4 shows trade coverage ratios of "narrow" NTBs in selected Western markets (note that anti-dumping and other trade remedy action, taken up further below, is not included in the table). While the use of NTBs against transition economies has visibly declined in the EU and the United States between 1989 and 1993, it still remains substantial and Austria's use of NTBs has actually increased. This is explained by the fact that NTBs are concentrated in so-called "sensitive sectors", which often remain subject to special regimes even within the trade agreements. At the same time, as shown in Table 8.5 for the case of exports to the European Union, sensitive sectors are of particular importance to the transition economies' exports and cover product ranges in which they appear to have a comparative advantage (agriculture, processed foods, footwear, simple manufactures).[17] As the table indicates, these products accounted for at least half of EA partners' exports into the EU in 1993 (with the exception of the CSFR), while the EU accounts for over 65 per cent of all Western imports of "sensitive goods" from the region.

Given the weight of the European Union as an export destination (see Chart 8.1), and in the absence of more widespread membership of the GATT, the provisions of the Europe Agreements (EAs, Box 8.1) are effectively setting the post-cold-war standard on trade rules for their signatories in eastern Europe. The Agreements provide far-reaching improvements in EU-market access to the transition economies, including the rapid elimination of tariffs and quantitative restrictions. The EAs have been criticised for the relatively slower liberalisation of EU imports in sensitive sectors such as textiles,[18] and for the lack of progress in the liberalisation of agricultural trade. These points have been

17 Some studies show a comparative advantage for central and eastern Europe in food, crude materials, basic manufactures and (oddly) fuels; and in fuels and crude materials for the former Soviet Union (Collins and Rodrik, 1991). Others, in turn, conclude that the region may have an advantage in industries that are intensive in capital and unqualified labour, such as motor cars, steel, transformation of metals, wood, plastics and textiles, (e.g. Neven, 1994).

18 However, market access in all sectors except textiles and agriculture is to be unrestricted from January 1995 ("Visegrad countries") and January 1996 (Bulgaria and Romania), respectively. In textiles, restrictions are to last through 1997. Note that the EAs thus chose to liberalise trade in textiles significantly sooner than the corresponding dates set in the Uruguay Round Agreements.

discussed in the EBRD's 1993 *Annual Economic Outlook* and are not taken up again here.

While the visibility of tariff cuts and quota increases is high, it can be out of proportion to their relevance. Improved procedures governing trade "remedy" action (i.e. defensive action against "unfair" or "disruptive" imports) and local content requirements may in reality be more important for the economies of eastern Europe. The EAs contain some weaknesses in this respect:

- The EAs fail to discourage the use of *contingent protection measures*, which can undermine the benefits of the tariff and quota liberalisation.

  (i) The Agreements contain not just one, but seven safeguard clauses, of which six refer to specific product groups or types of activity,[19] as well as the dominant general safeguard of Article 30/31.[20] While the preamble to the EAs commits the parties to "compliance with the rights and obligations arising out of the [GATT]", the specific Article 30/31 lacks any such provision.[21] Moreover, it lacks the GATT reference to "unforeseen developments" as a condition for invoking the clause, explicitly refers to quantitative restrictions and minimum prices as measures available to the importing country, and, unlike GATT Article XIX, is conceived in purely bilateral terms. This makes selective use very likely, as exemplified by the restrictions imposed on Czech and Slovak steel imports shortly after the coming into force of the respective interim agreements.[22] Furthermore, Article 30/31 offers an additional loophole for managed trade as safeguard measures are permitted if imports cause "serious disturbances ... or difficulties which *could* bring about serious deterioration in the economic situation of the region" (italics added). The lack of definition of "serious deterioration" or "region" – which may refer to depressed areas within countries, for instance – as well as the pre-emptive spirit of the phrase, leave wide latitude in the application of the clause.

  (ii) The EAs have not significantly altered the regulations governing anti-dumping (AD) measures. The Agreements specify that AD actions must accord with Article VI of the GATT, but this has not hindered GATT-consistent behaviour to be biased against exporters in the past.[23] Nevertheless, the recent evidence on AD action is encouraging. Table 8.6 reports the number of AD measures against countries of eastern Europe and the former Soviet Union taken in 1980-91, as well as those currently in place. In the first half of 1993, new rulings against EA partners occurred in only two cases, while in the second half of the year there were none (one procedure, against Romania, was initiated in the second half of the year). By contrast, measures were introduced by the EU against non-EA transition economies in seven cases in 1993.[24] The relative decline of AD cases under the EAs is perhaps partly explained by the recourse in the steel sector to the relatively less constraining safeguard clauses of the Agreements, and partly by the flattening of EA partner export growth in 1993. It cannot be excluded, and would be unfortunate, if the decline in AD cases were to some extent proof of the effectiveness of the earlier action in this area, i.e. if potential exporters in the transition economies had been discouraged from a dynamic search for EU markets.

- A further drawback of the EAs is the "hub-and-spoke bilateralism" implicit in the stipulated rules of origin.[25] By setting a very high local content requirement of 60 per cent, the EAs have investment-deterring effects as, for example, assembly plants seeking to utilise cheap skilled labour with low value added will not qualify for EA trade preferences if too many inputs originate outside the area of the EA partners and the EU. Moreover, since cumulation of local content (to reach the value added threshold) between the "Visegrad countries" on the one hand, and Bulgaria, Romania[26] and the EFTA countries on the other is not permitted under the EAs, the EAs effectively discourage economic integration between the countries, thereby "marginalising the spokes" and reducing the potential for trade in the region. The EFTA Free Trade Agreements with the same countries allow both bilateral

19 Referring to agriculture, meat, processed agricultural products, re-exports to third parties that undermine export restrictions, eastern Europe infant industry protection, and textiles.

20 The numbering differs in the various EAs.

21 Not surprisingly, the GATT secretariat has critically reviewed the safeguard provisions of the EAs in its 1993 Trade Policy Review for the EU: "the Community seems to consider these [safeguard] provisions to allow not only for the suspension of concessions granted under the Agreement but also of obligations under GATT (e.g. Article XIX)," (GATT, 1993).

22 Note that while the EAs have hence introduced less stringent safeguard clauses, the Uruguay Round has actually tightened the GATT provisions on safeguard measures. According to Section VI of the Agreement on Safeguards, all "grey areas" (Voluntary Export Restraints, Orderly Marketing Arrangements, etc.) usually resulting from a sidestepping of the safeguard Article XIX of GATT will be phased out, and "members shall not encourage or support the adoption or maintenance by public and private enterprises of non-governmental measures equivalent to those referred to".

23 Notably, the Uruguay Round has tightened GATT rules also in this regard. While administrative proceedings have been made more transparent by more detailed rules for the conduct of investigations and criteria for determining dumping margins and injury to domestic industry, the Agreement on Implementation of Article VI (the GATT AD article) also prohibits price undertakings without the prior establishment of dumping and injury caused by such dumping.

24 Six of these occurred during the second half of the year (source: GATT, Semi-Annual Reports by the EU under Article 14:4).

25 On this issue, see Baldwin (1994).

26 It appears that the "Visegrad countries" may have resisted multilateral cumulation with Bulgaria and Romania in order to reinforce the redirection of their own trade towards the West.

**Table 8.6 Anti-dumping action by the European Community**

| Countries | No. of EC cases | Restrictiveness rate[1] | No. of anti-dumping measures in force as of 21.5.94 | Average rate of duty imposed | No. of other measures (U/T, min. price)[2] |
|---|---|---|---|---|---|
| | EC anti-dumping cases, 1980-91 | | EU anti-dumping rulings presently in force | | |
| Bulgaria | 6 | 50 | 1 | – | 1 |
| CSFR | 25 | 76 | 4 | 19.5 | 3 |
| Hungary | 16 | 56.3 | 2 | 21.7 | 1 |
| Poland | 15 | 73.3 | 4 | 9.6 | 2 |
| Romania | 21 | 76.2 | 3 | 18.1 | 1 |
| Russia | na | na | 7 | 39.6 | 2 |
| Other former Soviet Union | na | na | 8 | 38 | 2 |
| Total former Soviet Union | 22 | 76.2 | 15 | – | 4 |
| Total for the region | 105 | 71.2 | 29 | – | 12 |
| **Goods** | | | | | |
| Industrial chemicals | 50 | 81.6 | 8 | 18.2 | 4 |
| Iron and steel | 6 | 83.3 | 5 | 23.7 | – |
| Non-electrical machinery | 7 | 85.7 | 0 | – | – |
| Other | – | – | 1 | – | – |
| **Total** | **63** | **–** | **14** | **–** | **–** |

Notes: 1 restrictiveness rate = restrictive outcomes as percentage of all known outcomes

2 U/T: price undertakings

Sources: For columns 1 and 2: P. Messerlin, "The EC and Central Europe", *The Economics of Transition*, 1:89

For columns 3 – 5: Commission of the EC, DG1, 21.05.1994

and multilateral cumulation of rules of origin, thereby encouraging integration within the region.

With the implementation of the Europe Agreements progressing, the main threat to eastern European exports and investment comes from actual, threatened, and "latent" trade remedy action employed for purposes of managing trade to support industrial policy objectives in the EU. Much of the problem of contingent protection is linked to the uncertainty it generates for exporters and potential investors. In addition, the administration of measures of contingent protection (especially so called "voluntary export restraints") can strengthen bureaucracies in the affected countries as well as existing exporters at the expense of new entrants; both of these effects are inimical to the objectives of transition.

Improvement of access to EU markets should therefore centre on making such action harder to invoke, more transparent and predictable, and on making procedures faster than is currently the case. One possibility is to use the agreement on the European Economic Area as a blueprint for dispute avoidance and resolution between the EU and eastern Europe. This implies, (a) the swift introduction and implementation of EU competition and state subsidy regulations and other areas of "acquis communautaire" in the partner countries (this is foreseen as part of the EAs and may receive further support under recent proposals by the Commission), (b) the subsequent elimination of anti-dumping and anti-subsidy provisions, and (c) subjecting remaining trade disputes to settlement within a joint committee and, if that fails, the European Court of Justice. A clear and short deadline should be set for implementation of such a system. Regarding rules of origin, the value added thresholds should be substantially lowered and multilateral cumulation among all EA partners and with all members of the European Economic Area permitted. At its Copenhagen meeting in June of 1993, the EU commissioned a feasibility study on the possibility of multilateral cumulation, the results of which are still pending.

## 8.5 Deficiencies of the commercial financial infrastructure

While there has been significant positive restructuring of trade, there has also been a considerable destruction and obstruction of commercial links that it would have made sense to maintain or create. A variety of reasons for this were discussed in the EBRD's 1993 *Annual Economic Outlook*.[27] The following concentrates on an important factor that is institutional in nature, namely the weakness of market-based, decentralised mechanisms of trade finance.

27 They include austerity programmes that reduced the demand for imports, especially those that were investment-related; the abrupt elimination of the internal plan-and-command based coordination of factor and input flows without the immediate emergence of functioning markets as a substitute; restrictive trade policies especially with regard to exports; the absence, initially, of functioning international payment and settlement systems; the tying of trade credits by Western countries and preferential trade agreements which introduced biases to the detriment of the previous commercial links; and extreme cases of under- and overvaluation.

Switching from plan-based allocations and state-orders to market-based transactions places particular demands on financial, legal and information systems, factors largely outside the sphere of control of the individual supplier.[28] In a developed market economy, the financial system provides the services necessary to extend transactions over time, clear and settle them, and it reduces the information needs of the transacting partners by assuming the default risk for a fee. As intermediaries of the transaction, therefore, the exporter's and importer's banks assume a central role in the efficient conduct of trade. Collectively, deficiencies in these areas raise the transactions costs of trade to the point where many transactions are obstructed altogether. Trade finance in the centrally planned economy was highly centralised; while foreign trade banks such as Vneshekonombank would offer payment guarantees and provide finance in foreign currency, they would have only one office in the capital and deal almost exclusively with the foreign trade organisations (with some exceptions in eastern Europe). There was no infrastructure for providing direct trade finance services to the enterprises.

Although differences regarding the availability and quality of financial services exist between the economies in transition, the financial infrastructure for cross-border trade shares a number of common features:

- Country risk is high because of economic and political instability, often high levels of foreign debt, uncertain capacity to generate the foreign exchange necessary to service it, and thus precarious convertibility of currencies even on current account. Country risk not only intervenes in the assessment by banks in eastern Europe and the former Soviet Union of the virtues of extending trade-related credit denominated in hard currencies, it also impedes their ability to source matching funds with Western banks, irrespective of their soundness as financial institutions. The resulting exchange risk can severely hamper trade finance.

- Reliable, high-speed electronic interbank clearing and settlement facilities, whether bilateral or multilateral, are being established only slowly.

- The information necessary for banks to assess each other's risk – and thus be able to price its assumption – is often deficient due to lack of a track record in market-based trade finance.

- Banks often lack the technical skills required to assess the quality of trade documentation or to engage in the intricacies of risk management with assets and liabilities denominated in foreign currencies.

- Beyond directly trade-related issues, the soundness of domestic financial systems and the progress in their market-oriented transformation (or lack thereof) can obviously have serious repercussions on the availability and quality of financial services.

The transactions costs implied by these factors can amount to a significant and sometimes prohibitive tax on trade. Like other taxes, it carries an economic cost by preventing trade from taking place in conformity with the countries' resource and factor endowments. This, and the consequent impact on the pattern and speed of economic restructuring, is further aggravated by the fact that access to the limited available services is often rationed. To the extent that they receive access to funds for trade finance, and in the absence of financial reform, for instance, state-owned banks in particular tend to favour their traditional clients – large state-owned enterprises – to the detriment of the emerging private sector.

A crucial question that arises in the context of higher-than-necessary transactions costs is whether the market will rapidly erode them. There is unlikely to be a common answer in all circumstances, but some comments can be made. In certain cases, the observed deficiencies may be due to government interventions and it may be sufficient to eliminate those interventions to overcome the problems. This is true, for instance, when the financial system has not been restructured in a way that generates the necessary incentives for bank managers to seek out opportunities for trade finance in the entrepreneurial sector. To take a different example, capital account controls may prevent banks in the reforming countries from obtaining matching funds in hard currencies, or from paying them back later.

Risk management by Western financial institutions raises a complex set of questions as to the functioning of markets. Banks tend to control certain types of risk by subjecting them to quantitative ceilings instead of by pricing them, i.e. a credit may not be available to a borrower with certain characteristics, such as a particular country risk level, at any price. As explained in a footnote, the rationing of potential borrowers is the result of market failure: gaps in the availability of instruments for hedging risk, and information failure.[29] In the economies in transition – where country risk plays an important role in addition to the risk of the individual institution – a large number of potential borrowers can therefore be cut off from borrowing in the West because of such market failure. Even though there were both current and capital account convertibility, this can, as mentioned, make it very difficult

[28] The legal framework is outside the scope of this analysis.

[29] Fundamentally, the cause of this is that there are limits to the availability of placements that may be used to diversify risk, so that "insurance" (hedging) is unavailable. Meanwhile, the high level of interest rates necessary to price high risk can induce risk-seeking behaviors in the borrower that the creditor cannot control for lack of information (moral hazard), or attract only borrowers whose risk is higher than reflected in the price, thus lowering the quality of the portfolio (adverse selection).

for banks to hedge their exposure to hard-currency-denominated credits. It should be noted, however, that this will be true in particular for loans of longer maturity; in fact, even during the worst of the debt crisis in Latin America, very short-term foreign trade credits were mostly serviced – since they represented a lifeline for these economies – and tended to continue to be forthcoming.

The limited capacity to assess other banks' soundness and the establishment of cross-border clearing facilities may involve elements of coordination failure that are not easily overcome by the market alone. Thus, the possibility to use other banks' track records as information devices both depends on trade taking place so that track records can be established and is – to some extent – a condition for it. Clearing facilities among commercial banks, in particular with multilateral netting, are based on trust and can therefore face a similar hurdle. To "invest" in the information necessary to gain a thorough picture of the soundness of banks in other countries can therefore be quite costly for the individual bank (almost impossible without laws on transparency).[30] In both cases, the market tends to inch its way towards efficient solutions, but the process takes time and carries a high opportunity cost.

In spite of market failure as a result of imperfect information, which is endemic in financial markets, there is rarely a point to be made for government intervention. While government may be capable in theory of internalising externalities, of breaking coordination deadlock, and of overcoming other market failures, it will tend in practice – if anything – to be even more strictly constrained by information deficiencies than would individual commercial agents. The main problem to be confronted is probably the difficulty of differentiating between "correct" market decisions and market failure in the non-emergence of an institution or the failure of certain transactions to come about. Even in the absence of this problem, the complexity of government motives and the administrative challenge of translating them into action make it hard to intervene in a non-distortionary way.[31] Western export credit agencies, many of which have a history of subsidisation – not least in transactions with eastern Europe and the former Soviet Union[32] – attest to the potential cost of such interventions.

In the end, trade finance problems will be overcome by the strengthening of commercial financial institutions (based on growing experience and perhaps supported by technical assistance), and a gradual widening of access to sources of finance.[33] This is a process which the international financial institutions can play a main role.

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30 It also again involves an externality: the information obtained is transmitted to others via the decision to establish working relations with particular banks, so that the social value of that information is higher than the private one and investment in information remains suboptimal.

31 For an extensive discussion of "government or institutional failure", see Stern (1991).

32 Germany's Hermes was reported to have written off over DM 5 billion in 1993, much of it related to transactions with the area of the former Soviet Union.

33 The EBRD supports various projects aimed at strengthening financial institutions engaged in trade finance; these can be linked with credit and guarantees in an effort to gradually push back the risk frontier on the basis of track record.

# 9. Foreign direct investment

This chapter examines the environment for foreign direct investment (FDI) and the motivations of investors. Although governments in much of eastern Europe and the former Soviet Union have made substantial (and sometimes costly) efforts to attract foreign investors, FDI flows into the region have been concentrated on a few countries. This pattern may reflect an investor preference for macroeconomic and institutional stability as well as certain self-reinforcing characteristics of FDI. An interesting observation is that, according to surveys, the wish to gain access to local markets is the dominant factor inducing foreign companies to invest in the economies in transition (although the countries that have received the bulk of the region's FDI inflows represent relatively small markets). The relation between trade policies and FDI decisions may be particularly important in explaining this. Among other factors, the chapter analyses the role of protection in attracting FDI.

## 9.1 A summary of developments

Foreign direct investment may be defined as the transfer by a firm of resources - including capital, technology and personnel - into a foreign business venture with the objective of acquiring control of the venture.[1] In the transition economies, equity stakes have often been acquired by foreigners through in-kind contributions. As a result, the volume of FDI is hard to assess on the basis of financial flows alone. Even for balance of payments data, comparability across countries is often limited given definitional problems such as different thresholds for the equity stake that distinguishes direct investment from portfolio placement and failure to record reinvested earnings. In spite of these measurement difficulties, there is little doubt that foreign investment into the region has responded to the transition, though the amounts may have been smaller than the governments of the region had expected. Most strikingly, FDI flows have been heavily skewed towards a subset of countries. Table 9.1 provides some evidence on FDI based on balance of payments data.

- Annual measured FDI inflows into eastern Europe and the former Soviet Union rose 10-fold between 1990 and 1993. Even so, however, they represented only approximately 10 per cent of total FDI flows into developing countries in 1993.[2] In fact, in 1992 China and Mexico each reported FDI inflows that were substantially higher than those recorded for eastern Europe and the former Soviet Union as a whole, and Argentina and Malaysia received comparable amounts.

- While cumulative FDI flows into the region amounted to over US$ 12 billion between 1990 and 1993, the Czech Republic, Hungary and the Slovak Republic alone attracted two-thirds of the total. Together with Estonia and Slovenia, these countries accounted for shares of inflows into the region out of proportion to their size. The rest of the region, with 91 per cent of the population, received only 32 per cent of cumulative inflows.

- From the limited information available on the sectoral distribution of FDI, it appears that a strong majority of projects represent manufacturing activities (see Table 9.2).[3] In Hungary, for which disaggregated data are available, there is a more recent trend towards investment in the service sector, with commerce gaining particular prominence, but also with substantial flows into the telecommunications, roads and utility sectors.[4]

- FDI projects in the transition economies tend to be smaller than in other countries; nevertheless, a few large investments account for the bulk of capital invested. For instance, the region accounted in 1992 for only 1.3 per cent of registered German capital abroad, but for 3.4 per cent of the number of German FDI projects.[5] In Hungary, by the end of 1992, 32 foreign enterprises had each invested over one billion forints (about $10 million), whereas the average amount associated with FDI projects in Hungary was 21 million forints; half of the projects were for less than 1 million forints. The top 5 per cent of projects accounted for 85 per cent of the total paid-in capital in all projects in Hungary.[6]

What explains these developments? The analysis of FDI suffers not only from problems of measurement, but also from weaknesses in the theoretical foundation. Economics has never been renowned for its ability to predict domestic

1 See Meyer (1994). Operational definitions, usually following the IMF's *Balance of Payments Manual*, recognise that data on actual control are hard to obtain. The IMF recommends measuring FDI as cross-border equity participations whose original capital share surpasses a 10 per cent benchmark, reinvested earnings, and long-term loans by parent companies.

2 Note that the distribution of FDI among developing countries, just as in the transition countries, is far from homogenous, with a handful of countries in East Asia and Latin America - and China in particular - taking the lion's share.

3 Note that Table 9.2 refers to investment commitments by number of projects, not effective flows, and is based on journalistic evidence and thus incomplete for smaller projects.

4 Hungarian data are discussed by Lane (1994).

5 Meyer (1994).

6 As reported in Lane (1994).

**Table 9.1 Foreign direct investment into eastern Europe and the former Soviet Union [1]**

| | FDI (millions of US dollars) | | | | Cumul. | % of | FDI per capita | | % of PPP | % of current |
|---|---|---|---|---|---|---|---|---|---|---|
| | 1990 | 1991 | 1992 | 1993 [2] | 1990–93 | total | 1990–93 | 1993 | $-GNP [3] | $-GDP [4] |
| Albania | – | – | 19 | 20 | 39 | 0% | 13 | 6 | – | – |
| Bulgaria | 4 | 56 | 42 | 62 | 164 | 1% | 19 | 7 | 0.15% | 0.49% |
| Croatia | – | – | 16 | 30 | 46 | 0% | 10 | 6 | – | 0.25% |
| Former CFSR | 188 | 592 | 1,054 | – | 2,600 | 21% | 167 | – | – | – |
| Czech Republic | – | – | 983 | 606 | – | – | – | 59 | 0.82% | 1.92% |
| Slovak Republic | – | – | 71 | 160 | – | – | – | 30 | 0.56% | 1.46% |
| Estonia | – | – | 58 | 122 | 180 | 1% | 113 | 76 | 1.31% | 7.05% |
| Hungary | 311 | 1,459 | 1,471 | 2,200 | 5,441 | 44% | 528 | 214 | 3.81% | 6.03% |
| Kazakhstan | – | – | 100 | 300 | 400 | 3% | 24 | 18 | 0.42% | 1.40% |
| Latvia | – | – | 43 | 60 | 103 | 0% | 38 | 22 | 0.54% | – |
| Lithuania | – | – | 5 | 40 | 45 | 0% | 12 | 11 | 0.34% | – |
| Poland | 88 | 117 | 284 | 350 | 839 | 7% | 22 | 9 | 0.18% | 0.41% |
| Romania | –18 | 37 | 73 | 48 | 140 | 1% | 6 | 2 | 0.08% | 0.19% |
| Russia | – | 100 | 800 | 1,100 | 2,000 | 16% | 13 | 7 | 0.14% | 0.63% |
| Slovenia | –2 | 41 | 113 | 123 | 275 | 2% | 138 | 62 | – | 1.03% |
| Uzbekistan | – | – | 100 | 45 | 145 | 1% | 7 | 2 | 0.08% | 0.18% |
| **Totals/Averages** | **571** | **2,402** | **4,178** | **5,266** | **12,417** | **100%** | **41** | **18** | **0.37%** | **1.17%** |
| Central Europe | 585 | 2,209 | 2,938 | 3,469 | 9,201 | 74% | 129 | 49 | 1.38% | 2.38% |
| The Baltics | – | – | 106 | 222 | 328 | 3% | 40 | 27 | 0.69% | – |
| Southern Europe | –14 | 93 | 134 | 130 | 343 | 3% | 10 | 4 | 0.12% | 0.35% |
| Central Asia | – | – | 200 | 345 | 545 | 4% | 14 | 9 | 0.27% | 0.75% |

Sources and notes:

1 FDI values from national balance of payments statistics.

2 Results for 1993 are preliminary.

3 1993 FDI divided by 1993 GNP at purchasing power parity (PPP values from *World Development Report*) as defined in footnotes in Appendix 10.1.

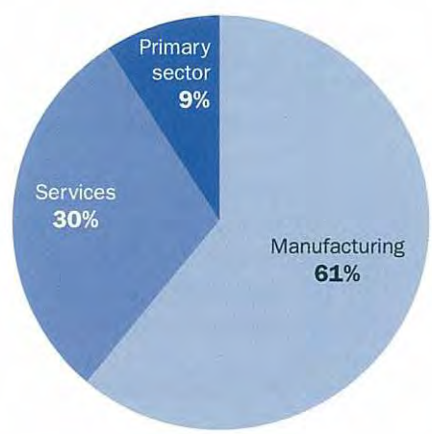
4 1993 FDI divided by 1993 current dollar GNP.

**Table 9.2 FDI by sector in eastern Europe and the former Soviet Union**

| Sector | number of projects | per cent of the total number of projects |
|---|---|---|
| Electricals, electronics, computers, telecommunications | 472 | 11.4% |
| Food & beverage production, agribusiness | 426 | 10.3% |
| Oil & gas, mining & metals | 389 | 9.4% |
| Automotive, aircraft, railway manufacture, shipbuilding | 373 | 9.0% |
| Financial services | 340 | 8.2% |
| Chemicals, plastics, glass | 188 | 4.5% |
| Engineering, heavy machinery | 180 | 4.4% |
| Building materials, construction | 165 | 4.0% |
| Textiles, fashion, footwear | 157 | 3.8% |
| Miscellaneous services | 901 | 21.8% |
| Miscellaneous manufacturing | 544 | 13.2% |
| **Total** | **4,135** | **100.0%** |

Source: *East European Investment Magazine* database. Based on the number of completed, failed, announced and tentative projects in the period 1991 to March 1994, as reported in the Press.

**Sector breakdown**




Source: *East European Investment Magazine* database. Based on the number of completed, failed, announced and tentative projects in the period 1991 to March 1994, as reported in the Press.

investment, and the cross-border dimension of FDI adds further difficulties.

The principal industrial organisation theories of FDI focus on the internalisation of transaction costs and on the behaviour of oligopolies. The internalisation approach may explain why a firm would favour one particular organisational form in a foreign country over others - direct investment over licensing or subcontracting, for instance.[7] The oligopoly approach derives the investment decision from company strategies aimed at gaining or preventing competitors from acquiring (additional) market share. Both approaches stress firm-specific and sector-specific factors in the investment decision, and neither is well suited to explain aggregate levels of FDI or its variation across countries.

Other theories of FDI emphasise locational factors - market size, factor cost advantages, proximity to major markets, and the legislative, political and economic environment - but suffer from the diversity of motives that firms might have in establishing production bases abroad. The classical focus on differential returns to capital across countries has provided only limited explanatory power in empirical tests.[8] In a classification according to J. Dunning,[9] firms may seek resources (e.g. raw materials, labour and technology), markets, efficiency (in optimising multinational production networks), or strategic assets (such as brand names or existing distribution systems, which refers back to the oligopoly approach). The weight of individual locational factors differs depending on these motives.

In view of these difficulties, the discussion on FDI in the region in the following section adopts an eclectic approach. First, the legislative environment for FDI is analysed. Second, a number of investor surveys are examined to detect patterns in the motivations and obstacles perceived by actual and potential investors. These results then form the basis for a discussion of the observed patterns. The aim, at this stage of analysis, is to raise questions; the provision of answers will have to await further research.

## 9.2 The legislative environment for FDI

Almost all countries of eastern Europe and the former Soviet Union have passed legislation designed to make the environment for foreign investment more attractive. Table 9.3 contains some of the salient features of the present legislation. In spite of the progress made, it remains difficult to start and to operate a business, and the pace of change in the region often leads to legal inconsistencies and a lack of clarity. To overcome some of these difficulties, 10 countries have established agencies to facilitate and promote FDI, and more plan to do so.[10] The establishment of "one-stop-shops" should help in tackling the lack of transparency and reduce the frustrations of dealing with frequent modifications and complex administrative processes.

In the pre-reform transition economies, FDI was generally prohibited or suffered from excessive regulation. The majority of countries in eastern Europe and the former Soviet Union are in the process of removing restrictions.[11] Over the past three years most have enacted or amended specific foreign investment laws, often in advance of other legislation to support the new market environment. The former Yugoslavia's Foreign Investment Laws (1967) have been revised in Slovenia, but are still valid in Croatia. New laws have been submitted for parliamentary approval in Russia and Armenia. Only in the Czech and Slovak Republics have foreign investment laws been replaced by new Commercial Codes (similar to those in force in most Western countries) which deal with both foreign and domestic investments in the same legislation.

As markets have been liberalised, most organisational forms and most economic activities have been opened to foreign capital. It is now common for governments to guarantee that foreigners will be no less favourably treated than their domestic counterparts. Complete foreign ownership is permitted everywhere (except for Georgia where foreigners are, somewhat mysteriously, limited to 99 per cent). FDI regulation typically stipulates that FDI is allowed unless prohibited by other legislation. Yet special registration of ventures with foreign participation is still required in two-thirds of the countries in eastern Europe and the former Soviet Union, and, depending on the sector of operation, authorisation and licences are frequently required. Restrictions on FDI are generally in the sensitive military, financial and mass media industries, but can be more extensive, as in Latvia. Foreign participation in privatisation programmes is increasingly permitted but is often subject to approval by different levels of authorities.

7 See, for instance, Casson (1987).

8 See, for instance, Agarwal (1980).

9 For instance, Dunning (1993); this is based on earlier work by J. Behrman.

10 Many of the foreign investment agencies (FIAs) have been established with the assistance of the EC-PHARE programme. FIAs can be found in Albania, the Czech Republic, Hungary, Kazakhstan, Kyrgyzstan, Lithuania, Poland, Romania, the Slovak Republic and Slovenia. Russia, Estonia and Tajikistan are expected to open offices before the end of 1994. Further assistance is available from the chambers of commerce, and government foreign economic relations departments.

11 Two recent examples illustrate progress in the lagging economies of the former Soviet Union. In August 1993, the Belarus National Bank abolished the special investment exchange rate. In another conscious effort to remove barriers to FDI, Kazakhstan abolished the local taxes levied on the purchase and sale of foreign exchange. Before February 1994, these taxes had accounted for up to 20 per cent of transaction value.

In most transition countries foreign investors are guaranteed unrestricted after-tax repatriation of profits, yet many countries limit capital repatriation to the cessation of operations. In addition, the Czech Republic, Hungary and and the Slovak Republic restrict, in support of capital controls, the transfer abroad of salaries to expatriates. Five countries (Romania, Slovenia, the Slovak Republic, Ukraine and Uzbekistan) charge withholding taxes of 10–15 per cent on remittances. Conversion of local currency revenues into foreign exchange may be subject to approval. Furthermore, in a number of CIS republics, local currency profits must be exchanged at rates that are less favourable than those applied to other current account transactions.

In various countries governments extend guarantees to foreign investors against losses due to property restitution. In the majority of countries, foreign enterprises may own buildings and other assets, although this is often subject to restrictions and regulations. In contrast, land ownership is either prohibited or remains a strongly debated issue in more than half of the countries. Restrictions on property ownership may be offset by government guarantees, leases of up to 99 years and legislative loopholes. For example, while foreign land ownership is highly restricted in Russia, foreign investors theoretically have the right to own all assets acquired through privatisation, including the land under the facility's buildings.

Investment incentives for foreigners and new domestic enterprises can be found to varying degrees in most countries of the region, with tax holidays and reduced profit tax rates being the most common. Tax holidays tend to be available for periods from two to five years after the first year's profit has been recorded. However, in Turkmenistan foreign companies can enjoy up to 16 years relief, with further extensions possible if profits are reinvested. Apart from profit tax exemptions, many of the transition economies try to entice FDI with special trade regulations. In nearly every country, FDI is exempt from some export licensing and quota requirements, as well as from duties and other fees.[12] The extent and duration of incentives is often dependent on the amount of capital contributed, the degree of foreign ownership, and the reinvestment of profits. Several countries provide extra incentives to encourage investment in less developed regions. Concessions are also often granted in areas, such as infrastructure development, which have been identified as priority sectors. Furthermore, 14 of the countries for which information is available have established free economic zones with special operating conditions for export producing ventures.

While the attractiveness of investment incentives in developing countries is often offset by restrictions tied to them, special performance criteria for FDI, such as export or local content requirements, are rare in eastern Europe and the former Soviet Union.[13] Incentives linked to industrial or social policy objectives tend to be available to both foreign and domestic enterprises.

Special incentives for FDI, that emerged at the beginning of the transition period, are being removed in some countries where legislation is shifting towards genuine "national treatment" of all investment and portfolio placements. The Czech Republic eliminated nearly all special FDI incentives in 1993. At the beginning of 1994, Hungary followed suit by abolishing tax holidays for companies with foreign participation. Yet, faced with a sharp decrease in foreign investment in 1994, the newly established socialist government in Hungary has promised to reinstate broader incentives. Russia, Bulgaria and Estonia have also recently removed tax relief for foreigners.

Certain governments offer foreign investors guarantees which are meant to mitigate risk. In Azerbaijan and Bulgaria the FDI legislation is contained in laws with the title "Protection of Foreign Enterprises". In Uzbekistan, the law on foreign investments protects management from government interference. Turkmen legislation places FDI squarely under "state protection". Furthermore, several countries have included "grandfathering" clauses which exempt foreign enterprises from unfavourable legal changes for up to ten years.[14]

## 9.3 Investor motivations

While the overview over legislative provisions shows several shortcomings and some contrast between countries, these appear hardly sufficient to explain the pattern of FDI that has been observed. Additional evidence can be derived from surveys among potential investors in eastern Europe and the former Soviet Union. Summaries of 10 such surveys are contained in chronological order in Table 9.4, which lists obstacles to and motivations for investment by order of importance. Comparing and interpreting these surveys is problematic, since they cover different groups of countries and respondents with different characteristics. They also sometimes use radically different methodologies.[15] Nevertheless, keeping these shortcomings in mind, the combination of surveys reveals

[12] In the Czech Republic, it is estimated that total savings of companies with foreign participation as a result of duty-free imports might amount up to one billion koruna annually (*East West Investment News*, No.4, 1993).

[13] However, participation in privatisation programmes may be subject to employment and other guarantees (such as in Estonia).

[14] Azerbaijan, Tajikistan, Ukraine and Uzbekistan stipulate that foreign companies are protected from legislative changes for 10 years, and Belarus offers 5 years protection. Although automatic tax holidays were abolished in Hungary in 1994, existing beneficiaries may theoretically continue to enjoy benefits until 2003.

[15] In addition, the quality of some of the surveys is questionable; unfortunately, full methodologies cannot be reproduced here.

## Table 9.3 Legal environment for foreign investment in each country in transition

Eastern Europe and the Baltic states

| | Foreign investment laws | Restrictions on activities | Profit & capital repatriation | Property ownership |
|---|---|---|---|---|
| **Albania** | Law on Foreign Investment (Nov. 1993). Law on Profit Tax (1993). | Restrictions on basis of national security and public order. National treatment. 100% ownership by foreigners not explicitly allowed. Licence for activities that affect the environment. | No restriction on after-tax profit or capital repatriation. 10% withholding tax eliminated in 1993. | May lease property for up to 99 years, or own in cases of "special importance" subject to parliamentary approval. |
| **Bulgaria** | Law on Protection of Foreign Investment (June 1992) repeals Foreign Investment Law (July 1991). | Licence or permission required for defence, banking, natural resource sectors, and if in certain geographic areas. | No restriction on after-tax profit or capital repatriation. | Constitution prohibits foreign land ownership. Foreign "persons" may own buildings, and lease land. If foreign ownership is less than 50%, may acquire agricultural land. |
| **Croatia** | Former Yugoslav Investment Law (1967) still valid. Law of Companies forthcoming in 1995. | Restrictions for military, rail and air transport, telecommunications, publishing and media. Foreign investor personal liability only possible if Croatian co-owner is also personally liable. | No restriction on after-tax profit or capital repatriation. | May own buildings and sites if business is performed in Croatia. Agricultural lands and coastal sites are excluded. No restitution law set or planned. |
| **Czech Republic** | Commercial code (1991) supplants Foreign Investment Laws. | Prohibited in some infrastructure sectors. Approval generally not required unless large privatisation, defence, financial sector or trade projects. | No restriction on profit repatriation. Capital may be repatriated at cessation of business. Restriction on salary repatriation. | Property ownership is a guaranteed constitutional right. Only Czech-registered businesses may own property. |
| **Estonia** | Law on Foreign Investments (Sept. 1991), some amendments by Act on Implementation of the Rights in Things, Dec. 1993. | No restrictions on sector. Specific licences for foreign investors required in banking, mining, energy, certain utilities, transport, retail sales of medicines and communication. | No restriction on profit or capital repatriation. Reporting requirements on foreign exchange abolished May 1994. | Property ownership allowed, with approval for offices and business purposes. Land not yet subject to trade, but can be owned if part of production premises. Uncertainty due to restitution. |
| **FYR Macedonia** | Foreign Investments Act (May 1993). | Investment in insurance, banks regulated by law. | 1991 Constitution (Art 59) guarantees free transfer of profit and invested capital. | Former Yugoslav Property Law that has been accepted as a republic law since 1980 still applies. Draft law on restitution in preparation. |
| **Hungary** | Act XXIV of 1988 on the Investments of Foreigners in Hungary (amended 1990, 1991 and 1994), Act LXXXVI of 1991 on Corporate Tax (amended 1992 and 1993). | Prior government approval necessary in banking. Otherwise, foreign investors face the same rules as domestic companies. | No restriction on profit or capital repatriation. Only 50% of expatriate salaries may be remitted outside the country. | Restriction on acquisition by foreign individuals or companies. No restriction for Hungarian companies with foreign ownership. |
| **Latvia** | Law on Foreign Investment (Nov. 1991) amended (March 1993). | Must be limited liability or joint stock. Permission needed if gaining control of company with capital greater than $1 million. Few industries prohibited, many others require licences. | No restriction on profit or capital repatriation. | May not own land. May lease for up to 99 years, and own buildings on leased land. Uncertainty due to restitution but claims had to be filed by 1 June 1994. |
| **Lithuania** | Law on Foreign Investments (Dec. 1990, amended Feb. 1992). New law expected to be adopted before end-1994. | Foreign activity subject to licensing, but not the buying of shares in stock corporations. Restrictions in a number of sectors. Permission of Council of Ministers required for monopolies. | No restriction on after-tax profit or capital repatriation. | Non-citizens may not own buildings and structures. May not own land, but can lease at fixed rent for up to 99 years, with priority right to prolong lease. |
| **Poland** | Law on Companies with Foreign Participation (1991), Commercial code (1932), Law on Public Trading in Securities (1991). | Permit required for defence, real estate, port and airports, wholesale trade in securities and legal activities. Approval required for bank, insurance and other financial services. | No restriction on profit or capital repatriation with the exception of banks. | Permit from the Ministry of Interior is required unless foreign shareholding is below 50%. In certain situations a permit from the Ministry of Privatisation is required. |
| **Romania** | Foreign investment Law no. 35 (1991, amended 1993), Privatisation Law no. 58 (1991), Foreign Investment in Petroleum Sector Law no.66 (1992), Law on Additional Incentives for Investments in Industrial Sector no.71 (July 1994). | Allowed in all sectors provided not against environment, national security and public order, health and good morals. Special authorisation required for banking, insurance and securities transactions. | No restrictions on profit or capital repatriation. 10% withholding tax on dividends and profits transferred. | Romanian registered company may theoretically buy land for business activity; in practice, the most accepted vehicles are long-term lease or concession. May lease agricultural land. In June 1993 parliament refused to confirm foreigners' right to buy land. |
| **Slovak Republic** | Commercial Code supplants Foreign Investment Laws. Decree on Tax Holidays and other fiscal incentives (March 1993). | Not in national security, some infrastructure sectors. Approval required for JV with state participation, or international trade projects. Special permission required for banks. | No restriction on profit repatriation. Capital may be repatriated at cessation of business. Some restrictions on salary repatriation. Repatriation subject to some withholding taxes. Licence required to hold foreign currency. | May own property. Slovak-registered businesses may own land. |
| **Slovenia** | Foreign Investment Law (1967, revised 1988), Law on Foreign Trade Transactions (Feb. 1993). | May operate in any sector. 100% ownership prohibited in military, rail & air transport, mass media and insurance sectors. Minimum investment of $950 for limited liability, $9,500 for joint stock. | No restrictions on profit repatriation in currency of original investment. Capital may be repatriated at cessation of business. 15% tax on paid out dividends. | Foreign companies or JVs may own real estate, but not foreign legal or natural persons. |

| Tax treatment and incentives | Participation in privatisation | Other |
|---|---|---|
| Corporate tax rate is 30%, 40% for tourism, 50% for 100% foreign owned oil or gas activities. Exempt 2 years, reduced by 50% next 3 years. 60% rebate on tax if profits are reinvested. | Participation in privatisation permitted with approval from National Agency for Privatisation; approval by Council of Ministers required for large-scale enterprises. | Exemption from payment of customs duties may be granted. |
| Corporate tax rate is 30%. Tax relief for foreign investors removed. Priority industries may be tax exempt. If in free economic zones, exempt for 5 years, then reduced by 20%. | Participation in privatisation permitted with authorisation from relevant economic ministry. If investment is greater than 10 million levs, authorisation from Privatisation Agency is required. If greater than 200 million levs ($ 33 million), authorisation from Council of Ministers is required. | Laws refer to foreign persons instead of foreign investment. Free economic zones. Despite FDI exemption from import duties for export production, these are charged in practice. |
| Corporate tax rate is 25%. Exempt up to 2 years, or longer if profits are reinvested. | Participation in privatisation requires approval by management, employees and Croatian Fund for Privatisation. | Custom duties (average 8%) on invested equipment unless foreign ownership is greater than 20%. |
| Corporate tax rate is 42%. Most exemptions for foreign investors eliminated in 1993, but negotiable for priority sectors. Some incomes are tax exempt (i.e. electricity plants), others are taxed at special rates (i.e. consulting services). | Participation in privatisation is permitted with approval from the Ministry of Privatisation. | Free economic zones. If foreign ownership is greater than 30%, exempt 1 year from custom duties. |
| Corporate tax rate is 26%. Special tax holidays for foreigners eliminated in new tax law in force since Jan. 1994 (but "grandfathering" clause). | No specific restrictions on foreigners. Evaluation of "entire bid" takes employment and investment into consideration. | |
| Corporate tax rate is 25%, 5% for food production, 10% for most services. Income tax reductions in initial period and if profit reinvested. | Privatisation programme to begin in 1994. Foreign participation in certain JVs permitted. | Some customs duty relief for foreign investors. Large monetary fines for economic crimes such as not meeting investment laws. |
| Corporate tax rate is 36%. Automatic holidays abolished in 1994, but "grand-fathering" until 2003. Priority investments (independent of foreign participation) may get tax preferences. 85% tax holiday for 100% foreign-owned offshore companies under certain conditions. | Participation in privatisation permitted upon agreement with State Property Agency (AVÜ) and State Holding Company (AV Rt.). | Free economic zones. Offshore companies. Export licence and import quota and licences required for certain goods. Technology and infrastructure projects may receive grant from the Investment Promotion Fund. |
| Corporate tax rate is 35%, 25% for non-incorporated companies, 45% financial, trade sectors. If foreign ownership greater than 30%, exempt 2 years after first profit, reduced 50% next 2 years. If in priority sector, or foreign ownership greater than 50% and more than $50,000, exempt 3 years, reduced 50% next 5 years. | Participation in privatisation permitted with approval from branch of the appropriate Ministry and from Ministry of Economic Reforms. Foreign investment encouraged in priority industries such as construction and light industry. | |
| Corporate tax rate is 29%. If investment made before Dec. 93, tax reduced 70% for 5 years, reduced 50% next 3 years. If invested Jan. 94-Dec. 95, reduced 50% for 6 years. Further reductions for priority sectors or if profits are reinvested. Exemptions pro-rated for JVs. | Participation in privatisation permitted if objects on special list of privatisation against hard currency (confirmation by Central Privatisation Commission). Employees have right to obtain up to 50% of shares in privatising company. | Drafting group established to set up free economic zones. |
| Corporate tax rate is 40%. 3-6 years exemption may be granted if investment in priority sector, made before Dec. 1993, and greater than ECU 2 million. If exports and other conditions, may be reduced 25-50%. Revenue from agriculture, forestry exempt. | Participation in privatisation permitted with approval from the Ministry of Privatisation. | Free economic zones. |
| Corporate tax rate is 30% for profit up to Leu 1 million, 45% thereafter. If foreign ownership is greater than 20% or $10,000 exempt 2-5 years depending on sector. Reductions may be extended for activities with certain characteristics (exports, R&D, other). Additional special tax incentives in petroleum and industrial sectors. | Participation in privatisation permitted with approval from the State Ownership Fund and, as the case may be, the Private Ownership Fund. Foreign participation not allowed in natural resources, infrastructure and arms sectors. | Free economic zones. Exemption for 2 years on custom duties on raw materials used for production purposes. Special import duty exemptions in petroleum and industrial sectors. Exempt from import duty on equipment if contributed in kind or financed by foreign cash contribution. |
| Corporate tax rate is 40%. If investment was made after 1993, exempt 1 year, 2 years in specified regions. If foreign ownership is greater than 30%, exempt next 2 years. Further reductions if profits are reinvested. Special reductions for banks. | Participation in privatisation permitted with approval from the Ministry of Administration and the Ministry of Privatisation of National Property. | If foreign ownership is greater than 30%, or 10 million crowns ($.3 million), duty-free import of investment goods valid until end of 1995. Free economic zones. |
| Corporate tax rate is 30%. Reduced 20% for 1 year. If profits are reinvested in Slovenia, tax reduced up to 10% for next 4 years. Further incentives to hire, train unemployed workers. | Participation in privatisation permitted with approval from the Agency for Privatisation. Decision to privatise must come from management and employees. | Six free economic zones. Discounts on customs duties if the products are not manufactured domestically. |

## Commonwealth of Independent States

| | Foreign investment laws | Restrictions on activities | Profit & capital repatriation | Property ownership |
|---|---|---|---|---|
| **Armenia** | Law on Foreign Economic Activity (Jan. 1992) New law submitted to parliament. | May form JV with government or private firms. | No capital controls in place. | May not own land, but may lease for up to 99 years. |
| **Azerbaijan** | Law on Protection of Foreign Investments (Jan. 1992). New FDI law is to be debated in parliament in autumn 1994. | Allowed in any activity not prohibited. Some require licences. Government may impose territorial restrictions for national security. Must pay in 50% of declared capital by end of first year. | No restriction on after-tax repatriation of profit and capital. | May be granted use or lease of land. |
| **Belarus** | Law on Foreign Investment (1991, amended 1993). | Must pay in 50% of declared capital in the first year, entire amount in 2 years. Foreign ownership in insurance limited to 49%. | If foreign investment is greater than 30%, may repatriate export currency earnings. Limits on purchase of foreign-exchange. Capital may be repatriated at cessation of business. | May own property and lease land for up to 99 years according to laws. May lease land for farming. |
| **Georgia** | Law on Foreign Investments (Aug. 1991, review planned). | May own up to 99%. Capital contribution calculated at official rate. | No restriction on profit or capital repatriation. | May not own land. No land disposition rights. |
| **Kazakhstan** | Presidential Decrees (1994), Foreign Investment Law (Jan. 1991, amended April 1992). | Prohibited in military sector. Must register. Authorisation required for finance sector and large investments. | No restriction on after-tax profit repatriation, limits on capital repatriation before cessation of business. | May own buildings. No private market in land. Presidential Decree of April 1994 allows markets in all land rights including permanent use, except absolute ownership. Legal entities may buy such rights. |
| **Kyrgyzstan** | General Principle of Foreign Economic Activity (April 1991), Law on Foreign Investments (June 1991, amended May 1993), Law on Concession (March 1992). | Must pay in 50% of declared capital in first year. Many activities require licences or permits. These may be cancelled if investment not implemented within 12 months. | No restriction on profit repatriation. 5% withholding tax if tax concessions used. | May acquire buildings necessary for business. May use and transfer investment to other juridical persons. May lease land. |
| **Moldova** | Law on the basis of foreign activity (Jan. 1992). | JVs limited to certain sectors. Minimum investment of $10,000. Foreign ownership in banks limited to 35%. | No restriction on profit or capital repatriation. | May not own land, but may lease for up to 99 years with possibility of extension. |
| **Russian Federation** | Law on Foreign Investments (July 1991), Law on Currency Regulation and Control (October 1992), Law on Enterprises and Entrepreneurship (Dec. 1990), Presidential Decree No. 1,466 (Sept. 1993), a number of Government Decisions concerning various aspects of foreign investor activity, "Regulation governing the activity of joint-stock companies" (Decision No. 601, Dec. 1990). | No restrictions to foreign investment unless imposed by law or Presidential Edicts. Certain types of activities (insurance, banking, some others) are subject to licence issued by the relevant state authority. | No restriction on profit or capital repatriation. Non-resident dividend withholding tax. Must convert at authorised banks. Use of cash foreign currency banned, but other forms of foreign currency allowed. | May buy land and buildings used for business, but difficult in practice, especially in relation to land. May own land occupied by enterprises bought during privatisation. In certain regions (e.g. Moscow) only lease rights are available. |
| **Tajikistan** | Law on Foreign Investment (1991, amended 1992). | | No restriction on profit or capital repatriation. | May not own land. Government guarantee that foreign property will not be nationalised. |
| **Turkmenistan** | Special Presidential decree (1993), Foreign Exchange Control Law (1993), Exemptions in tax law (March 1994). | Allowed in any activity not prohibited. Some sectors require licences. | No restriction on profit repatriation. Capital may be repatriated at cessation of business. | No restriction on the right to use property or capital. |
| **Ukraine** | State Programme (1994) revises Decrees on Foreign Investments (May 1993) which replaced Law (March 1992). Law on Protection of Foreign Investments (Sept. 1991). | Allowed unless prohibited. Some sectors incl. financial activities require licences. Permission required if foreign investment is greater than $1 million. Minimum investment of $500,000 for joint stock. Ten priority areas. | No restriction on profit repatriation, yet cumbersome as exchange subject to screening. Capital may be repatriated at cessation of business. 15% tax on transfer of income, profits, assets. | May own buildings, and lease land for up to 50 years. Ownership of natural resources is regulated. |
| **Uzbekistan** | Law on Foreign Investments (June 1991, amended July 1993, May 1994). | Allowed unless prohibited. May require authorisation. Finance, agribusiness, resources, tourism, telecommunications are priority sectors. Foreign trade barters deals prohibited, except in construction, timber and oil where they are taxed. | No restriction on profit or capital repatriation, subject to 10% tax. 15% tax on hard currency earnings. | May own facilities, and lease land. No decision yet made on land privatisation. |

| Tax treatment and incentives | Participation in privatisation | Other |
|---|---|---|
| Corporate tax rate is 30%. If foreign ownership is greater than 50%, reduced 50%. If greater than 30%, may carry loss forward 5 years. | Participation in privatisation permitted as per Privatisation and De-Statism Law (July 1992). Investment subject to certain hard-currency requirements. | 50% export surrender requirement at official rate. |
| Progressive 25-35% corporate tax rate. 45% for banks and insurance. If foreign ownership is greater than 30%, corporate tax rate is 25% on foreign share of profits. JVs may have 2-year tax holiday in cases of "material production". | Participation in privatisation permitted as per Privatisation Law (Jan. 1993). | JVs exempt from export licences. 10-year "grandfathering" clause. Export surrender requirement at official exchange rate, but JVs with more than 30% foreign participation are exempt from this requirement, as well as from export licences where they export their own goods. |
| Corporate tax rate is 30%. If foreign ownership is greater than 30%, exempt for 3 years. If in priority industries, reduced 50% next 3 years. | Participation in privatisation permitted as per Foreign Investment and Privatisation and De-Statisation[Statism?] Laws (1993). | All concessions for foreign investors only valid after 50% of declared capital has been certified. 5-year "grandfathering" clause. Free economic zones in development regions. |
| General corporate tax rate is 20%, 10% for industry and construction, 35% for banks and insurance. New enterprises exempt 1 year, reduced 50% next 2 years. Foreigners exempt 2-5 years. | No limits on foreign participation in privatisation. | Price controls for electricity, water, natural gas, coal and transportation. Current account convertibility through licensed foreign exchange dealer. 32% export surrender requirement at official rate. |
| Corporate tax rate is 35%. If foreign ownership greater than 30% and priority sector, exempt 5 years after first profit, reduced 50% next 5 years. If in free economic zone, exempt up to 5 years. Exemptions now in doubt since apparently abolished by March 1994 "Explanation Letter" of Min. of Finance. | No limits on foreign participation in privatisation. Licence from the National Agency for Foreign Investment required. | Must insure assets, etc. with Kazakh insurance companies. Free economic zones. 50% export surrender requirement to local currency market, but rates largely unified. |
| Corporate tax rate is 35%. If foreign ownership is greater than 50%, exempt 5 years, reductions extended if profits are reinvested. Priority activities exempt 100% for 5 years, reduced 50% next 5 years. | Participation in privatisation permitted in priority sectors including hydro-electricity, military conversion, oil and gas industries. | Material imported custom free. Other privileges in free economic zones. |
| Corporate tax rate is 35%. Exempt up to 6 years depending on industry. | No relevant legislative provisions. | Legislation brought forward which would require 10% of declared capital to be paid up front. 35% export surrender requirement. JVs with investment over $250,000, foreign dividends, profits from securities are exempt this requirement. |
| National treatment. Maximum rate of profit tax is 38%, but 43% for Banks and insurance companies. In certain activities, small enterprises (<100 employees) with less than 25% state participation exempt from profit tax for 2 years after registration. A number of regional and local taxes, but also regional incentives. | National treatment with several exceptions. Participation in privatisation in certain branches of industry subject to approval of RF government or local authorities. If foreign investor is only participant in an auction or tender, a special price applies. | Free economic zones. 60% tax on personal items brought in by expatriate employees (if in excess of $2,000). Contributions to the charter fund of JV with Russian partner exempt from taxes if made within specified time period. Exporters obliged to sell minimum 50% of currency earnings to Republican Fund or 30% to foreign currency exchanges. |
| Corporate tax rate is 30-45%. If foreign investment is greater than 30%, rate is 30% and there is a 2-year exemption. In free economic zones may carry operating loss forward 5 years. | No relevant legislative provisions. | Free economic zones. 10-year "grandfathering" clause. 30% export surrender requirement. |
| Corporate tax rate is 25%. If foreign ownership is greater than 30% exempt 3 years, 50% next 3 years, 30% reduction next 10 years. Further exemption if more than 50% of profit is reinvested. | Privatisation remains largely at planning stage. | Foreign Investment "under the protection of the State". 40% export surrender requirement at official rate, plus 10% at double the official rate. |
| Corporate tax rate is 35%. If foreign investment is greater than $10,000 exempt 1 year after first profit. Reduction for priority sectors extended 1year, 2 years if investment is greater than $500,000, 3 years if greater than $5 million, 5 years if greater than $50 million. | Participation in privatisation permitted with approval from the State Property Fund or the local privatisation agency. | Free economic zones. Marginal personal income tax for income over $150 per month is 90%. 10-year "grandfathering" clause. 50% of export earnings must be sold to foreign exchange fund at official fixed rate. |
| Corporate tax rate is 18%, 30% for banks. If foreign ownership is greater than 30%, or if priority, tax reduced up to 5 years. Further reductions if foreign ownership is greater than 50%. | Mass privatisation planned for 1994-95. | Law protects foreign investors from government interference. 10-year "grandfathering" clause. 15% export surrender requirement at official rate. This requirement exempt if foreign ownership is greater than 50%. |

## Table 9.4 Results of foreign investor surveys

| Survey | Sample and date | Obstacles |
|---|---|---|
| Susan Collins & Dani Rodrik, "Eastern Europe and The Soviet Union in the World Economy", Institute for International Economics, 1991. | Survey of 54 large firms (of which 21 investors) from Europe, Japan, US on investment intentions for CEE and the FSU. Winter 1990-91. | Political and economic uncertainty, lack of protection of private property, repatriation restrictions. |
| Jonathan B. Welch, "Investing in Eastern Europe: Perspectives of Chief Financial Officers", The International Executive, Vol. 35 (1) Jan./Feb. 1993. | Survey of 39 chief financial officers of Boston companies with actual or planned investments in eastern Europe. April-May 1991. | Primary risk in financing, distribution systems and technology. Political unrest, low labour skill levels less important. Relatively less concerned with regulatory and hard currency problems.National Economic Research |
| Associates (NERA), "Foreign Direct Investment to the Countries of Central and Eastern Europe", 1991. | Survey of 144 large companies (of which 79 investors) from Europe, Japan, US interested in East Germany, CEE and the FSU. Oct.-Nov. 1991. | Political and economic uncertainty. |
| Pietro Genco, Siria Taurelli & Claudio Viezzoli, "Private investment in central and eastern Europe: survey results", EBRD Working Paper, July 1993. | Survey of 82 companies already in eastern Europe, and their 34 parent companies in France, Germany, UK and Italy. Sept. 1991 - March 1992. | Lack of clearly defined legislation more important than economic problems. Operational problems, often associated with lack of infrastructure. |
| Deloitte Touche Tohmatsu International, "Successfully Managing Investments in Eastern Europe", 1992. | Survey of 168 companies with JVs in Bulgaria, Czechoslovakia, Hungary, Poland, Romania and Russia. April - Sept. 1992. | Lagging infrastructure. Regulatory issues. General economic situation. |
| Zhen Quan Wang, "Foreign Investment in Hungary: A Survey of Experiences and Prospects", Communist Economies & Economic Transformation, Vol. 5. No. 2, 1993. | Survey of 90 Western small and large companies with JVs in Hungary; conducted in 1992. | Major problems are inconsistent rules, poor infrastructure, shortage of hard currency and insufficient convertibility of the forint. Less frequent responses included inflation and economic uncertainty, difficulty of negotiating with local partner and operating problems. |
| Creditanstalt and The Economist Intelligence Unit (formerly Business International), "1992 East European Investment Survey", 1993. | Survey of 87 companies (of which 48 investors) in CEE and the FSU followed by some in-depth interviews. July 1992 | Political, economic, legal environment. Dealing with governments. Restructuring costs. Less concern with currency issues and ownership. |
| Matija Rojec & Marjan Svetlicic, "Foreign Investment in Slovenia: Experience, Prospects and Policy Options", Communist Economies & Economic Transformation, Vol. 5. No. 1, 1993. | Interviews of 11 Slovene enterprises and their foreign parent companies; conducted in 1993. | Economic and financial instability and risk due to transition. Inadequacy of and gaps in legal framework, particularly lack of privatisation law. Ambiguities about access to former Yugoslav markets. |
| Miklós Szanyi, "Experiences with Foreign Direct Investment in Hungary", Institute for World Economics, Hungarian Academy of Sciences, Working Paper No. 32, April 1994. | Survey of 15 European and American firms in a variety of sectors operating in Hungary. Aug.-Oct. 1993. | Deficient flow of information. Bureaucratic inefficiency and high tax. Problems with the financial system, physical infrastructure, privatisation practice. Economic and political uncertainty. |
| Arthur Andersen, "Assessing Investment Opportunities in Economies in Transition", for the OECD Advisory Group on Investment, forthcoming in 1994. | Interviews with 291 Western companies (162 investors) in CEE and the FSU, and professionals. Nov. 1993. | Main obstacles are bureaucratic administration and legislation, and weak infrastructure. Concern with economic and political climate. 50% claim no internal constraints. Others mention human resources. |

| Motivations | Other findings |
|---|---|
| New and expanding market, potential to beat out competitors by being first and proximity to EC markets most important. Low labour costs, skilled labour force, and investment incentives not considered strong attractions. | Number of investors expected to increase, but remain small in size. |
| Motivated by both defensive (eroding domestic profit) and offensive (market opportunities) reasons. Higher expected profits in the long term. | Best opportunities in next 5 years. Required ROI distribution concentrated between 16-20%. Low perception of education levels, work ethic. |
| Market potential most important. A few manufacturing companies also interested in export potential to other countries in the region and EC. | Small investment size indicates wait and see attitude. Little diversion of FDI from lagging EC regions where conditions and skill levels are deemed to be comparable. |
| New or broader markets for own products. Gather experience and establish a foothold. Acquire a dominant position. Much lower importance given to cheap labour, immediate profits, incentives. | Low opinion of skills of local managers. Prefer to set up new company rather than acquiring and restructuring. |
| Motivations for forming a JV: Western partners look for knowledge of local market, access and tax advantages; Eastern partners look for access to capital, new products, training, new technology. | Major staffing issues include task management, lack of language skills, lack of understanding of free markets, rising salaries due to excess demand and inflation. |
| Firms had multiple objectives. Top were market oriented: better access, expanding exports, maintain a foothold, transition opportunities. Less important motives include previous experience, relatively low cost labour, incentives, defending position against competition and diversification. | Past contacts with Hungarian firms affected FDI decision. While most JVs were less or equally profitable, 20% were more profitable than home-based operations. The majority said ROI had reached expectations and JV was successful. |
| Establishing market share. Base for regional market and EC. Low cost sourcing less important. Also following the client and going where resources and opportunities are. | Investment type and size dependent on key motivation, industry and country. Perception of problems differs by investor nationality and host country. |
| Market considerations (access, preserve, serve by export) by far most important. Some export-oriented FDI attracted by reduced costs. | Given small size of domestic market, preferential access to rest of former Yugoslavia very important. Slovenia's relative stability makes it attractive to serve other republics. |
| Size of domestic and regional markets most important motives. FDI also to follow key suppliers and customers. Attracted to Hungary by geographical location and quality of labour force. Financial incentives play almost no role. | FDI is part of a global strategy with a strong emphasis on seeking regional markets. Hungary regarded as a regional centre. |
| Key attraction is domestic market rather than low wages, cheap resources, investment incentives. | Most use a country-specific approach; however. some US and UK developing regional strategy. Obstacles led to change of strategy for 40%, cancellation or postponement of 18% of projects. |

some interesting patterns regarding locational factors and investor strategies.

Most striking perhaps is the predominance of market access among factors of importance to investor decisions. Eighty per cent of respondents in the NERA study of 1991, for instance, professed to be primarily interested in the local market, with little variation across (potential) host countries. More recent studies, such as the Arthur Andersen survey from late 1993, support this finding. While the domestic market of the host economy appears to be the main target, some studies also indicate that the possibility of subsequent expansion into regional (transition economy) market is of importance to investors.

Factor cost advantages are clearly rated as less important than market access in all the surveys. While some surveys (Collins and Rodrik, NERA, Creditanstalt) suggest that proximity to EU markets matters to investors - indicating perceived efficiency gains in locating production in the transition economies - most studies explicitly play down the role of cheap labour. The Szanyi study gives some importance to human capital in decisions to invest into Hungary, but in the Collins and Rodrik survey labour skills are discounted as a significant motive. In fact, findings reported in the last column of Table 9.4 suggest that Western executives often have a low perception of both labour and managerial skills and of the working ethic in the countries in transition. It is worth mentioning that other studies have shown that this perception tends to improve markedly with experience.[16] The virtual absence of access to natural resources as a motivation - in spite of the substantial commitments of foreign investment funds for this purpose reported in the press - is probably explained by the fact that projects in that sector tend to be large but few, as well as by the geographical bias towards central Europe of many of the surveys.

Strategic considerations reinforce the incentive to seek market access. Some of the surveys stress the importance of gaining a foothold in the new markets - a strategy designed to reduce capital exposure in risky environments while enabling companies to exploit potential opportunities. In the study by Collins and Rodrik, Genco et al. and in the Creditanstalt surveys, the role of some objectives, such as those of acquiring a dominant market position or beating competitors by acquiring first-mover advantages, suggests oligopolistic behaviour that is often dissociated from immediate profit motives. Lastly, the Creditanstalt and Szanyi surveys reflect some investors' desire to follow existing (Western) clients into the new markets.[17]

Given the substantial tax privileges granted by most countries of the region to foreign investors (as described in the previous section) it is remarkable how little weight is given by potential investors to tax incentives. This conforms with experience with FDI in other regions of the world.[18] While sectors with standard cost structures and few linkages into the local economy - such as clothing - have been shown to respond to such incentives, most others have not. Investors tend to perceive incentives as a windfall but base their decisions on more stable and fundamental considerations. Consequently, tax breaks are often judged to be a costly and unnecessary luxury that countries with fiscal constraints can ill afford.[19]

The investor surveys also identify various obstacles which foreign investors encounter in doing business in eastern Europe and the former Soviet Union. Economic and political uncertainty in the process of transition rate high among investor concerns, particularly in some of the earlier surveys. Hungary, which receives the most favourable rating on political uncertainty (Creditanstalt survey, 1992), has attracted the lion's share of FDI in eastern Europe. This may suggest that FDI to date has been concentrated in the handful of countries whose transition and macroeconomic stabilisation is particularly advanced, while low threshold levels of economic and political risk has not yet been reached elsewhere. However, while early research highlights these preconditions for foreign investment, more recent findings tend to focus on micro-level operating difficulties.

Legislative uncertainty and regulatory hassle are the most commonly cited investment obstacles. The prospect of changes in the legislative environment is an important consideration in FDI decisions. Also, foreign companies are attracted to tax systems that are transparent and impose a reasonable overall burden, yet a biased system is deemed preferable to one which changes constantly. Only a limited legal framework currently exists to deal with FDI disputes, and investors appear concerned with incomplete and inconsistent legislation and patchy enforcement.[20]

16 See, for instance, OECD, "Barriers to trade with the CEECs and NIS", Synthesis Report, 1993; this suggests that some of the findings reported in Table 9.4 are influenced by differences in the perceptions of investors and non-investors.

17 This motive may be of particular relevance for suppliers - note the moves by Renault's suppliers into Slovenia described in Box 7.1 - as well as for service sector firms such as advertising agencies or consultancies.

18 See, for instance, Guisinger (1985).

19 Note, however, that certain forms of incentives, such as negotiable tax certificates, have apparently been successful in risky environments by reducing the capital exposure of the investor in the crucial first years. Examples include Costa Rica in the 1980s. See EBRD (1993) Section 4.3.

20 For example, Bulgarian laws are viewed as confusing because they refer to foreign persons instead of investments. Furthermore, while one decree provides exemption from import duties on machinery, equipment and raw materials for exportable production, this is inconsistent with another law, and thus not applied.

Many of the operational problems encountered refer to either management difficulties or limited infrastructure (particularly as regards telecommunications, financial markets and established distribution networks). The Deloitte Touche Tohmatsu International survey underlines the differences in Western and Eastern partners' objectives in entering a joint venture. Apart from the difficulty of finding a suitable local partner, some surveys identify as important the problems of negotiating and successfully working together, as well as locating and training staff. Related internal constraints include the difficulty of obtaining quality expatriate management with appropriate business, language and culture skills as well as a willingness to relocate.[21]

## 9.4 Explaining FDI patterns

As discussed earlier, there is no general theory of FDI which explains the relationship between the investment environment, motivations and outcomes. A full discussion of the different facets of FDI behaviour is beyond the scope of this report. Nevertheless, some of the characteristics of FDI that have been described invite comment and offer some basis for speculation about future developments. The key challenges are to understand, first, the dominance of market access as a motive for investment; and second, why so much FDI has been concentrated in a few, relatively small countries.

### *9.4.1 The relation between trade and FDI*

To approach these questions, it is useful to consider the relation between foreign trade and investment, which cuts across both locational and firm-level characteristics. While trade and FDI are usually approached separately in both economic theory and policy, they are in fact strongly interrelated, not least since they tend to be undertaken by and often within the same multinational enterprise.[22] It has been estimated that in 1990 multinational enterprises were responsible for 80 per cent of world trade, while a third of worldwide exports took the form of intra-firm trade.[23] Trade and FDI can be substitutes, as happens when FDI is undertaken to jump import barriers or to reduce transport costs in serving a particular market.[24] On the other hand, they can be complements, for instance when a company invests in distribution systems or in trade-related services to boost exports to a foreign market. FDI can create trade, where it is undertaken to serve world or regional markets from a low-cost production base, and conversely the opportunity to trade can cause FDI while restrictions may dissuade it. Lastly, FDI can contribute to trade diversion in the context of rules of origin within free trade areas or quota restrictions on imports from certain locations but not from others. In sum, a large number of influences on trade will affect FDI and vice versa.[25]

**Table 9.5 Trade regime, investor motivation and enterprise strategy**

| Situation | Trade regime | Investor motivation | Multinational enterprise strategy |
|---|---|---|---|
| A | Protected markets and no regional preferences | Domestic market-seeking (most products) | Multi-domestic production, little trade in final products |
| B | Strong regional preferences | Domestic market-seeking (in particular non-tradable products).<br>Cost reduction (in particular easily tradable products, incl. input outsourcing) | (i) Multi-domestic production and sales<br>(ii) Regional strategy - few production centres serving the regional market |
| C | Liberal trade regimes and regional preferences of little importance | Domestic market-seeking (non-tradable products).<br>Cost reduction (easily tradable products, incl. input outsourcing) | (i) Multi-domestic production and sales<br>(ii) Global strategy - even fewer production centres |

21 Several other unusual restrictions that affect the investment climate are worth mentioning. In Russia, foreigners are subject to a 60 per cent tax on personal items brought in by expatriate employees. In Kazakhstan, foreign enterprises may only take out insurance with Kazakh providers. Furthermore, FYR Macedonia's 1993 Foreign Investment Act sets out penalty regulations with monetary fines of up to 250 monthly salaries. Improperly drawing up the investment contract, as well as failing to register profit reinvestment or transfer of ownership are considered punishable economic crimes.

22 On the relations between trade and FDI see also Meyer (1994).

23 UNCTAD (1993).

24 In fact, often FDI undertaken with the motive of avoiding trade restrictions substitutes the import of final products into the host economy by the import of intermediate goods that are necessary in production.

25 Also, clearly, the benefits of a "unit" of FDI can be leveraged up or they can be (partly) offset by the accompanying effect on trade.

Building on these observations it is possible to make some broad - but certainly not comprehensive - associations between the trade policy environment and investor motivations on the one side and investor strategies on the other. This is illustrated in Table 9.5 and discussed further below.

- *Situation "A"*: A country's market may be hard to penetrate through imports, perhaps as a result of high tariff or non-tariff barriers or limited convertibility of currencies. If this situation is perceived to be likely to persist for some time, the market-seeking motive will dominate foreign investor decisions even in (potentially) tradable product sectors. Not only exports to, but also export-oriented production within the protected area may be unprofitable - since protection from imports effectively constitutes a tax on exports. The strategy of multinational enterprises operating throughout a particular region would then tend towards the establishment of production sites in each country, producing the same final product for each local market ("multi-domestic").

- *Situation "B"*: When an economy is linked into regional multi-lateral trade schemes with substantial barriers to the outside - including restrictive rules of origin - but a relatively free flow of goods within the regional market, then it may make sense for companies or their suppliers to distribute the different components of their production process across member countries of the scheme in accordance with factor cost or other considerations; the whole of the regional market could then be supplied from the most efficient "platform".

- *Situation "C"*: This same logic can apply to wider geographical areas or even globally when restrictions to trade are few, a process that has gained increasing prominence with progress in GATT-led trade liberalisation and technological developments which have reduced effective distances.[26]

Other components of the investment environment being equal (legal, uncertainty, etc.), it would appear reasonable to expect situation "A" to prevail in many countries of the former Soviet Union, where - as described previously - convertibility as well as other components of the trade regime remain precarious (and where some markets, including the Russian and Ukrainian markets, are large).[27] Situation "B" appears to describe the context of many countries of eastern Europe, in which the trade environment is strongly influenced by the progressive integration into the western European economic sphere.[28] Situation "C", lastly, may be of relevance for many of the same countries in product groups for which neither their own trade regimes nor those of the EU or EFTA create impediments to extra-regional trade.[29]

### 9.4.2 What explains the domestic-market orientation of FDI ?

The domestic market-orientation of FDI emphasised by the surveys is easy to reconcile with investments in most sectors of the larger countries of the former Soviet Union and in the services and other non-tradable sectors of eastern European countries, where these sectors were often neglected under central planning. However, the emphasis on market access sits somewhat uneasily with the concentration of investment in the (mostly tradable) manufacturing sectors that characterised the early transition, and with the smallness of the countries that have been most successful at attracting FDI.

There appears to have been limited investor interest in exploiting factor cost advantages for regional strategies in central Europe. This is surprising, given the abundant supply in central Europe of human capital at relatively low wages (Table 9.6 below lists average monthly wages in US dollars).[30] Educational achievements in the transition economies are on average much higher than in non-transition countries in the same income group.[31]

These apparent contradictions may be explained by other factors which may have been important to foreign investors. Factors reducing investor interest may include the lack of investor experience with, for instance, fluctuations in the real exchange rate and the transience of its level during the economic transition. Meanwhile, some countries may have been able to stimulate inflows by discretionary government policies designed to attract foreign investors.

#### *Factors linked to the process of transition*

The Genco et al. survey points to the importance of "foothold" investments, presumably with low capital exposure, which

26 These developments are extensively described in UNTCMD (1993) and in Oman (1994).

27 However, foreign investment agencies in nations along the East-West border stress their strategic geographical location. Both Poland's PAIZ and the Estonian Ministry of Economic Affairs attempt to entice companies by offering their relatively stable environments as an entry point into the huge Russian market.

28 Note, however, that the rules of origin of the Europe Agreements do not encourage intermediate product trade among all the associated countries (hub-and-spoke bilateralism), and that threats from contingent protection remain on the EU market. See Section 8.4 and Baldwin (1994).

29 However, political tension between Russian and Estonia has resulted in higher tariffs on Estonian trade.

30 Labour efficiency incorporates both labour related expenses (wages, non-wage benefits and training costs) and productivity which is a function of education, skill level, experience and work ethic.

31 See Box 1.1 in Chapter 1. This compares 1992 data on enrolment or completion of secondary education (usually attended between the ages of 12 and 17) of transition countries with the average for the middle income group of countries. Source of data: *World Development Report* (1994). On country by country information on education levels, see also Chapter 3 of the present report. The poorer performance by the Baltic republics and Moldova may be attributed to a lack of comparability of educational systems.

would partly explain the small size of FDI in the region. More generally, investors might treat some of the smaller, more stable, higher-income countries of central Europe as a testing ground for subsequent expansion of sales and production into the region as a whole, including the EU market.[32] Local production may also be favoured over exports since foreign exchange risk may be reduced by using local sourcing to match the currency composition of payables with that of receivables.

In addition, some investors clearly do not view current (low) factor costs as permanent, believing them to be affected by the adjustment processes during the economic transition. Thus, they avoid pre-committing their regional strategies at this stage. Wages account for a diminishing proportion of costs in many manufacturing processes. Investors to whom labour costs remain important may opt to rely on more predictable locations.[33] Even where the quality and potential of labour are appropriately recognised, retraining is expensive, and weak company loyalty may result in wasted efforts. This may induce investors to adopt a free-rider strategy: for the individual investor it may appear sensible to wait until others have prepared the ground.

Lastly, existing deficiencies in the transport and communications infrastructure may bias choices towards somewhat autonomous, domestic-market-centred ventures. Local production may minimise transportation expenses and time, and increase responsiveness to demand conditions.

Most of these factors are of a temporary nature. As the economic transition progresses and some of the current obstacles are overcome, regionally oriented FDI, based on factor cost advantages, should gain in prominence. In fact, over half of American ventures in the most recent survey (by Arthur Andersen - see Table 9.4), had adopted some form of regional strategy, including a pan-European strategy.

### *The active use of trade policy to attract FDI*

Some of the largest investments have been at least partly enticed by selective, "tailor-made" protection from imports, even in countries that otherwise display very open trading systems,[34] (i.e. countries position themselves, at least in targeted sectors, in the type "A" situation described in Section 9.4.1).

**Table 9.6**
**Monthly wages in the economies in transition [1]**

| | Wages (in US dollars/month) |
|---|---|
| **Eastern Europe and the Baltic states** | |
| Albania | na |
| Bulgaria | 114 |
| Croatia | 250 |
| Czech Republic | 221 |
| Estonia | 85 |
| FYR Macedonia | na |
| Hungary | 317 |
| Latvia | 98 |
| Lithuania | 65 |
| Poland | 194 |
| Romania | 82 |
| Slovenia | 421 |
| Slovak Republic | 201 |
| **CIS** | |
| Armenia [2] | 6 |
| Azerbaijan | 28 |
| Belarus | 73 |
| Georgia | na |
| Kazakhstan | 119 |
| Kyrgyzstan [3] | 12 |
| Moldova [2] | 31 |
| Russia | 99 |
| Tajikistan | na |
| Turkmenistan [2] | 54 |
| Ukraine [2] | 20 |
| Uzbekistan [2] | 25 |

1 Nominal monthly dollar wages at going exchange rates based on average 4th quarter 1993 earnings.

2 Covers 3rd quarter 1993.

3 Covers 2nd quarter 1993.

Source: OECD and IMF.

32 Given historical links, and reform progress, Hungary is often considered a regional centre for FDI (Institute for World Economics survey). For example, GM has used its JV with car components maker Raba in Hungary as an entry point to eastern Europe (Creditanstalt survey, 1991).

33 Romania, where investments in the textile sector play a significant role, may be an exception to this.

34 Governments in the transition economies are not alone in employing trade policy actively as a means of attracting FDI. Use of trade-policy measures for that purpose is probably more common in developing than in developed countries, but some member states of the EU, for example, are alert to the fact that EU actions against imports - anti-dumping action, for instance - may induce foreign producers to manufacture or assemble their products in the EU.

**Table 9.7 FDI and import protection in Hungary and Poland**

| Products | Hungary [1] Average tariff (%) [2] | Range of tariffs (%) min | Range of tariffs (%) max | NTBs [3] | FDI-intensive sectors | Poland [4] Average tariff (%) [2] | Range of tariffs (%) min | Range of tariffs (%) max | FID-intensive sectors |
|---|---|---|---|---|---|---|---|---|---|
| 1 Rawhides and skins | 9.1 | 3 | 14 | 9 | | 24.5 | 15 | 35 | |
| 2 Rubber | 9.2 | 2 | 20 | 12 | | 14.3 | 5 | 15 | |
| 3 Wood and cork | 8.4 | 0 | 15 | 18 | | 13.3 | 5 | 15 | |
| 4 Pulp and paper | 7.6 | 0 | 40 | 12 | yes | 13.4 | 0 | 35 | yes |
| 5 Textiles and clothing | 11.7 | 0 | 20 | 17 | | 20.6 | 5 | 30 | yes |
| 6 Glass and chemicals | 7.4 | 0 | 25 | 19 | yes | 13.0 | 3 | 40 | yes |
| 7 Precious stones | 6.5 | 0 | 13 | 12 | | 15.3 | 5 | 45 | |
| 8 Ores and metals [4] | 7.7 | 0 | 50 | 5 | | 14.1 | 5 | 35 | yes |
| 9 Coal and petroleum | 6.3 | 0 | 30 | 30 | yes | 11.2 | 0 | 20 | |
| 10 Chemicals | 9.9 | 0 | 40 | 7 | | 14.3 | 5 | 45 | |
| 11 Non-electrical machinery | 18.7 | 0 | 50 | 28 | yes | 15.2 | 0 | 20 | |
| 12 Electrical machinery | 26.2 | 0 | 50 | 13 | yes | 16.3 | 15 | 30 | yes |
| 13 Transport equipment | 17.4 | 0 | 50 | 20 | yes | 20.1 | 0 | 35 | yes |
| 14 Scientific instruments | 27.2 | 6 | 60 | 16 | | 17.0 | 15 | 45 | |
| 15 Footwear and bags | 10.1 | 9 | 12 | 7 | | 22.4 | 15 | 35 | |
| 16 Photographic instruments | 9.4 | 0 | 25 | 2 | | 15.0 | 15 | 15 | |
| 17 Furniture | 10.0 | 8 | 12 | 5 | | 19.5 | 15 | 20 | |
| 18 Musical instruments | 8.9 | 0 | 12 | 8 | | 22.4 | 15 | 30 | |
| 19 Toys | 11.2 | 0 | 13 | 3 | | 20.2 | 20 | 35 | |
| 20 Works of art | 0.0 | 0 | 0 | 4 | | 0.0 | 0 | 0 | |
| 21 Firearms | 8.5 | 0 | 13 | 5 | | 34.4 | 15 | 35 | |
| 22 Office supplies | 10.0 | 6 | 12 | 3 | | 18.7 | 15 | 20 | |
| 23 Other manufacturing | 9.5 | 0 | 13 | 6 | | 17.9 | 5 | 35 | |
| 24 Foodstuffs | 28.1 | 0 | 80 | 29 | yes | 27.4 | 10 | 45 | yes |
| 25 Grains | 3.4 | 0 | 25 | 12 | | 13.0 | 10 | 25 | |
| 26 Animals and produce | 18.1 | 0 | 35 | 34 | | 29.0 | 5 | 40 | |
| 27 Oil seeds | 10.6 | 0 | 35 | 9 | | 18.4 | 5 | 35 | |
| 28 Cut flowers | 19.0 | 5 | 35 | | | | | | |
| 29 Beverages | 48.5 | 0 | 150 | 17 | yes | 45.8 | 20 | 145 | yes |
| 30 Dairy products | 30.3 | 20 | 60 | 28 | yes | 35.1 | 10 | 40 | |
| 31 Fish | 17.5 | 0 | 45 | 10 | | 18.4 | 5 | 55 | |
| 32 Tobacco | 58.3 | 10 | 90 | 15 | yes | 41.4 | 30 | 120 | |
| 33 Other animals | 15.5 | 5 | 35 | | | | | | |
| 34 Other vegetables | 15.8 | 10 | 35 | | | | | | |
| All products [6] | 16.0 | 0 | 150 | | | 18.4 | 0 | 145 | |
| Computed figures [7] | | | | | | | | | |
| All sectors | 15.0 | 2.1 | 35.8 | 13.4 | | 19.8 | 9.1 | 37.6 | |
| FDI-intensive sectors | 24.9 | 3 | 62.5 | 21.1 | | 21.3 | 7.3 | 49.4 | |

Sources: GATT Trade Policy Review, Volume I: Hungary (1991) and Poland (1992), P.Messerlin.

Notes: 1 1988 Tariff schedule

2 Simple average tariff rates

3 Numbers of non-tariff barriers (NTBs) observed at 2-digit level

4 1992 Tariff Schedule

5 Includes steel and aluminium

6 Simple average tariff rates for the whole economy

7 Simple averages based on rates by sector.

Trade policy inducements can take various forms. J.Gács[35] discusses several examples of "active" trade policy aimed at attracting FDI into Hungary, ranging from changes in effective rates of protection reflecting elimination of tariffs on inputs and increases in tariffs on final goods (as in the TV-assembly industry) to the introduction of discriminatory and product-specific import quotas (as in the paper industry).[36] Also, since the sale of the Hungarian cement industry to foreign companies was preceded by a series of safeguard actions against imports of cement from neighbouring countries, it is not unreasonable to conjecture that the Hungarian government had been offering inducements to the foreign investors.[37] Similar policies have been used in both Hungary and Poland to attract FDI into the local motor vehicle industry. Some policy actions in this regard are sketched in Box 9.1 and Table 9.8.

More generally, Table 9.7 shows that high levels of protection against imports are accompanied by high levels of FDI, at least in the manufacturing sectors of Poland and Hungary. In Poland, FDI-intensive industries have average tariffs on imports that are 66 per cent higher than in manufacturing as a whole. The corresponding figure for Hungary is 10 per cent, but Hungary uses quantitative restrictions more heavily than Poland. When non-tariff barriers are taken into account, the strong link between high protection and high FDI appears also in Hungary.

A common justification for government incentives for FDI is the notion that FDI generates economic gains for residents of the host country – gains that will be neglected by potential investors when deciding whether to proceed with the investment. Some of these externalities have been discussed in Box 7.1 which suggests that, when FDI occurs "naturally" - that is, without policy inducements - it is reasonable to presume that the host country benefits from it. When FDI is induced by policy, however, there is less ground for such a presumption, since the cost of the intervention can conceivably surpass the investment's benefits.

A government might find trade-policy action necessary to attract a particular investment. However if such action is required, this strongly suggests that the potential investor's costs of production would be higher in the transition economy than elsewhere. Compensation of the investor for this will be paid from public funds and/or cause a loss of consumer welfare in the host country.[38] Moreover, in some cases, where special incentives are not required for investments to be realised, investors may nevertheless manage to convince host governments that inducements are needed.

- Positive externalities associated with the investment may theoretically justify the cost to the public. However, as argued in Chapter 7 and in Section 8.3, externalities are hard to identify and measure in the context of an individual project, and the neat trade-off suggested by theory may look quite different in practice, where imperfect information, bureaucratic limitations and interest-group pressure often combine to turn well-meant interventions into costly failures. This is reinforced by the fact that many of the costs of such intervention are even less visible than the benefits of the investment: they can include, apart from the standard costs of protection (lost consumer surplus and excess costs of production given the higher sales price that protection affords the investor), a loss of dynamism and efficiency given the lack of market discipline, as well as a strengthening of the discretionary powers of bureaucracies and therefore, in a period of transition, the wrong signal to the rest of the economy. Is it really plausible that estimated benefits are concentrated on the few sectors that enjoy substantial protection? And is it a coincidence that these have the lobbying power either of large indigenous enterprises or large multinational corporations?

- A government offering active inducements to FDI must face the problem that its policy creates an incentive for potential investors to deceive it. A company that would undertake an investment without governmental inducements nevertheless has an incentive to persuade the government that the investment will be undertaken only if the government provides sweeteners - so that sweeteners are provided.

35 Gács (1992).

36 Reporting on lobbying for increased protection in the Hungarian TV-assembly industry, the *Financial Times* commented (30 May, 1992) that "Ironically, western multinationals have become eastern Europe's most effective lobby for protection and their efforts to link investment commitments to guaranteed markets have become all the more intense as local demand has fallen below expectations."

37 See also Box 8.2 on Hungary's use of non-tariff barriers.

38 When FDI is actively induced, however, comparison of costs at the start of an investment might seem over-simplistic. A major part of the expected benefit of FDI is that the skills and management techniques it brings will reduce costs over time. It might be argued, therefore, that lower costs in the future will compensate a host country for high current costs. At first glance, this might seem an attractive position (it is, of course, very close to the infant-industry argument for protection). But private investors can know that current investment will give rise to lower costs in the future, and they can take that possibility into account in their own calculations about the value of the investment.

If trade-policy inducements are necessary, therefore, the investor probably does not believe that future costs will be low enough to compensate him for higher present costs. To reconcile that assessment with a possibility of net social gain to the host country, some distortion in the investor's vision must be claimed - the mere fact that costs will be lower in the future is not enough.

## *Box 9.1*
## FDI in motor vehicle production

(Information based on Press reports that have not been independently confirmed by EBRD.)

The motor-vehicle industry has been a particular focus for FDI-related trade policy.

### *Poland*

In late 1991, Poland raised its tariff on imported new cars from 15 to 35 per cent. General Motors is reported to have made the increase a condition of GM participation in a joint venture with Poland's FSO (Financial Times, 9 March 1992). The increase, however, raised a problem in the context of Poland's Europe Agreement, which aims, in part, at free trade in manufactured products between Poland and the EU. To "compensate" for the tariff increase, Poland introduced a duty-free quota of 30,000 cars, reserved for EU carmakers. Officially, the quota is available on a "first come, first served" basis. In fact, it is allocated under complex rules that allow biases in favour of firms that have invested in Poland.[39] The Financial Times (9 March 1992) commented that "...much of GM's $75m investment could well be financed through increased sales volume in Poland under the duty free quota. Indeed, earlier talks with GM broke up when the outgoing Polish government decided that the revenues it would forego by giving GM the 40 per cent of the duty free quota it wanted would be greater than the $75m GM was willing to put on the table...".

In 1993, Poland prohibited imports of cars older than 6 years. It also eliminated GSP concessions to India, apparently to bar imports of Suzuki cars assembled in that country, and excluded the entire car sector from offers for tariff concessions in the Uruguay Round.

### *Hungary*

Ford has established in Hungary a plant producing components for export to the EU. It is discussing with the Hungarian government plans for another plant to manufacture cars. In May 1992, the Hungarian government abolished the 18 per cent tariff on commercial vans. "Commercial van" was so narrowly defined, however, that the elimination of duties applied only to Ford Transit vans. After fierce opposition from other EU producers of vans (Renault-Matra and Peugeot-Citroen in France, and Fiat in Italy), the 18 per cent duty was restored in June 1992. In April 1993 - again after objections from EU producers - the Hungarian government withdrew a tax concession to Ford. Ford then asked the Hungarian government for "restitution of benefits lost". It claimed that these would amount to more than US$ 25 million by 1999 (Ward's Automotive International, April 1993).

### *Czech Republic*

In 1991, Volkswagen made maintenance of high tariffs on imports of passenger cars for four years a condition of its purchase of capital in Skoda. This commitment of the Czech government did not become generally known, however, until August 1993, when the sixth increase in Skoda list prices since 1990 led to suggestions that tariffs should be reduced. VW-Skoda's prices for similar models increased by 15 per cent in real terms between 1991 and 1993.

The Czech government has also engaged in negotiations with Mercedes. The Financial Times commented (on 27 February 1992) that "... Mercedes last month ... [requested] ... high duties on imported trucks and a long tax holiday. The Czech government, which approves all large joint ventures, has objected to such demands, which Mercedes insists are only a basis for negotiations".

### *Consequences*

(a) Imports of cars into all three countries have fallen since 1991 - barriers on imports of used cars were important in achieving this result.

(b) Domestic sales (local production plus imports) by local firms represent between 60 per cent of registrations of new cars in Hungary and 80 per cent in the Czech Republic and Poland - a situation strongly reminiscent of that prevailing in 1989.

(c) Domestic production is very concentrated - from a near monopoly in the Czech case to a duopoly with a largely dominant firm in Poland (Fiat). However, between 1989 and 1992 there has been noticeable increase in the share of exports in domestic production.

(d) The share in new registrations of cars imported from firms of Japanese origin is very low by world - or even EU - standards. Moreover, the 1994 share is only one-third of the 1992 share. This atypical evolution is shown by imports from all Japanese firms, whether or not they operate plants in the "Visegrad"-EU region.

[39] Messerlin (1994).

**Table 9.8 Central European car markets: selected indicators (in per cent), 1988-94**

| | 1988 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 [3] |
|---|---|---|---|---|---|---|---|
| **CSFR [1]** | | | | | | | |
| Dom. sales/New car regist. | 75.5 | 74.5 | 81.6 | 58.4 | 80.5 | – | – |
| Dom. sales/Total regist. | 73.3 | 68.2 | 72.8 | 28.4 | 48.8 | – | – |
| Imports/Total regist. | 26.7 | 31.8 | 27.2 | 71.6 | 51.2 | – | – |
| Exports/Production | 38.9 | 37.5 | 34.1 | 66.4 | 53.7 | – | – |
| Used car regist./Total regist. | 3.0 | 8.5 | 10.7 | 51.4 | 39.4 | – | – |
| **Hungary [1]** | | | | | | | |
| Dom. sales/New car regist. | 0.0 | 0.0 | 0.0 | 0.0 | 29.4 | – | – |
| Dom. Sales Total regist. | 0.0 | 0.0 | 0.0 | 0.0 | 7.2 | – | – |
| Imports/Total regist. | 100.0 | 100.0 | 99.7 | 100.0 | 92.8 | – | – |
| Exports/Production | 0.0 | 0.0 | 0.0 | 0.0 | 0.0 | – | – |
| **Poland [1]** | | | | | | | |
| Dom. sales/New car regist. | 82.0 | 87.6 | 85.4 | 68.7 | 68.8 | – | – |
| Dom. sales/Total regist. | 76.8 | 62.5 | 54.1 | 28.3 | 56.9 | – | – |
| Imports/Total regist. | 23.1 | 37.5 | 43.5 | 71.7 | 43.1 | – | – |
| Exports/Production | 34.4 | 33.6 | 21.8 | 7.8 | 37.6 | – | – |
| Used car regist./Total regist. | 6.4 | 28.6 | 36.7 | 58.8 | 17.2 | – | – |
| **Total sales by companies producing locally (dom. produced & imported cars) as a percentage of new registrations [2]** | | | | | | | |
| Czech Republic & Slovak Republic | | | | | | 79.5 | |
| Volkswagen | – | – | – | – | – | 79.5 | – |
| Hungary | | | | | 48.5 | 66.7 | 45.6 |
| Ford | – | – | – | – | 3.0 | 6.0 | 3.4 |
| GM-Opel | – | – | – | – | 23.4 | 27.3 | 23.5 |
| Suzuki | – | – | – | – | 22.1 | 33.4 | 18.7 |
| Poland | | | | | 76.5 | 83.7 | 73.9 |
| Fiat-FSO | – | – | – | – | 38.2 | 53.5 | 44.4 |
| FSO-GM-Opel | – | – | – | – | 38.3 | 30.2 | 29.5 |
| **Imports of Japanese cars as a percentage of new car registrations [2]** | | | | | | | |
| Czech Republic & Slovak Republic | – | – | – | – | – | 3.7 | – |
| Hungary | – | – | – | – | 14.2 | 10.4 | 5.5 |
| Poland | – | – | – | – | 6.7 | 3.0 | 2.7 |

Sources:

1 Calculated from data by DRI/McGraw-Hill Automotive Group quoted in Ward's Automotive International, March 1993.

2 Ward's Automotive International, April and May 1994.

Notes:

3 for 1994, annual estimates are based on data for the first quarter of 1994.

Dom. sales: Domestic sales of domestic producers.

Total regist.: Total registrations of (new and used) cars.

Production: domestic production.

– : information not available.

### *9.4.3 The concentration of FDI on a few locations*

As noted, FDI has been concentrated in only a few countries of the region. The Czech Republic, Estonia, Hungary, the Slovak Republic and Slovenia have attracted shares of total investment flows to the region which are out of proportion to their size. These four are relatively advanced as regards social stability, macroeconomic stabilisation, and thus perceived country risk. Even relatively small amounts of risk and uncertainty can significantly "leverage" benchmark levels of return for an investment decision. However, it is still surprising how "elastic" FDI appears to be in reacting to these factors, in particular since the countries in question lack other advantages such as market size (the main FDI motivation according to the surveys). This suggests that other issues are at play.

Proximity to countries that are the source of FDI matters, in both geographical and cultural terms. The Czech Republic, Hungary, the Slovak Republic and Slovenia share borders and history with countries of origin for much of the FDI, namely Germany, Italy and Austria. Estonia is a short distance away from Finland, with which it is culturally related.[40] Proximity promotes FDI by small and medium-sized enterprises. Marginal SMEs that are threatened by structural change in their home countries may save their industry-specific assets by moving "over the border", and changing their labour force as they close down domestic operations.[41]

The organisation of the privatisation process has played an important role in attracting FDI. While most countries of the region permit foreign participation in the privatisation process - with certain restrictions (Table 9.3) - some, including Hungary and Estonia, have made it the central pillar of their privatisation strategies.[42] Privatisation may be particularly effective at triggering FDI decisions in oligopolistic markets. Like all corporate actions, FDI decisions are not taken in isolation, but reflect current characteristics and anticipated changes in the competitive playing field. FDI may be action-oriented, aimed at pre-empting a rival's move into a given market. While operating conditions may be less than ideal, the ability to acquire strategic assets (distribution systems and suppliers, local brand names) at low costs is a strong motive for moving quickly, since it allows enterprises to secure market shares while pre-empting competitors from doing likewise.[43]

Other factors may provoke a cumulative increase of FDI into a location once certain benchmark levels of foreign presence have been reached.

The behaviour not only of the leaders (i.e. the "first-movers") but also of the followers should be taken into consideration. "Follower" strategies in oligopoly may induce FDI decisions which would not have been taken in isolation. Since, in certain industries, it is possible to raise entry barriers for subsequent competitors by building product commitment and luring consumers into products with high switching costs, the presence of a critical number and size of early investments may trigger a follow-the-leader (defensive) reaction to competitors' moves among initially less-interested investors. In particular in consumer goods sectors (and in economies that "begin" with only a limited degree of saturation with consumer products), FDI may draw further FDI. In the Institute for World Economics' survey of investors in Hungary, 40 per cent of firms declared their general investment behaviour as defensive.

The uncertainties of operating in a new environment, and one in which market institutions are only beginning to take hold, are one of the strongest deterrents to FDI. Early movers, by their mere presence, provide a strong and informative signal to more hesitant investors that operations in such an environment are feasible and potentially rewarding. Again, additional FDI decisions can thus be positively correlated with the amount of existing foreign capital in a transition economy.[44]

Lastly, agglomeration effects (the effects of achieving a critical mass in a particular location, often the capital) may have played a role. Firms even in unrelated product sectors share common supporting services,[45] infrastructure and perhaps suppliers, and the size of the "pool" of skilled labour provided by an existing cluster of firms can reduce the entry costs for new projects. The existence and quality of these factors may - as has been described in Box 7.1 on the benefits of economic openness - be positively influenced by the presence of other foreign, rather than

40 While ties with Greece have been close in south-eastern Europe, and with Turkey in some of the Central Asian and Caucasus republics, and investors from those countries have been fairly active, the amounts involved were smaller.

41 Meyer (1994).

42 See Transition Indicators (Appendix 2.1) and Box 7.1.

43 Nevertheless, other countries that have remained relatively less prominent as FDI destinations, such as Poland, have also sought to draw foreign capital into the privatisation process.

44 More formally, risk raises the benchmark level of financial returns required for an investment decision. The information derived from observing investment decisions by others may reduce the variability of potential outcomes and thus lower the risk premium, making a positive decision more likely.

45 This can include services to production, for instance those provided by the government, communications, legal services, advertising etc., but also services (housing etc.) that affect the quality of life of expatriate managers - a factor that is often of some importance.

domestic, firms in the transition environment. A related issue, which has been stressed by a number of the investor surveys, is the desire to serve other foreign customers that are establishing themselves in eastern Europe. This is particularly true for service organisations where the nature of the business may preclude the transportation or storage of outputs. Such investments are often easier to get started as there is less need to adapt to the culture and practices of the region when serving foreign customers. Again, this would suggest that the number of investors in a country (and in particular locations within that country) may rise quickly once a certain "agglomeration threshold" has been surpassed.

None of these factors substitutes for the need to maintain open investment (and trade) regimes and to reduce uncertainties in the economic and political environment. Stable macroeconomic conditions and predictable government policies have doubtless been decisive in explaining the initial success of the principal FDI destinations. Once these conditions are met and induce a sufficient amount of "early" FDI, there may be a self-reinforcing effect on the inflows. There is therefore some ground for optimism that other transition countries that have met, or are beginning to meet, the fundamental requirement of stability may experience foreign investment activity in the future at the level seen to date in Hungary and the Czech Republic, raising the region's total inflows towards amounts that had been predicted at the beginning of the reform process. It is important to note that discretionary, "activist" policies designed to attract FDI - except in the context of privatisation programmes - have little effect on these flows.

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