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MARKET ACCESS -- FDI/TRADE LINKAGES IN EASTERN EUROPE

Report on a meeting of management experts
held under the OECD Labour/Management Programme

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Foreword

Under the OECD Labour/Management Programme for 1993, a meeting of management experts on "Market Access -- FDI/Trade Linkages in Eastern Europe" was held in Paris on 7 December 1993. The meeting was prepared in collaboration with the Business and Industry Advisory Committee (BIAC) to the OECD.

Below is an overall report of the discussions of the meeting of experts, prepared by Professor Alice H. Amsden who was designated as General Rapporteur for this activity.

A list of the participants in the meeting is given in the Annex.

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FINAL REPORT ON THE MEETING

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INTRODUCTION

The meeting took place on 7 December 1993. It was attended by management experts, the Secretariats of BIAC and the OECD, and experts from the then PIT countries (Hungary, Czech and Slovak Federal Republic and Poland). It was co-chaired by Mr. Thomas Hagdahl, Director, Federation of Swedish Industries and Mr. Paal Frisvold, Manager, BIAC Secretariat.

The purpose of the meeting was to enable views to be exchanged on the following four points:

- (i) The reasons for foreign investment in Central and Eastern Europe (CEE for short);
- (ii) The impact of foreign market access on investment decisions and project performance;
- (ii) The impact of domestic market access on investment decisions and project performance;
- (iv) The policy recommendations to the OECD and CEE governments to stimulate further foreign investment in the region.

All four points were covered in the discussion, although to varying degrees. The lead-in was provided by the OECD Secretariat on the following topics: the motives for FDI and the trade barriers that confronted it. It was noted that the barriers to CEE's exports in OECD countries were largely the same barriers facing the exports of other countries, but existed principally for sensitive products such as steel, textiles and agricultural products. Then a short presentation was made by the chairperson arguing that the only solution to the problem of market access is to have one large market with no trade barriers because business enterprises were more likely to invest in countries which maintained easy access to the markets of other countries so that firms could sub-contract and practice product-by-market specialisation.

Following these introductory remarks, the four points on the agenda were discussed in turn.

STRATEGIC BUSINESS OBJECTIVES FOR INVESTMENT IN CENTRAL AND EASTERN EUROPE (CEE)

It was generally agreed, based on various statistical studies with which some of the participants and the OECD Secretariat were familiar, that the major objective for FDI in CEE was "markets." Therefore, the size of a country (its population, gross domestic product), and the expected growth rate of its economy, were major factors in influencing FDI. Also of major importance (depending very much on the industry) was the level of a country's production costs and the level of its workforce's skills.

Nevertheless, it was emphasised by the participants that the major motive for FDI -- related to access to a host country's domestic market -- tended to spill over into other motives, such as using the host country as an export base to penetrate the markets of other countries, or an import base to source parts and components from other countries. For instance, it was believed that many firms had invested in Hungary with the hopes of using Hungary's ties to former COMECON countries as a way to access COMECON consumers. In this respect, foreign investment and trade were inextricably tied.

It was generally believed that foreign investment followed a logical sequence which often started with foreign licensing. Firms that had licensed technology or other types of know-how to firms in a foreign country often then follow-up on that licensing activity with an equity investment in that (or another) company.

In some cases, the FDI/trade nexus would take the form of firms from a relatively high-income country (Sweden, the former West Germany) supplying "parts," such as cloth, to a lower-income country (Estonia, Poland), for labour-intensive processing (cutting and sewing), with a view towards re-exporting the finished product (apparel) back to the high-income country.

Given the importance of re-exporting and sourcing important parts and components across international borders, the issue of market access was generally agreed to be of great importance for increasing FDI in CEE.

It was pointed out in discussion that FDI in Eastern Europe (understood to include the former Soviet Union) did not really start until the end of 1990. By the end of 1992, the total of FDI in the whole region was only \$14 billion. Of that sum, roughly \$4.5 billion had gone to Hungary. This figure may not accurately reflect all investments flowing to the region, particularly if investments to the former Soviet republics are included. A more inclusive figure for foreign direct investment may be approximately \$40 billion by mid-1993. Still, there was general agreement that most countries in the region had received relatively small amounts of foreign investment. Therefore, the scope for increasing the quantity of FDI in the region was great.

While the complementarity of FDI and trade was recognised, it was also recognised that sometimes foreign investment and trade could be substitutive -- firms might not invest in a market if they could export without any barriers to that market.

THE IMPACT OF FOREIGN MARKET ACCESS ON INVESTMENT DECISIONS AND PROJECT PERFORMANCE (ACCESS OF ENTERPRISES LOCATED IN CEE TO OECD MARKETS)

There was almost unanimous agreement that the level of trade barriers in OECD countries made a large difference in the amount of FDI flowing to the area. The best way to increase FDI in the CEE was to remove tariff and non-tariff barriers impeding CEE exports. While CEE countries benefited from technical assistance from the OECD, such assistance was not a substitute for open markets. The CEE countries desperately needed to export in order to earn the foreign exchange to import the raw materials and capital goods that were vital for building the infrastructure necessary for profitable foreign investments.

An example by one of the business delegates concerned his firm's experience with respect to a ferro-alloy plant in Kazakhstan. His company was arranging an export venture for the plant. When, however, the United States erected trade barriers against ferro-silicon imports of 104%, it was difficult to arrange finance. The owner of the plant also found that investing in the modernisation of his plant was difficult because of the same tariff barrier.

One participant noted that in a questionnaire on foreign investment in Poland, one of the top-ranked suggestions was to apply more pressure on Western governments and firms with a view to ensure better access of Polish goods to Western markets.

It was observed that on occasion, for certain products (e.g., steel), exports from the CEE were not exhausting their quotas in specific Western markets (e.g., the United States). It was further observed, however, that sometimes such quotas were not filled due to trade restrictions other than quotas, or due to soft markets in the importing countries, which resulted in the under-utilisation of quotas by most exporting countries. One example of trade restrictions were the veterinary barriers used in 1993 to stop beef exports from CEE countries.

There was general agreement that bilateral trading arrangements were less ideal than multilateral free trade agreements. The greater the number of countries connected through free trade arrangements, the warmer the invitation to foreign investors to locate in a single country and then trade with the remaining countries in the free trade region.

It was noted that in the case of small- and medium-size enterprises attempting to export to the OECD from CEE, frequently export finance from OECD countries was unavailable to them because the ceilings for qualifying for such finance were too high.

THE IMPACT OF DOMESTIC MARKET ACCESS ON INVESTMENT DECISIONS AND PROJECT PERFORMANCE (ACCESS TO CEE MARKETS BY FIRMS FROM THE OECD)

The longest discussion was devoted to the topic of barriers to foreign investment existing within the CEE. An initial, quick straw vote on the most important barriers suggested that too much bureaucracy was an impediment, along with unclear investment procedures, inadequate infrastructure, and the absence of investment guarantees.

The discussion on CEE impediments to foreign investment was wide-ranging. In part, this was a reflection of the fact that the investment climate varied significantly by individual CEE country. Some of the more frequently cited hindrances were as follows:

- (a) The political uncertainty in the area was a fundamental barrier to foreign investment. To reduce this uncertainty there was enthusiasm among many of the participants for more investment guarantees (as discussed more fully under the heading of "policy recommendations").

- (b) It was generally agreed that whatever the content of laws relating to foreign investment, it was important for a country's investment code to be consistent and not to change arbitrarily or without warning. Frequent changes in the bureaucracies related to foreign investment were also considered detrimental. The importance of guaranteeing profit repatriation was emphasised as a precondition for many investors. The importance of streamlining regulations and making them simpler was also stressed. Not least important, some participants emphasised the significance of establishing credible dispute settlement procedures, with clear rights for foreign investors to sue in impartial courts.
- (c) A key barrier to foreign investment in any particular CEE country was considered to be the absence of a strong and clear commitment to open markets among the CEE countries, and among all the former members of the CMEA or COMECON (the old trade association of centrally-planned economies). Participants were enthusiastic about the possibilities of the Visegrad Treaty between the PIT countries, which they viewed as opening up opportunities for FDI with the aim of exporting.
- (d) Little discussion was devoted to the issue of ownership of CEE enterprises, but some participants mentioned that it was easier for foreign investors to deal with privatised firms than with state-owned enterprises.
- (e) Structural impediments to foreign investment were noted, such as an absence of investment services in the CEE which foreign investors might require.
- (f) The third party competition (say, from China and some of the other fast-growing East Asian countries) to CEE as a locus for foreign investors was noted. It was further observed that in some cases CEE governments had offered subsidies to foreign investors as a precondition for making a commitment to the area. The question, therefore, of whether such subsidies should be sanctioned was discussed. Some participants felt that subsidies should not be offered; they established a bad precedent. Others felt they were inevitable, and should be handled case-by-case. Others noted that if they were inevitable, they should be made above-board and rationalised.
- (g) Again, the two-sided character of the trade/FDI nexus was observed. That is, some participants noted that foreign investors could be more interested in foreign investment in the CEE region when they faced export barriers. Trade and foreign investment were both complementary and substitutive, depending on the industry and country.

THE POLICY RECOMMENDATIONS TO THE OECD AND CEE GOVERNMENTS TO STIMULATE FURTHER FOREIGN INVESTMENT IN THE REGION

Throughout the discussions, many policy recommendations were articulated to stimulate FDI. Some of the most frequently recommended policies were as follows:

- (a) It was most often noted that the best spur to FDI in Eastern Europe was to remove trade barriers to Eastern Europe's exports in the OECD and other foreign markets.
- (b) Considerable enthusiasm among all participants was demonstrated for two suggestions -- (b.1) strengthen investment guarantees; and (b.2) strengthen the flow of information about CEE to prospective OECD investors.

(b.1) With respect to investment guarantees, it was emphasised that such guarantees were necessary given political uncertainty, and that any investment scheme should be designed in recognition of persistent political uncertainty in the region in the near future. Some participants felt strongly that such guarantees should be made free to prospective investors and that the finance for such guarantees should come from OECD governments. In the event of a loss of an investment due to politics, the OECD government offering the guarantee would be responsible for suing the foreign country in question. It was proposed that the subject of investment guarantees be considered explicitly and carefully by the next advisory group.

(b.2) With respect to the subject of information, it was observed that all the CEE countries already do quite a bit of promotion, but that the flow of information to prospective investors overseas could be vastly improved. One suggestion was to build on expatriate communities. Other suggestions concerned how much pro-activity was cost-effective. Some said "beating the bushes" might help, while others were convinced of the importance of building up the overall image of CEE countries as politically stable, economically sound places in which to invest. The best publicity to foreign investors was generally considered to be good economic policy and stable economies.

ANNEX

LIST OF PARTICIPANTS

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