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Insights from a New Survey

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The Changing Patterns of Foreign Direct Investment in EU Accession Countries: Insights from a New Survey¹

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Abstract

Foreign direct investment (FDI) in Central and Eastern Europe (CEE) has been maturing as the region prepared to join the European Union (EU). Since the beginning of transition the pattern of FDI has evolved, reflecting new business strategies pursued in anticipation of EU membership. Based on first results from a questionnaire survey conducted in 2003 in Hungary, Lithuania and Poland, we portray the recent patterns and developments in foreign investment, the motives for investment, and managers' assessment of the local business environment. Some questions have been replicated from a study conducted in the emerging economies of Egypt, India, South Africa, and Vietnam, which allows us to benchmark FDI patterns in CEE against other emerging economies in different parts of the world. We find that there were fewer changes over the period of the 1990s than we expected, but some interesting differences across the three countries in our study, and between CEE and other emerging economies.

Introduction and Research Questions

Central and Eastern Europe (CEE) has joined the countries in Asia and Latin America as emerging economies. However, CEE economies are unusual emerging economies due to their rapid institutional change. Firstly, they opened to international business only around 1990. Secondly, many countries joined the European Union in 2004 and thus enjoy (almost) free market access and the shared legal framework of EU member countries. They thus attract investors willing to take the risk of operating in volatile environments in expectation of market growth or reduced production costs.

Foreign direct investment (FDI) plays an important but varying role in transition economies in terms of restructuring and upgrading of local firms and industries (Estrin et al. 1997, Javorcik, 2004, World Bank, 2004). However, it is not well understood how country and region specific factors influence the pattern of FDI, and its evolution over time. Therefore, we conducted surveys of foreign investors in CEE, replicating a study in other emerging economies (Estrin and Meyer, 2004), to analyze FDI across a wide range of countries in a comparative perspective. This allows for a unique benchmarking of CEE as emerging economies.

The institutional development has been identified as a major determinant of FDI in CEE (Bevan *et al.*, 2004, Campos and Kinoshita, 2003, Meyer and Peng 2005) and EU accession presents another major institutional change expected to facilitate international business. With both investment diversion and investment creation effects, the net effects of EU integration are theoretically ambiguous (Baldwin *et al.*, 1996, Buch *et al.*, 2003). In particular, reduced administrative barriers were expected to facilitate pan-European integration of business operations, which would generate some new FDI projects, but closure of certain small operations serving local markets. Secondly, more small and medium size firms were expected to seek to serve markets in accession countries. Third, liberalization and privatization of sectors such as telecommunications and banking creates major opportunities for FDI in service industries; and fourth, accession countries would participate in the merger and acquisition activities of European MNEs (Meyer and Jensen, 2005). Empirical evidence suggest that already the announcement of the EU accession process had a positive effect on FDI inflows (Estrin and Bevan, 2004). At the same time the major privatization programs have been completed, such that FDI was expected to increasingly come in form of greenfield FDI.

Preliminary evidence suggests that locational determinants of FDI are converging with those in Western Europe (Disdier and Mayer, 2004), while unit labor costs continue to be an important determinants of FDI (Bevan and Estrin, 2004). It has also been shown that FDI in CEE creates spillovers for the local economy. However, they are more likely to occur in form of vertical rather than horizontal spillovers (Javorcik, 2004), and they may be dependent on specific features of the recipient firms (Konings, 2001, Sinani and Meyer, 2004) and be limited to local communities of interrelated firms (Jensen, 2004).

*** *Figure 1 approximately here* ***

Figure 1 illustrates the net FDI flows to the three countries of this study, along with the average for the eight EU Accession Countries in CEE, using net per capita inflows to account for the very different sizes of the countries (Poland has 38.5 million inhabitants, Hungary 10.1 and Lithuania 3.5). Moreover, the average FDI inflow to these countries continued to increase up to 2002, despite global recession, mainly due to high FDI in the Czech Republic and in Slovakia. Hungary has been an early leader due to its FDI-oriented privatization program, with peaks in the years of the largest privatization deals. However, outward FDI from Hungary picked up in 2002 and even exceeded inflows in 2003 leading to a net outflow of FDI. This, again, is driven by a few large investments, notably the acquisitions by oil company MOL in Slovakia and Croatia, and a major acquisition by OTP, the largest

Hungarian bank, in Bulgaria. But there have also been withdrawals of FDI projects, especially in labor-intensive industries.

In the early years of economic transition, several surveys investigated not only the volume of FDI (Meyer, 1995) but also various aspects of the patterns of FDI (Meyer, 1998, OECD, 1995, Pye, 1998).³ Fewer studies assess FDI in the later stages of transition. Thus, we know little how FDI has evolved during the transition. Moreover, does the institutional change reported for instance by the EBRD every year actually impact on the assessment of the business environment as perceived by foreign investors? Are patterns of FDI converging with those of other emerging economies? Is a unique East European pattern of FDI emerging, or are variations within the region just as large as between CEE and, say, East Asia?

To investigate these questions, we have conducted a questionnaire survey of foreign investors in 2003 in three accession countries, of which this article presents the first results. These three countries represent a cross-section of the accession countries: *Hungary*, an early-leader in attracting FDI; *Poland*, a strong second mover receiving a boost of FDI in the mid and late 1990s; and *Lithuania*, a relative latecomer who attracted FDI only after shedding the legacy of having been part of the Soviet Union.

The survey data show cross-country differences in the patterns of foreign investment, in the motives and performance of investment, and in investors' assessment of the local business environment. Following a brief introduction to the survey methodology, we discuss first the investors, and then their views on the local business environment. Our data point to costs and risks created by institutions 'in transition', which will be overcome only once the period of institutional change has been completed and the institutional environment again becomes stable and predictable. On the basis of the discussion of investors and the context, we review their entry motives, entry modes and performance. Generally, we find fewer changes over the period of the 1990s than we expected, but some interesting differences across the three countries in our study, and between CEE and other emerging economies.

Survey Methodology

Local research teams in the three East European economies have administered the survey in the year 2003, during the run-up to EU membership. In all countries, the base population includes all FDI established over the period 1990-2000, that have at least 10 employees and foreign equity participation of 10 percent. We have constructed the base population in each country from multiple locally available databases to obtain as full coverage of FDI as possible. The questionnaire was sent to the chief executive

³ For a review of the early literature on FDI in CEE see (Holland *et al.*, 2000).

of each firm for which contact information was available in the database. In most cases, this was followed up with telephone calls and personal interviews to secure high return rates. We have obtained replies from over 500 foreign investment firms including 200 in Poland, 225 in Hungary and 107 in Lithuania.

To coordinate the research, to discuss the research questions and to design the common research instruments, the research teams met three times, once in Budapest and twice in Copenhagen. The survey is based on a common research instrument that has been translated into local languages where appropriate. The sample framework and some of the questions have been designed such as to replicate the study by Estrin and Meyer (Estrin and Meyer, 2004), which was conducted in India, Vietnam, South Africa and Egypt. This allows us to conduct a comparative analysis across countries in different parts of the world, that aims to unveil the specificities of CEE economies among the emerging economies.⁴

The Foreign Investors

Table 1 depicts the distribution of sample firms across broad categories of industries. Table 1 shows that, in CEE services account for more than 60% of the total number of projects, while in the case of India, South Africa, and Vietnam investments in manufacturing prevail over investments in other sectors. This reflects the attraction of various services sectors, where CEE had considerable catch-up needs in the early 1990's, and where EU association and later preparation for accession opened market to a much larger extent than in other emerging economies. Lithuania received a particular high share of FDI in services as the local market is too small to attract production aimed for the local market only, and the geography provides opportunities for transport and energy services related to business with Russia and Belarus. Hungary and Lithuania still have a high share of FDI in trade and other services, which includes sales operations of companies exporting to these countries. Note that these data refer to the number of projects. Since manufacturing projects are on average larger and more capital-intensive than FDI in the service sector, the distribution of affiliates across sectors may be different when the industries are ranked by capital investment.

Manufacturing FDI is too a larger extent in the heavy industry and chemicals sector in Hungary and Poland, yet these sectors are particularly underrepresented in Lithuania. In contrast, Lithuania receives more investment in the light industry sector and far less in chemicals and heavy industry than any of the benchmark countries. This includes textiles and food processing, industries where cheap labor or access to agricultural produce are key competitive advantages. Thus Lithuania

⁴ Henceforth, we refer to the two sets of countries as the 'three CEE economies', and the 'four emerging economies' respectively.

appears to be focused on the less sophisticated parts of the industrial value chain. In services, we observe particular variation in FDI in the financial sector where the regulatory framework is particular important in shaping business opportunities and risks. Poland and Lithuania, but not Hungary, have over 10% of foreign investors in the financial sector, presumably an outcome of their recent privatization policies of this sector, as HU has started privatizing the banking sector only starting 2003 when Erste, an Austrian bank, bought Postbank.

*** *Table 1 approximately here* ***

The second part of Table 1 reports the pattern of foreign investment by countries of origin, and illustrates the importance of proximity in international business. Multinational enterprises (MNE) from Western Europe are the most important investors in CEE, which corresponds to the role of Asian investors in Vietnam and Arab investors in Egypt. In Lithuania, European investment account for almost 95% of all FDI projects out of which a remarkable 16% originate in other CEE countries – including both firms expanding across the Baltic States, and investors from Russia.

The importance of West European partner countries can be explained in part by geography and cultural familiarity:

- in Lithuania 42.9% of the parent companies originate from Nordic countries,
- in Poland both German (29.5%) and Nordic (13.7%) parent companies are important,
- in Hungary 30.7% of the investing firms are German.

Early studies of FDI in CEE observed a similar affinity of West European investors, especially of small and medium size enterprises, though it was widely believed to be a transitory phenomenon (Meyer, 1995, OECD, 1995). Yet, our data show that the pattern persists; it may even have become stronger! Moreover, it is not unique to Europe: in Vietnam, Taiwanese investors are the largest group followed by Korean and Japanese, while Egypt attracts investors from across the Middle East.

The geographic position of CEE in Europe holds, theoretically, considerable potential for American or Asian investors aiming to serve West European markets. CEE offers relatively low cost production sites within the borders of the EU (or, before May 2004, already tariff-free within the Europe Agreements). Especially business wishing to establish new production sites in Europe, and thus not facing costs of closing down existing operations, would have been expected to take advantage of these conditions. Yet, our data suggest that there has been no rush to ‘enter fortress Europe through the back

door', apart from some well know examples such as Daewoo in Poland (which was ultimately unsuccessful).

The importance of North American investors varies a lot among the three CEE countries: Lithuania has only 2% of investing firms originating from this region while this share is as high as 20% in Poland.⁵ Plausibly, American investors are focused primarily on large markets, and have only secondary interests in smaller markets, such as Lithuania, which may be served by exports from affiliates in other European countries, such as Poland. Their share in the other emerging economies underlines the global importance of North American MNE – except, for political-historical reasons, in Vietnam.

The third part of Table 1 shows the pattern of FDI projects by size, as measured by employment in the year preceding the survey. Note that firms had to have at least 10 employees at some point in time to be included in the base population. About one third of the foreign owned subsidiaries in Hungary, Lithuania and Poland have started with less than 10 employees; but they exceed the 10 employee threshold by the time of the survey.

In terms of the number of employees eventually employed in the company, affiliates are in a similar range as those in the other emerging economies. However, in Poland, by 2001 more than 60% of the surveyed foreign subsidiaries had more than 100 employees and almost 12% had more then 1000 employees. Considering the capital stock, projects in the CEE sample are in median smaller than those in the benchmark countries.

Overall, Table 3 suggests that FDI in the accession countries is mainly driven by European economic integration and the creation of pan-European business operation, but less by integration of CEE into the global economy and into the supply chain of MNE operating worldwide. The relatively easy access from Western Europe may in particular facilitate the FDI in service industries and the establishment of small operations.

Evaluations of the local business environment

Many analysts consider institutional development as a precondition for private investment. This view has been given a theoretical grounding by proponents of the 'new comparative economics' (Djankov *et al.*, 2003), as well as the institutional perspective in international business strategy (Peng 2003; Meyer & Peng 2005). Independent agencies such as the EBRD (EBRD, 2003) and the World Bank (World Bank, 2004) report an improvement along their respective indicators. This is expected to make the

⁵ Official statistics are collected using different definitions in the three countries, or not published at all, such that comparisons and assessments of the representativeness of our data are difficult. To the extent that we can benchmark our data to official statistics, they show similar tendencies albeit the differences between the three countries are not as large.

business environment more attractive for both domestic businesses and for foreign investors (Djankov *et al.*, 2003, World Bank, 2004). Thus, institutions have been identified as determinants of FDI both worldwide (Globerman and Shapiro, 2003) and in CEE (Bevan *et al.*, 2004, Brenton *et al.*, 1999). Moreover, local resource endowment, especially human capital and supply of intermediate goods, are crucial for many investors.

However, periods of institutional change also create obstacles to business. A new institutional framework cannot be created overnight. Even where rules and regulations are implemented fast, as in East Germany in 1990, informal institutions such as procedures and value systems change only gradually. Elsewhere, institutional development has been a gradual process of changing the legal and regulatory framework, with repeated changes and fine-tuning. However, this implies that institutions during periods of transition are instable, which created higher transaction costs for businesses (Swaan, 1997). Firms thus rely increasingly on informal mechanisms of exchange, such as business networks rather than arm-length market transactions (Peng, 2003), and they have to be flexible to adapt to changing circumstances (Uhlenbruck *et al.*, 2003). Hence, although we would expect the recent institutional change to favor business in the long run, we might see short-run effects that inhibit efficiency of the economy.

Official reports generally report an improvement of the business environment, yet how do foreign investors themselves evaluate the local business environment in the accession countries? Are the improvements suggested by the EBRD indices also reflected in foreign investors own assessment? We asked respondents to evaluate on a scale from 1 to 5 various aspects of the local business environment, at two points in time: the initial year of operation and at the time of the survey.

Table 2 shows respondents' evaluations concerning the local availability of labor with different qualifications. Across all seven countries the ratings are above the midpoint of the scale at 3.0, suggesting that staff can 'sometimes' to 'mostly' be recruited. Moreover the general trend over time is an improvement of the availability of labor, except for two categories in Hungary. Moreover, as one would expect, the scarcity of labor increases with the qualification levels, as executive managers are far more difficult to find locally than low-cost low-skill labor. These features apply to both CEE countries and the other emerging economies.

*** *Table 2 approximately here* ***

In Hungary, we observe a paradox: many FDI projects were initially motivated by cheap labor, but the shortage of cheap labor is seen as a constraint. Low-cost workers are becoming scarcer while executives become more available, such that the evaluations show smaller margins in the year 2002 than for the

time of investors initial entry. The scores for low-cost low-skill labor and skilled non-managerial categories diminish only in Hungary. This suggests the emergence of a labor shortage for unskilled labor as the economy advances with economic development and EU accession. No such tendencies emerge in Poland or Lithuania. In Lithuania, in contrast, availability of low skilled staff has improved while executive managers continue to be harder to recruit. The large margin of improvement in labor availability in Poland, as seen from the corporate perspective, may be explained by the sharp increase the unemployment rate from 10,4% in 1998 to 17,5% in 2001, and reaching 20.4% in 2004. Unemployment grew despite the remarkable growth rates of GDP achieved by Poland.

The perceived unfavorable development of the labor supply in Hungary may come as a surprise to observers from a West European perspective, where relocation of production is of major concern to both business communities and policy makers. It may also reflect economic progress and upgrading of the labor force to higher qualification levels, which makes Hungary attractive for more sophisticated types of operations. However, unit labor costs are an important concern to some foreign investors (Bevan and Estrin, 2004) and relocation of production using semi-skilled or low-skilled labor may thus seek locations other than Hungary, as labor supply shortages constrain future FDI.

The local industries receive lower rankings in Table 2 than the evaluations of labor; thus managers of foreign affiliates perceive the local inputs as being of medium or low quality. However, they improve over time in all three countries. The quality and range of products are the most problematic items in all three countries, followed by the level of technology. Management and marketing capabilities receive more favorable ratings, which may be surprising given the low esteem of CEE management in the early 1990s.

In all respects, foreign investors give the most favorable assessment to Hungarian firms, and scores have been improving over time. Lithuania ranks the lowest when foreign investors first arrived, but improvements have been more pronounced such that by the year 2002, Lithuania ranks higher than Poland for all local inputs. Thus, the local resource endowment in terms of local industry and local human capital is improving by most criteria in the three countries.

*** *Figure 2a & 2b approximately here* ***

The evaluation of the institutional environment varies considerably with the different criteria that we asked respondents to consider (Figure 2).⁶ Most ratings are around the midpoint of the scale, 3.0, reflecting partial agreement with the statements suggesting institutional obstacles. However, respondents in all three countries considered it important to stay informed about legal and regulatory changes (with

⁶ The exact wording of the items is contained in the appendix.

scores over 4.0 for all countries). Moreover, they are concerned about the costs caused by the frequency of changes in laws and regulations, especially in PL. The Polish government introduced in the years 1999 to 2001 reforms in the area of social security, health care and pension system, as well as in the legal forms of enterprises and while reforming the public administration. These reforms aim to bring Polish law in line with EU legislation. However, according to a Polish expert interviewed for this research, “this has at least tripled reporting obligations of enterprises and created unimaginable mess at the beginning of implementation process. The paperwork of Poland’s private enterprises in 2004 reached level last seen when leaving communist regime in 1990.”

Asked about specific institutions, respondents indicate moderate concern about customs and tax procedures, as well as (except Hungary) procedures of registering the business. However, access to utilities is not seen as problematic, if we use the midpoint of the scale (3.0) as cut off. Similarly personal contacts with officials are considered only moderately important. Since the question is often used as indicator of corruption, we may infer that foreign investors do not appear to face bribes as a major obstacle to business. Across countries, Poland respondents appear more concerned about procedures, while in Lithuania and Hungary investors are more concerned with maintaining personal contacts, which is consistent with case evidence (Antal-Mokos, 1998).

To investigate the institutional change, we moreover asked foreign investors whether they observe an *improvement* of the business climate over time (Figure 2b). Thus we included three items as change variables that correspond to the last items in Figure 2a. Given the widely reported progress of institutional development (EBRD, 2003), we expected that our respondents would, at least on average, report that institutional improvement would facilitate their business and reduce costs. However, the scores are all below 3.0 (except Hungarian customs) suggesting that on average respondents see little improvement of the institutional environment. This contrasts with the widely held believe that EU accession would enhance the institutional framework.

Overall, these data suggest that rather than the state of laws and regulation, their **frequent change** is of concern to business, although it presumably generally makes the business environment more business friendly. Thus the evolution of the legal framework remains a major concern because of the uncertainty and transaction costs associated with legal changes. This indirectly supports Swaan’s contention that the transition process itself raises transaction costs during the period of institutional change (Swaan, 1997). Businesses may thus prefer an imperfect institutional framework to institutions that are supportive to business but change frequently and unpredictably. Moreover, the accession to the EU adds to the **complexity** of the legal framework, and at least during the preparation phase, it may have raised rather than lowered transaction cost, even where they open new business opportunities and create a fairer, more level playing field for competition (e.g. in public sector tender processes).

Thus, businesses are concerned not only with the state of the institutions, but with their stability and predictability. Notably, businesses have to develop capabilities to deal with frequent institutional change, which underlines the crucial importance of strategic flexibility as a means to secure long term success of business in transition economies (Uhlenbruck *et al.*, 2003). Future research thus ought to explore stability and complexity of institutional frameworks as determinants of businesses development, and FDI in particular.

*** Table 3 approximately here ***

Entry Strategies

We expected that the changing business environment in terms of resource endowment and institutional frameworks would lead to changing patterns of FDI, even though these changes emerged to be less substantial than we expected. Firstly, we expected an increasing integration of CEE into global trade, and thus initial market seeking FDI giving way to more FDI serving both local and export markets. Table 3 shows the market orientation of the foreign investors. In the three CEE countries, foreign affiliates produce mostly for local markets; thus the main investment motive in these countries is market seeking, similar to the other emerging economies, except Vietnam. Many investors thus appear initially attracted by the large domestic market, but develop the export potential of their operations later.

However, there are interesting differences among the three CEE countries. Foreign affiliates in Hungary and Lithuania export more than Polish affiliates, presumably because of the large domestic market in Poland. Yet, over the time, Polish affiliates have increased the share of sales exported, thus diminishing the difference to Hungarian and Lithuanian affiliates. The high export orientation among the Lithuania firms may be in part due to the small size of the domestic market as MNE serve markets in all three Baltic States from one FDI operation.

Unlike the four other emerging economies, in Poland, Lithuania and Hungary the share of exports to global markets is very small, less than 3% compared to 10% to 20% in the four benchmark countries. The bulk of their exports goes to regional markets in all three CEE economies, and this share increased over time. The exports to other CEE countries has in all three countries been low initially but grown faster than the exports to other destinations. We report separately the exports to other affiliates of the investing MNE. These are important for some firms, but account for less than 10% in all countries except India. Hence, we see an integration of accession countries into the EU economy, and less (direct) integration in the global economy, as we already suggested based on the pattern of countries of origin.

To examine differences between early and late investors, we plotted the share of domestic sales in the initial year of operation by year of entry in Figure 3. Only in Hungary a trend emerges as sales in

the domestic market in the initial year fell from 97.6% for investors arriving in 1991, to 56.7% in 1997, after which the export propensity stabilized at over 60%. No clear trend emerges in Poland or Lithuania. The outlier observation for 1993, where 40% of sales of new investors in Lithuania went to exports, may be due to the brief period when newly independent Lithuania was perceived as basis for exports to Belarus and Russia. Due to the disappointing economic performance of the Eastern neighbors, Lithuanian eastward exports did not thrive as expected.

*** *Figure 3 approximately here* ***

*** *Table 4 approximately here* ***

In CEE, acquisitions are a major mode of FDI, which distinguishes this region from other emerging economies (Table 8, Figure 4). Only South Africa had a similarly high proportion of foreign investment in the form of acquisitions, presumably due the availability of attractive acquisition targets – i.e. the industrial development – and the development of markets for corporate equity (Estrin and Meyer, 2004). The percentage of acquisitions in CEE is still less than in South Africa. Among the CEE countries, Poland received least FDI in form of acquisitions, which may be due to a privatization policy that relied less on FDI. CEE has been highly industrialized – arguably over-industrialized – before engaging in transition. Thus acquisition targets were in principle available, albeit typically in need of major investment and restructuring. In the absence of equity markets, privatization has substituted as a market for corporate equity. Conventional acquisitions from private owners to private owners have increased in the late 1990s. Thus, opportunities for acquisitions have been available and facilitated the inflow of FDI. However, even so, Greenfield investments outnumber acquisitions in all three CEE countries.

Compared to other emerging economies, few foreign investors enter by JV. They account for only one in five FDI projects. Foreign investors in Egypt, India and Vietnam have higher preferences for partially owned subsidiaries than in CEE and South Africa. The partially owned subsidiaries include two-thirds conventional joint ventures and one-third partial acquisitions, i.e. foreign investors taking an equity stake in an existing company. The share of partial acquisitions is higher in Poland, presumably because the chosen methods of privatization. Some of these patterns may be attributable to differences in the cross-sector distribution of FDI among the seven countries.

While JVs may have been particularly common around 1990, entry modes quickly shifted to full foreign ownership (Meyer 1995). We expected that the share of joint ventures and partial acquisitions

would further diminish as institutional obstacles were removed. However, our survey data show considerable year-on-year volatility over the 1990s but no clear trend (Figure 4).

In Figure 4, we graphically show the changing pattern of entry modes over time, as percentages of all FDI in the respective country in the same year. While there has been some decline of FDI with partial ownership over time, this decline has been fairly modest, and is subject to considerable volatility. Moreover, there has been no clear shift away from acquisition after the privatization was completed. Rather, in Poland and Lithuania we see an increasing share of acquisitions in the last years covered by this study! This may reflect second round privatizations as foreign investors acquire firms earlier privatized to domestic owners.

The continuous high proportion of acquisitions has important implications for the expectations for future FDI, and the likely impact of FDI on the local economy. Future acquisitions will depend on the supply of attractive target firms. As privatization programs come to a close, FDI may thus decline unless private firms emerge as attractive FDI targets. In terms of impact, acquisitions make a major contribution to the restructuring challenges in the region, yet they do not add new capacity, new clusters, and employment. Contrary to expectations, and despite considerable governmental efforts in creating new industrial zones (Mallya et al., 2004), we do not see a rise in greenfield investment in the region.

*** *Figure 4 approximately here* ***

*** *Table 5 approximately here* ***

Performance

Foreign investors flocked to CEE in large numbers, yet were they successful? We asked respondents to assess their own performance by two different benchmarks, firstly relative to their expectations (on a scale from 1 to 7), and relative to their peers in the local industry (on a scale from 1 to 5). These are appropriate measures of subsidiary performance given the problems associated with financial data for the subsidiary level, and the fact that firms usually such internal data them as highly confidential. Most but not all scores are above the midpoint of the respective scale, suggesting that investors on average are moderately satisfied with their FDI performance.

Across all seven countries, except Hungary, **the profitability of the subsidiary is the weakest performance indicator**, both in terms of having met expectations, and in terms of the ROA and ROS measures relative to other firms within the industry (Table 10). This is a powerful result because it holds across such a diverse set of emerging economies, and for two very different measures of performance. It serves as a warning that foreign investors may be fairly successful in managing their operations and their

marketing in emerging economies, but still find it difficult to make satisfactory profits. The long-term motivation of sacrificing short term profits to achieve a long term market position may play a role here, but it can only be part of the explanation because the majority of investors in the survey have been in the market for more than 5 years, by which time investments usually are expected to generate profits. Comparing the results between countries, it is remarkable that margin of difference between the performance measure and the other items is less in CEE, which suggests that lack of profits may be less of a concern in CEE than elsewhere. On the other hand, investors in Vietnam are least satisfied with their profitability (relative to other scores), possibly due to administrative obstacles to business.

Among the three CEE countries, we note that foreign affiliates in Lithuania lag behind the performance of Hungarian and Polish affiliates, both relative to investors' expectation and relative to industry performance. This might be due to industry effects (a high share of investors in service sectors) and country-of-origin effects (a high share of investors from other CEE economies). Affiliates in Hungary and Poland also out-perform foreign affiliates that were set up in Egypt, India and Vietnam, and are on par with the performance of South African affiliates.⁷

Polish respondents give the highest scores for their productivity, followed by market share, while Hungarian affiliates perform best by revenue growth, followed by productivity. In Lithuania, the scores for different performance indicators vary little. The positive assessment of labor productivity in Poland may be a result of fast employment restructuring and increase of manufacturing output. Within the period of 1995-2001 the manufacturing output per one employee increased by 68,1% in constant prices (Statistical Office of Poland, 2003). Apparently, Polish affiliates seem more oriented towards local markets: their performance in terms of domestic market share scores higher than the performance of Lithuanian and Hungarian affiliates, and Polish firms are more successful in developing new products (which are more likely to be sold in the local market) than the foreign affiliates in Hungary and Lithuania.

Conclusions

This study confirms the emerging economies in CEE share many features with other emerging economies, yet there are also important qualitative differences. Communalities include strong presence of investors from nearby origins and many small investment projects that may attract few headlines but in aggregate make a substantial contribution to international business relationships. Across countries, except Vietnam, FDI is predominantly driven by market seeking motives, with 63% to 75% percent sold in the local market (Vietnam 50%). Moreover, across countries, we find that investors are moderately

⁷ These direct comparisons of Likert scale scores across countries, however, need to be considered with caution as cultural differences may inhibit equivalence, i.e. consistent interpretation of the scales across countries.

satisfied with most aspects of their operations, but may still find it difficult to generate satisfactory profits.

However, there are also important differences. Exports from FDI operations in CEE are primarily oriented towards Western Europe, with less than 3% aimed at global markets. The motive of an export platform for global markets is more important elsewhere, reaching 20% in India and Vietnam. The pattern of entry modes also varies considerably as a result of both institutional environment and the attractiveness of local firms. South Africa is an outlier among emerging economies with an unusually high share of acquisitions, due to developed capital markets and strong indigenous firms. In CEE, acquisitions account for a much higher share than in Egypt, India or Vietnam. Interestingly, the pattern persists even as the major privatization wave comes to an end. Thus, conventional private-to-private acquisitions replace privatization-related acquisitions. Joint ventures are less common in CEE than in the other emerging economies, but their share is, surprisingly, persistent over time. Future research should thus investigate not only variations of investment motives and entry modes across countries, but explain the determinants of change on the pattern of FDI over time.

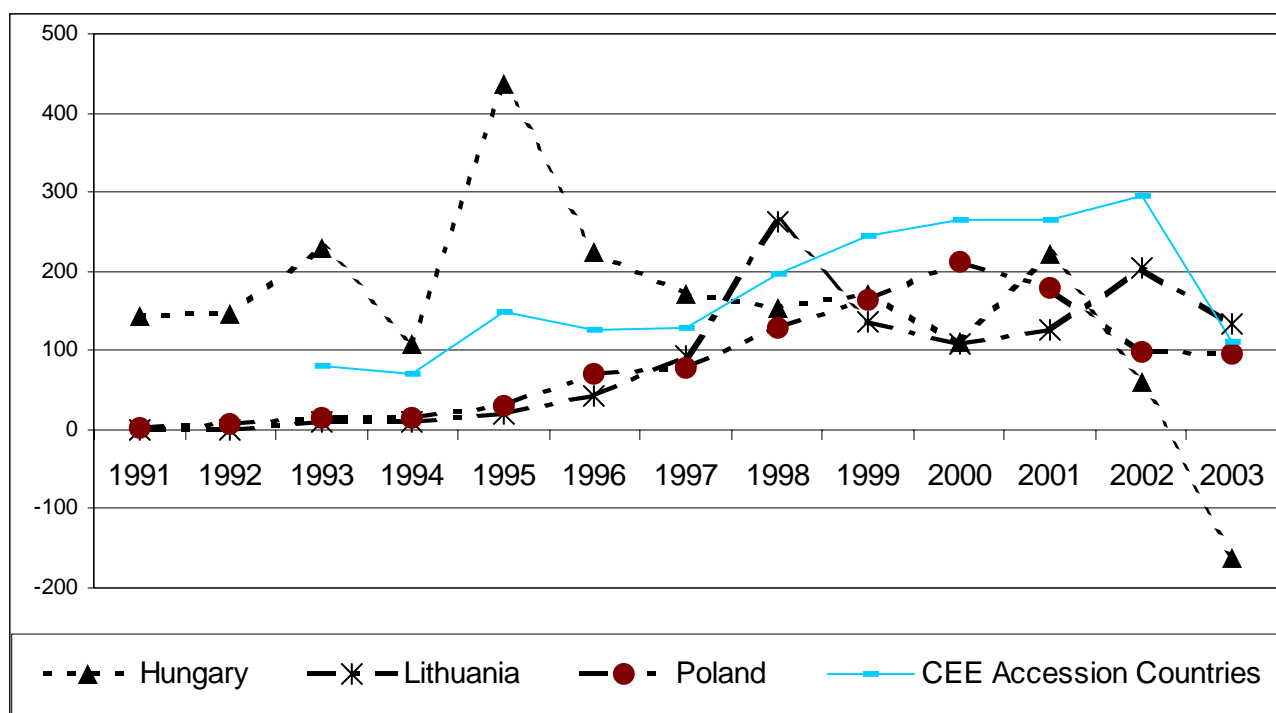
In CEE, FDI has been largely driven by business strategies that integrate operations and markets across Europe. This has resulted in stable, or even increasing, FDI flows in CEE at a time when FDI worldwide is in decline. Overall we see FDI in CEE being driven by economic integration across Europe, even well ahead of the political union accomplished in May 2004. This is likely to continue, especially if the current uncertainty and instability of the regulatory environment stabilizes. However, one driving force of FDI in the 1990's, the privatization process, is coming to an end. It resulted in a high share of FDI by acquisition, compared to other emerging economies. To sustain the high levels of FDI inflow, CEE economies thus have to develop attractive private firms worthy to be acquired, or attract more greenfield investment. The patterns observed in this study suggest that the forces of European integration are driving this trend:

1. The main countries of origin continue to be neighboring North and West European countries.
2. Most investors are motivated by market seeking motivations, thus further integrating markets within the enlarged EU, and providing consumers with increasingly similar product and brand portfolios.
3. To the extent that FDI operations are exporting, these exports are going towards Western Europe, while only 3% are sold in global markets.

The business environment, as seen from the perspective of managers in MNE, is improving, but not at the pace one might have expected. The change indicators on local firms and human capital are overwhelmingly positive, but small.

Particular interesting are the views on the institutional environment. The instability and uncertainty associated with the introduction of new (and hopefully superior) rules and regulation emerges as major obstacle, and respondents agree only partially that the business environment has at all improved. Institutional change creates costs and risks, even if it is moving in the direction of a more market friendly environment. This confirms Swaan's (1997) concern about increasing transaction costs during transition, and indirectly Peng's (2003) concern about increased usage of informal mechanisms of coordination during periods of transition. Future research may take up these observations and investigate not only how present institutions affect business, but how instability and unpredictability of rules and regulation inhibit business. As a policy implication, these results warn that political debates over details and delays may undermine the overall objectives of reform, and suggest that comprehensive institutional reforms should have lead-times that allow business to prepare.

Figure 1: Net FDI inflow per capita in Accession Countries, in US\$



Source: own calculations based on data from EBRD (2004)

Figure 2a: Institutional Environment (level)

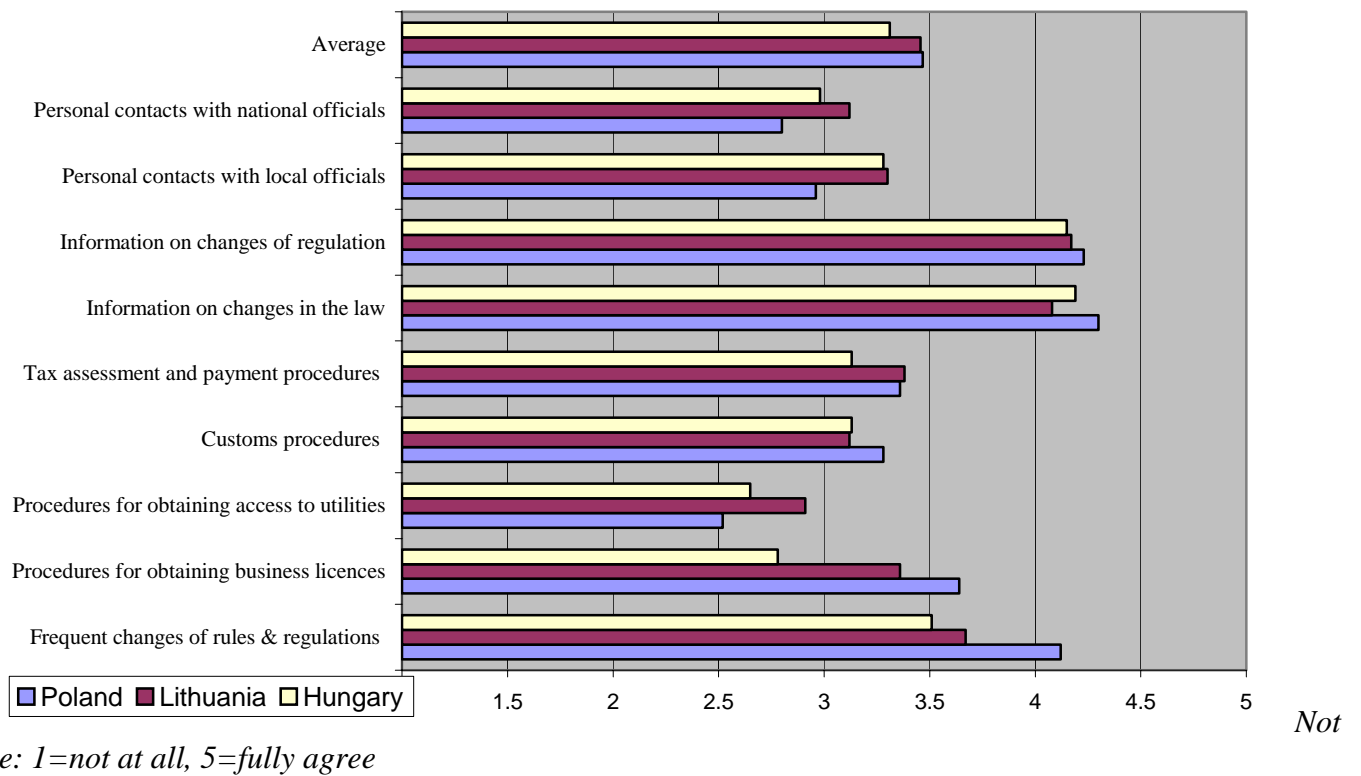
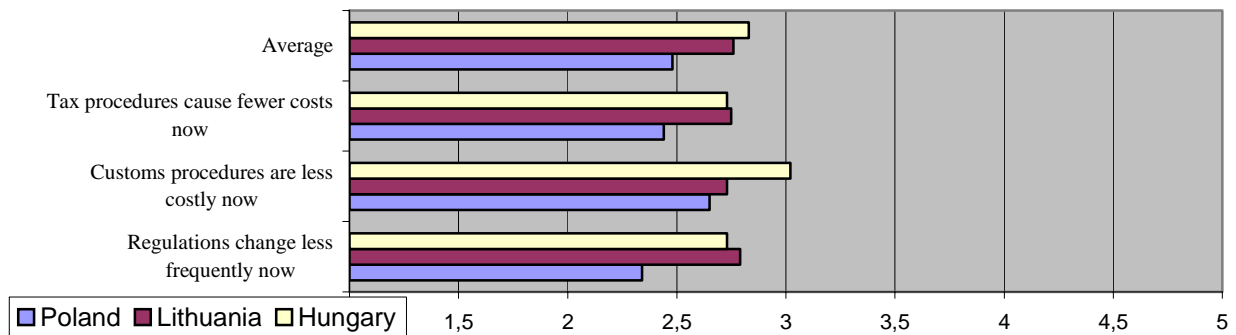
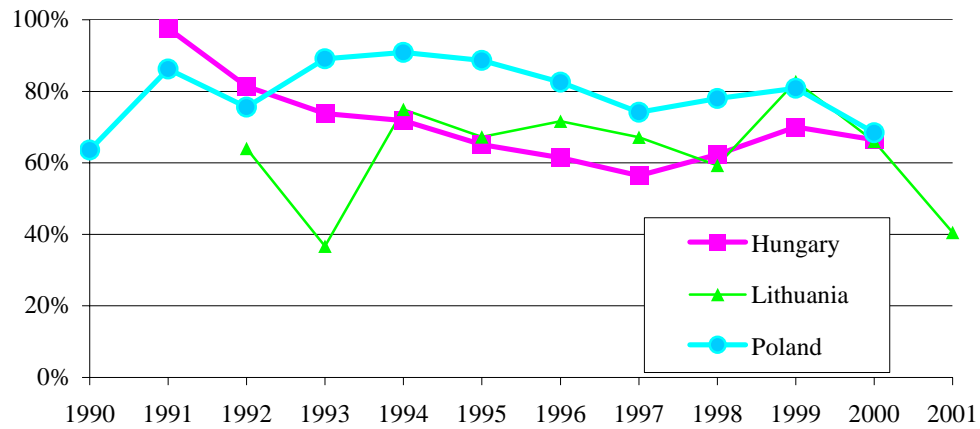


Figure 2b: Institutional Environment (Change)



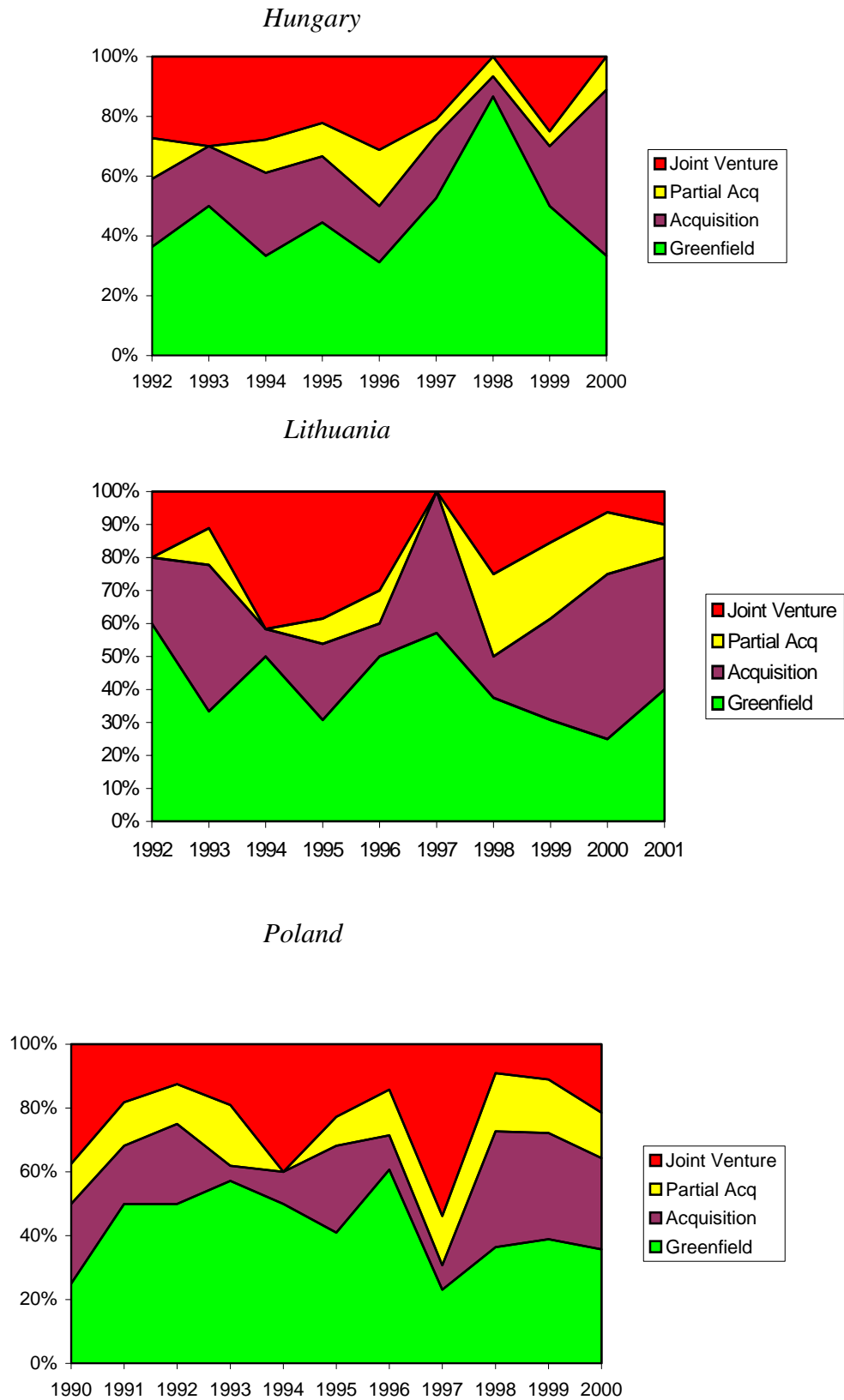
Note: 1=not at all, 5=fully agree

Figure 3: Sales in domestic market, initial year



Note: percentage of sales in the domestic market in the initial year of operations. Only years with more than 5 observations in the respective country are reported.

Figure 4: Entry Modes over time



Note: percentage of each mode in each year. Only years with more than 5 observations in the respective country are reported.

Table 1: Sample Characteristics (% of affiliates)

By sector	Hungary	Lithuania	Poland	Egypt	India	South Africa	Vietnam
Agriculture, Mining & Construction	5.5	7.6	4.8	15.3	2.7	3.7	5.9
Light manufacturing	10.1	22.6	15.6	18.0	19.2	36.4	34.3
Heavy manufacturing	27.2	2.8	21.5	14.7	29.3	12.4	20.7
Chemicals	7.8	0.9	6.5	8.7	13.8	3.7	15.4
Transport, Communication & Utilities	7.4	16.0	9.1	3.3	2.7	9.9	6.5
Sales (retail and wholesales)	24.9	27.4	14.5	6.7	0.5	1.9	0.6
Services (business, financial, hotels & others)	17.1	22.6	28.0	33.3	31.9	32.1	16.6
Total	100	100	100	100	100	100	100
<i>Number of observations</i>	<i>217</i>	<i>106</i>	<i>186</i>	<i>150</i>	<i>188</i>	<i>162</i>	<i>169</i>
By country of origin	Hungary	Lithuania	Poland	Egypt	India	South Africa	Vietnam
North America	10.8	4.7	20.7	18.8	32.8	22.4	4.7
Europe	84.0	492.5	76.1	43.8	48.5	56.5	14.8
Central and Eastern Europe	1.9	17.0	1.6	1.4	0.8	0.0	0.6
Germany	31.9	17.0	28.8	2.8	14.2	11.2	1.8
Nordic	6.1	41.5	13.0	4.9	3.0	9.9	1.8
Other W Europe	44.1	17.0	32.6	34.7	30.6	35.4	10.7
East Asia, inclusive Japan	0.5	0.9	1.1	3.5	15.7	17.4	78.1
Middle East / North Africa	0.0	0.0	0.0	33.3	2.2	0.0	0.6
Other (including Australia)	4.7	1.9	2.2	0.7	0.8	3.7	1.8
Total	100	100	100	100	100	100	100
By number of employees	Hungary	Lithuania	Poland	Egypt	India	South Africa	Vietnam
< 50	51	48	24	38	46	31	24
51-100	19	22	17	19	18	23	24
101-250	14	7	24	18	19	16	20
251-1000	15	14	23	18	16	20	27
More than 1000	2	9	13	6	1	10	5
Total	100	100	100	100	100	100	100
Median no. employees	48	60	140	73	56	90	127
Median capital stock	0.70	0.35	0.62	1.45	0.69	1.67	1.2

Note: columns may not add up due to rounding errors.

Note: The sampling criterion required that the firms had at least 10 employees at some stage. Thus they may well have less than 10 employees in any specific year.

Note: Median capital stock: median size of fixed capital stock in US\$ million

Table 2: Investors Evaluation of local resources

Human capital	Poland			Lithuania			Hungary		
	Initial	2002	Change	Initial	2002	Change	Initial	2002	Change
Executive managers	3.18	3.86	0.67	3.38	3.57	0.19	3.50	3.77	0.27
Professionals	3.41	4.18	0.78	3.67	3.81	0.15	3.82	3.95	0.13
Operational managers	3.50	4.11	0.61	3.73	3.86	0.13	3.73	3.76	0.02
Skilled non-managers	3.83	4.30	0.47	3.98	4.31	0.33	3.81	3.66	-0.15
Low-cost low-skill	4.51	4.72	0.21	4.49	4.96	0.46	4.16	3.84	-0.32
<i>Mean, human capital</i>	<i>3.69</i>	<i>4.23</i>	<i>0.55</i>	<i>3.85</i>	<i>4.10</i>	<i>0.25</i>	<i>3.80</i>	<i>3.79</i>	<i>-0.01</i>
Local industry	Poland			Lithuania			Hungary		
	Initial	2002	Change	Initial	2002	Change	Initial	2002	Change
Quality and range of products	2.45	2.54	0.09	2.17	2.66	0.49	2.97	3.20	0.23
Quality and range of services	2.58	2.62	0.05	2.29	2.78	0.49	3.03	3.24	0.21
Management capabilities	2.71	2.81	0.10	2.65	3.06	0.41	3.19	3.46	0.27
Marketing capabilities	2.73	2.84	0.11	2.57	2.96	0.39	2.99	3.26	0.28
Level of technology	2.62	2.63	0.01	2.35	2.76	0.40	2.83	3.17	0.34
<i>Mean</i>	<i>2.62</i>	<i>2.69</i>	<i>0.07</i>	<i>2.41</i>	<i>2.84</i>	<i>0.44</i>	<i>3.00</i>	<i>3.27</i>	<i>0.27</i>

Scales: Human capital: 1=never available, 5=readily available; local industry: 1= Local industry far inferior to your firm, 5= Local industry stronger than your firm

Table 3: Market focus of affiliates (% of sales)

Market focus	Poland		Lithuania		Hungary		Egypt		India		South Africa		Vietnam	
	Initial	2002	Initial	2002	Initial	2002	Initial	2000	Initial	2000	Initial	2000	Initial	2000
% of sales exported	19	27	33	36	30	35	23	26	36	37	19	25	51	50
of which:														
Regional markets	15	20	27	28	19	23	10	12	6	7	4	10	25	24
CEE	5.5	7.3	7.5	8	4.5	5.9	not asked							
Europe beyond CEE	9.2	12	19.5	19.8	14.5	17.1								
Global market	1	2	2	3	3	3	10	10	20	20	11	12	20	20
Other affiliates	3	6	4	5	8	9	3	4	11	10	4	3	6	6

Column total = 100 +/- rounding errors;

Table 4: Distribution of affiliates by entry mode (% of affiliates)

Sector	Hungary	Lithuania	Poland	Egypt	India	South Africa	Vietnam
<i>Greenfield</i>	43	40	42	46	35	31	56
<i>Joint Venture (JV)</i>	23	19	20	37	53	23	32
<i>Acquisition</i>	25	30	21	5	4	31	2
<i>Partial Acquisition</i>	9	11	16	12	7	14	11 ^a

Note: Column total = 100 +/- rounding errors; a = in Vietnam, partial acquisition were defined as JV where local firms transfer part of the existing operation to the newly created JV.

Table 5: Company performance

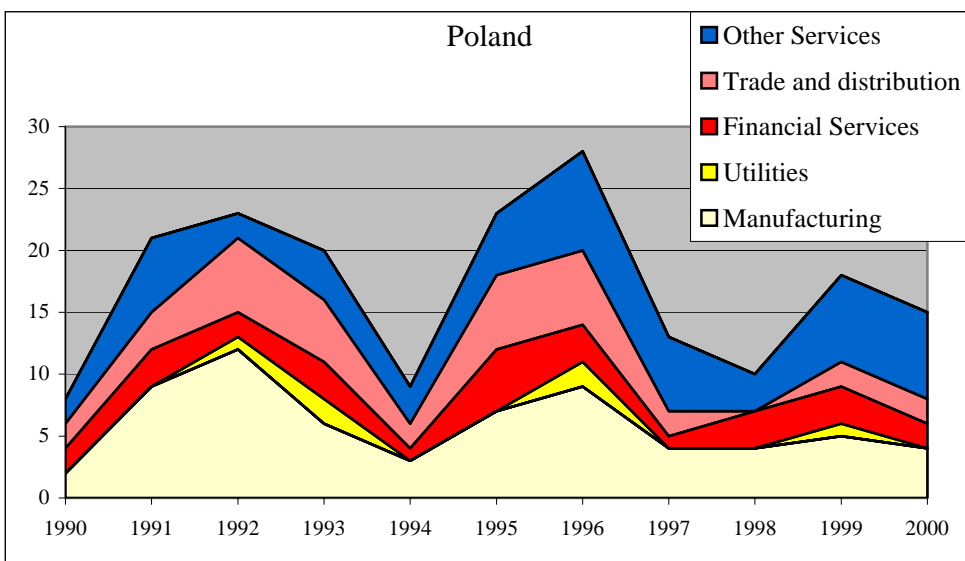
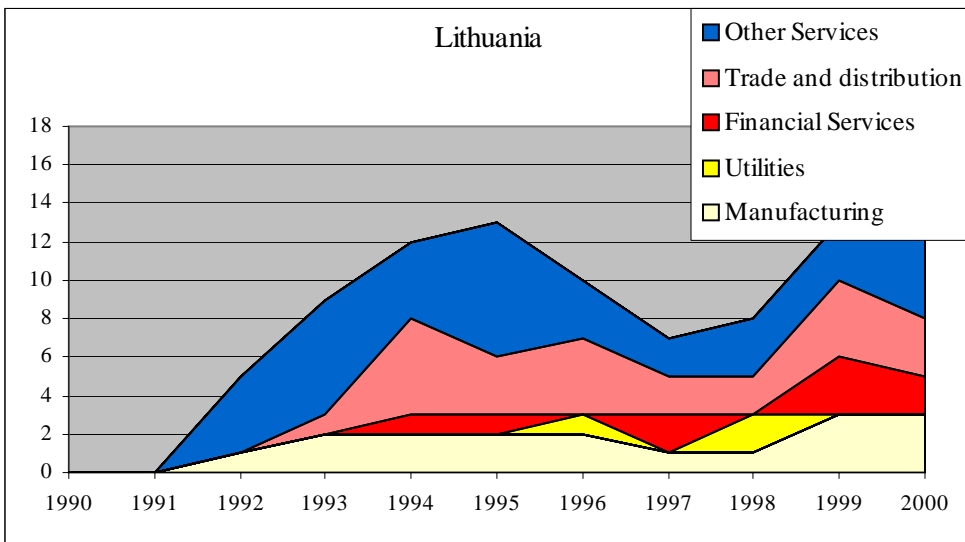
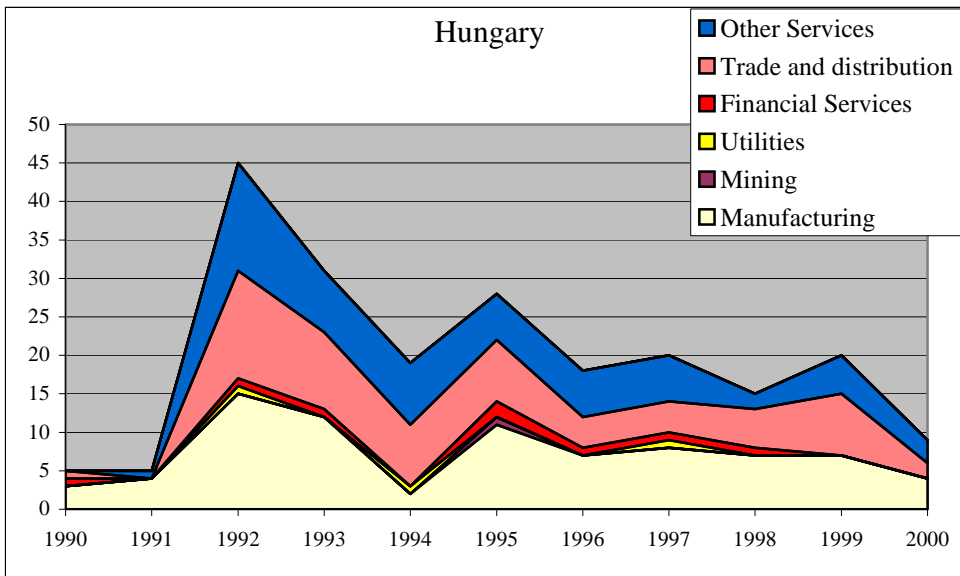
	Poland	Lithuania	Hungary	Egypt	India	South Africa	Vietnam
<i>Relative to expectations^a</i>							
Productivity	5.49	4.51	5.19	5.35	5.45	5.38	4.81
Profitability	4.89	4.46	5.00	4.57	4.60	4.85	3.70
Revenue growth	5.06	4.60	5.36	4.78	4.60	5.27	4.23
Domestic market share	5.20	4.72	4.94	4.85	4.96	5.35	4.29
New product development	5.37	4.60	4.39	N/a	N/a	N/a	N/a
<i>Average (first 3)</i>	<i>5.14</i>	<i>4.52</i>	<i>5.18</i>	<i>4.90</i>	<i>4.89</i>	<i>5.17</i>	<i>4.24</i>
	Poland	Lithuania	Hungary	Egypt	India	South Africa	Vietnam
<i>Relative to the industry^b</i>				not asked			
After tax return on total assets (ROA)	3.50	3.05	3.54				
After tax return on total sales (ROS)	3.57	3.05	3.47				
Firm total sales growth	3.75	3.25	3.71				
Overall firm performance and success	3.75	3.34	3.86				
Productivity	4.00	3.31	3.80				
<i>Average</i>	<i>3.72</i>	<i>3.20</i>	<i>3.68</i>				

Notes:

a: 1=performance expectations not met at all, 7=performance expectations entirely fulfilled. The data for the four emerging economies have been rescaled from a 5-point Likert scale to a 7-point one. Domestic market share is only reported for firms that do not export all their output.

b: 1=lowest 20%, 5=top 20%

Appendix 1: Patterns of Industry by Time of Entry



Appendix 2: Statements and Data underlying Figure X (Institutional Environment)

State Variables	Poland	Lithuania	Hungary
a. Frequent changes of rules & regulations cause substantial costs and/or delays	4.17	3.64	3.51
c. The procedures for registering the business and obtaining business licences cause substantial costs and/or delays	3.66	3.31	2.78
d. The procedures for obtaining access to utilities like electricity, water etc. cause substantial costs and/or delays	2.60	2.79	2.62
e. The customs procedures cause substantial costs and/or delays	3.33	3.15	3.12
g. The tax assessment and payment procedures cause substantial costs and/or delays	3.42	3.35	3.13
i. In our industry, it is important to obtain regularly information on forthcoming changes in the law	4.32	4.10	4.18
j. In our industry, it is important to obtain regularly information on forthcoming changes of regulation or decrees issued by government	4.26	4.16	4.16
m. In our industry, it is important to maintain close personal contacts with key officials at local level	3.02	3.33	3.33
n. In our industry, it is important to maintain close personal contacts with key officials at national level	2.86	3.18	3.03
Mean of the above	3.52	3.45	3.32
Change variables	Poland	Lithuania	Hungary
b. Changes of rules & regulations are less frequent now then when the foreign investment was first established	2.33	2.80	2.74
f. The customs procedures affecting our industry cause fewer costs and/or delays now then when the foreign investment was first established	2.71	2.74	3.01
h. The tax assessment and payment procedures cause fewer costs and/or delays now then when the foreign investment was first established	2.44	2.74	2.74
Mean of the above	2.49	2.83	2.74
Social responsibility	Poland	Lithuania	Hungary
k. In our industry, it is important to support social activities or charitable organizations	2.52	2.53	2.45
l. In our industry, it is important to demonstrate concern for the natural environment	3.60	3.04	2.32
Mean of the above	3.06	2.79	2.39

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