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Foreign Direct Investors' Behavior in CEE Countries in the Process of the EU Enlargement

Abstract

Strategies of transnational corporations (TNCs) for making investment abroad are influenced by deepening and widening of the European integration processes. The aim of this chapter is to present answers to the following questions: to what extent do enlargement change foreign investors' strategies towards CEE countries? Do activities of firms with foreign participation enhance adjustment processes in CEE countries to their membership of the EU?

The research results show that firms with foreign participation which operate in CEE countries gain a stronger and stronger position in their economies. They are better prepared than domestic firms to include into the single European market as far as reaching quality and environmental standards is concerned. Hence, their presence in CEE countries makes easier the adjustment processes to the requirements of the EU membership. However, some aspects of their activities in the domestic economies may bring about some impediments to these processes.

1. Introduction

The processes of deepening European integration and enlargement are important factors which have a bearing on the decision of transnational companies to make direct investments abroad. Experience has shown that European integration does modify the strategy of foreign investors. Changing business conditions in the area where integration is taking place forces investors to change their behavior. From the new candidate countries' point of view this

changing behavior of foreign investors and reconstruction of their strategies may be important for the whole adjustment process to the requirements of EU membership.

The aim of this paper is to present answers to the following questions:

- to what extent do enlargement perspectives change foreign investors' strategies towards the CEE countries?
- do the activities of firms with foreign participation enhance the processes of adjustment by the CEE countries to their future membership in the EU?

In order to find answers to these questions analysis of the following issues will be carried out in this chapter:

- changes in the main characteristics of FDI inflows to CEE countries during the transformation and integration processes;
- changes in foreign investors' motives for investing in CEE countries;
- the position of firms with foreign participation in CEE countries;
- the degree to which foreign investors operating in CEE countries are prepared to compete within the single European market;
- the impact of foreign investors' activities on key elements of the economies of the CEE countries.

Macro-economic data from CEE countries and some limited empirical research results obtained in Poland will be used in this paper. Limitations in empirical research results must be taken into account in assessing the validity of the conclusions.

2. The theoretical framework

Strategies of transnational corporations (TNCs) for making investment abroad are influenced by the deepening and widening of the European integration processes. Observations of TNCs' behavior at the earlier stages of the European integration allow for such a conclusion. Reactions of TNCs to the creation of a customs union between member states of the European Economic Community in the sixties boiled down to two main types of foreign direct investment (FDI) within the integrating area, i.e., tariff jumping investment and optimum location-seeking investment (W. Molle 1990). The first one was connected with the increasing interest of TNCs coming from so called third countries in making investments within the customs union. The aim of this investment was to avoid high protection barriers to foreign trade. The second type of investment was a response of TNCs already established within the

integrating area to the need of seeking new efficient sources in the conditions of increasing competition. Changes of foreign affiliates' locations within the European Community enabled TNCs to cut down on costs, to eliminate some inefficient activities, and to find new development prospects. The more detailed analysis of TNCs behavior in the formative years of the European Community allowed to distinguish four types of FDI as a response to the revealed effects of a custom union. These were: defensive import-substituting investment; offensive import-substituting investment; rationalized direct investment; and reorganization investment (Yannopoulos 1990).

The establishment of the single internal market implied further changes in TNCs strategies. Firms that were set up years ago and have been acting in the integrated area react in different ways to construction of the internal market than new comers. The latter were more flexible and able to adjust their strategies to the conditions of the large internal market without barriers. Reactions of TNCs on deepening of the integration process were diversified, and firm- and industry-specific (S. Young, M. McDermott, S. Dunlop 1991, H.Ramsay 1990, V.N. Balasubramanyam, D. Greenaway 1992). The changes in the TNCs' strategies which took place during the creation of the monetary union were of less importance in comparison to the previous stages of European integration. They were connected with some reduction of transaction costs and benefits from deeper integration of the European financial market (D. Gros, Lannoo 2000).

Deepening of the European integration process coincided with the enlargement of the Community, i.e. with the accession of new member countries. This also influenced TNCs behavior and modified their choices. New member countries offer new potential locations for FDI and add a new dimension to the market. This impacts the cost-return-risk calculations of potential investors. According to the evidence from the past we can expect that the integration process between CEE countries and the EU also will influence TNCs behavior. On the one hand, foreign investors could be interested in doing business in these countries and enhancing their position in this part of Europe. An increased interest may be expected from the European and third countries' firms. On the other hand, some rationalized and reorganization investment may occur.

The significance of processes of integration for the formation of new ownership-specific advantages for companies which operate within the integrated area has been observed (J.Cantwell 1987), as have the effects of these processes in strengthening the location advantages in countries undergoing integration (J.Witkowska 1996).

3. Activities of foreign investors in central and Eastern Europe during the period before eu membership

The implementation of far-reaching systemic transformations throughout Central and Eastern Europe radically changed the attitudes of foreign investors toward the region as a site for location of FDI. These countries quickly adopted new laws granting foreign investors the necessary protections for their investments, including the right to transfer profits abroad, the retransfer of capital in the case of liquidation or sale, as well as the right to compensation in the event of nationalization or a taking by eminent domain. In addition, the very process of rapid transformation lured investors with the prospects of new markets.

The positive reaction of foreign investors to the changes taking place throughout Central and Eastern Europe can be seen by a glance at the data which demonstrates the annual streams and accumulated investment of FDI into Central and Eastern Europe in the 1990's. At the beginning of the transformation period investment of FDI inward stock in the entire region was estimated at 3,7 billion USD, and by 2001 it comprised 160,4 billion USD worth of investment, which constitutes a 43-fold increase.

The annual stream of FDI into the region was approximately 2.4 billion USD in 1991, and reached 27,2 billion USD by 2001. Although this constituted only 3.7% of total FDI worldwide, still the amount was of great significance to the region. About 65% of FDI into the entire Central and Eastern European region was invested in Poland, Hungary, the Czech Republic, and Slovakia. Their relative positions as countries receiving FDI has varied throughout this time.

The activity of foreign investors in Central and Eastern Europe during the 1990s continued to be influenced by systemic transformation as well as the opening up of these countries to international co-operation. Such co-operation included affiliation agreements with the European Community (under the so-called European Agreement) as well as agreements to join the WTO and OECD. The decision to enter into these agreements had a direct bearing on the behavior of foreign investors since the nature of policy towards foreign investors changed in these countries. The beginning of transformation brings with it basic guarantees for investors, which are expressed in appropriate legislation. When the European Agreement was signed in 1991, it was regarded as the start of a process of political and economic stabilization. Although the reaction of investors was cautious, countries such as Hungary, Poland, and the former Czechoslovakia all saw an increased inflow of FDI.

The moment the European Agreement came into effect in 1994, further agreements signed during the Uruguay round of GATT/WTO negotiations and the agreement to join the OECD marked the second stage of the policy of these countries towards foreign investors. This meant the beginning of deregulation, the removal of restrictions with regards to foreign investors, and the introduction of principles of fair play, regardless of nationality. The reaction of investors was overwhelmingly positive. During the first half of the 1990s, the Czech Republic, Hungary, and Poland were the most attractive countries for investment in the CEE. In Poland, regulatory changes and deregulation coincided with a period of economic growth. As a result the trend was that up until 2000 FDI continued to grow. However, this dropped off at the beginning of XXIst century. In other countries (the Czech Republic and Hungary) this loss of momentum in FDI took place earlier. In 1996 the FDI stream almost halved in these two countries - this was caused both by economic slowdown and the slowing down of privatization in these countries. They adopted policies which were geared to using incentives, permitted by international agreements, for foreign investors. Investors in turn responded by increasing investment in the Czech Republic during 1998 and 1999, whereas the period of stagnation lasted longer – until 2000 – in Hungary (see Table 2).

In terms of the structure of foreign investment according to country of origin, it is readily visible that the dominating position is held by investors from the European Union Member States. Their share in overall FDI in the region fluctuates between 78%-84%, (UNCTAD data base and own calculations). This can be explained by the twin factors of proximity as well as the ongoing process of European integration.

The creation of a free trade area for manufactured goods under the terms of the European Agreement between the CEE countries and the European Community had both short-term and long-term effects in trade and manufacturing, which are encompassed by the theory of integration (Z. Wysokińska 2001). The trade creation and diversion effects which occurred in the area undergoing integration also led to changes in the behavior of foreign investors. During this period the investment stream from European Union Member States was stimulated, as well as investment from other non-EU states. The FDI stream from the EU was so dynamic that it caused a shift in the structure of FDI according to country of origin. Although there is no direct evidence that this was a result of the ongoing process of integration, surveys carried out among foreign investors during 1995 and 1997 in Poland and Hungary have nevertheless shown that these processes had an indirect influence on their decision to invest in this region (J.Witkowska, Z.Wysokińska 1997).

The branch structure of FDI in the region is characterized by certain common and long-term trends. At the beginning of the transformation period, 2/3 to 4/5 of FDI in the region was located in industrial manufacturing (Sector II), while by the end of the 1990's the share of this Sector in overall FDI in the region fell to a range between 2/5 and 1/2 (OECD, 2000; PAIZ 2000). The share of FDI in service industries (Sector III) has risen in proportion to its decline in industrial manufacturing. FDI in Sector I industries has been minimal throughout the entire analyzed period. A close analysis of the data concerning FDI in industrial manufacturing reveals that the pattern of such investment has been very similar in all the countries analyzed. Of greatest interest to foreign investors have been the food processing and automotive industries, and they have shown the least interest in the advanced technology industries. In the service industries a significant proportion of FDI has been located in financial services as well as in trade and maintenance services. It is worth noting that a general overview of the branch structure of FDI in the region is similar to that pertaining throughout the world.

4. The position of foreign investors in the economies of Central and Eastern European countries and their preparation for joining the single European market.

The significance of FDI for the economies of the states awaiting accession can be shown by a set of indicators such as inward FDI flows as a percentage of gross fixed capital formation, inward FDI stock as a percentage of GDP; and foreign affiliates' share in net sales. These indicators confirm the hypothesis that the importance of FDI flows and FDI stock is growing in the economies of the countries analyzed. For example, the index of inward FDI flows as a percentage of gross fixed capital formation fluctuated from about 15% in Hungary to almost 35%-36% in the Czech Republic and Slovakia. Inward FDI stock as a percentage of GDP for the same year was 21% in Poland and around 43% in the Czech Republic and Hungary (UNCTAD 2002). Foreign affiliates' share in net sales, categorized by industry, shows different rates of penetration by foreign investors in particular sectors of industry. The highest degree of penetration occurs in the production of motor vehicles and trailers in Hungary and Poland (in Hungary 96% and in Poland almost 90% of sales in this sector are by foreign companies) and in the production of beverages and tobacco (100% in the Czech Republic, 96% in Hungary and 93% in Poland). Similarly radio and TV set production is dominated by foreign investors (94% in Hungary, 82% in Poland and 67% in the

Czech Republic). The market share by foreign companies in the paper and paper products sector is also comparatively high (G. Hunya 2001).

The new indicator proposed by UNCTAD, the Inward FDI Performance Index, shows to what extent a country has been successful in attracting FDI. This Index is the ratio of a country's share in global FDI flows to its share in global GDP (UNCTAD 2002). Countries with an index value of one receive FDI exactly in line with their relative economic size. Countries with an index value greater than one attract more FDI than may be expected on the basis of relative GDP. This indicator for the analyzed countries varied considerably but both at the beginning of transformation and at the end of the 1990s the figure remained above 1. This means that the inward FDI stream was greater than would be suggested by their position in the world economy as measured by their GDP. These countries, for reasons mentioned above, proved to be attractive places for locating FDI.

The scale of inward FDI and the position that foreign investors have achieved in the economies of countries awaiting EU membership also has a bearing on the extent to which they are prepared to compete within the single internal market. For example, in the case of Poland the process for allowing the free flow of capital in relation to highly-developed countries, including EU countries, the freedom to establish business enterprises has resulted in changes at microeconomic level. Firstly, in the secondary sector of the Polish economy a significant group of companies partly financed by foreign capital has appeared which exerts an influence on the economy as a whole and on the performance of domestic enterprises – this includes the effects of demonstration, co-operation with domestic companies, and competition. Secondly, in the Polish financial sector the dominant position has been gained by foreign investment institutions which also not only affects macroeconomic parameters but above all the conditions that companies are made to operate in. Thirdly, the liberalization of capital transfer other than direct foreign investment has increased the opportunities for firms to participate in the European capital-finance market.

The increased involvement of foreign capital in the form of FDI in Poland and the strengthened position of domestic companies partly financed by foreign capital may have a beneficial effect on the economy, but at the same time it also results in some negative phenomena, which can be illustrated by the following figures:

- The ratio of accumulated FDI capital as a percentage of GDP grew from 0.3% in 1991 to 21.3% in 2000 - similarly the ratio of inward FDI to GDP has grown systematically (from 3.1% in 1991 to 5.9% in 2000); the share of the annual FDI stream in gross fixed capital formation has grown from 1.8% to 23.4% (UNCTAD 2002);

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- In the structure of the annual FDI stream a favorable shift in the make-up of this stream can be observed towards reinforcing Polish-owned capital directly invested in enterprises and a reduction in the share of foreign partner credit in inward foreign capital (NBP 2001);
 - In the structure the earnings of direct foreign investors the trend for a growth in earnings by way of dividends payable to investors and interest on credit incurred by Polish enterprises with direct investment has been maintained, but during 1996-97 favourably reinvested profits (the balance between reinvested profits and financial losses) fell and during 1998 and 2000 the balance dipped below zero and thus did not allow for an increase in Polish-owned capital directly invested in enterprises and must be regarded as a negative phenomenon (NBP 2001);
 - The earnings of direct foreign investors (dividends and interest) subject to transfer to the country of origin has grown steadily, in 1996 it reached 305 mln USD; in 1997 614 mln USD; in 1998 874 mln USD. In 1999 it fell slightly in comparison to the previous year and came to 849 mln USD, and in 2000 reached the level of 1098 mln USD (NBP 2001);
 - The structure of FDI according to the investors' country of origin shows a strong emergence of FDI streams from member countries; the overall size of this stream has grown, as well as its share of the annual inward FDI stream in general. Regardless of the data source used they confirm that investment by member states of the EU predominates - according to figures from the NBP in 2000 this share stood at 94.5%, in studies carried out by GUS this share stood at 79% (GUS 2001 and own calculations), and according to PAIZ - 70% (PAIZ 2002 and own calculations);
 - The structure of FDI by sector, based on PAIZ data, demonstrates a continual reduction in the accumulated FDI share located in the industrial sector and an increase in the FDI share located in the service sector such as financial agencies, trade, transport, and communications. Such changes in the structure of FDI by sector correspond with trends observed in the highly-developed countries (PAIZ 2002 and own calculations);
 - The share of foreign capital in the stock capital of commercial banks has grown to 61.3%. By the end of 2001 the capital funds of all banks combined stood at almost 37.7 billion zloties, of which 30.2 billion zloties belonged to banks dominated by foreign capital. The growing presence of foreign capital in the banking sector and the mergers that this has entailed has led to a greater concentration in the banking services sector and these banks are characterized by a greater ability to generate income, costs, and turnover than banks dominated by Polish capital, which is proof of their greater

efficiency and ability to generate gains based on the banking services market (R. Pac 2002, K. Dąbrowska, M. Gruszczyński 2001);

- The position of firms with foreign participation in the Polish economy is much more significant than would be expected based on their share in the total number of registered companies in Poland (10.6% in 2000). In the same year their share of the total income earned by these businesses in the national economy stood at 33.6% - in other words 1/3 of the total earnings was achieved by 1/10 of the firms; and in some sectors of the economy the share of these companies in total earnings was even higher e.g. hotel and catering – 51%, the food-processing industry –46,8%, transport, warehousing and communications- 46,5%. These figures point to the high level of penetration by foreign capital in particular economic sectors (J. Chojna 2002 and own calculations);
- Firms with foreign participation employed 999,500 people in 2000, which represents 10.3% of the total number of employees in the Polish economy. A comparison of the number of employees with company earnings shows productivity rates to be twice as high as the productivity of Polish companies (GUS 2001 and own calculations);
- Firms with foreign participation are characterised by a slight tendency to export their products, which can be measured by the share of sales from exports against company earnings as a whole (16.2% in 2000), however their share in the total export trade was significant and stood at 57, 3% in 2000(J. Chojna 2002);
- The investment turnover of firms with foreign participation is very high – their investment outlay made up more than 60% of investment expenditure as a whole and in two sectors this share even exceeded 70% in 2000 (transport, warehousing and communications, and trade and maintenance services). There has also been a growth in fixed capital share of the analyzed industries in the national economy (32 % in 2000.) (J. Chojna 2002);
- If we use basic economic indicators to compare the situation of firms with foreign participation with Polish firms in general, they show that their financial condition is improving. During 1994-1997 the financial situation of companies solely financed by Polish capital was better than firms with foreign participation. However, since 1998, the situation of the latter has improved and continues to strengthen its position (J. Chojna 2002);
- In firms with foreign participation we can observe processes of capital concentration (NBP 2001).

The above figures confirm the hypothesis that a significant group of firms has emerged which are essential to the future economic development of Poland.

The economic characteristics of firms with foreign participation indicate that this group generally appears to be better prepared to compete within the single internal market than other companies operating in Poland. This is backed up further by figures showing the size and type of their export market, continuing efforts at investment despite a general slowdown in economic growth, and the level of expenditure on research and development.

These firms are also better placed to be able to comply with EU norms and standards. This is shown by the results of a survey conducted among a group of firms with foreign participation on the introduction of global and EU standards for the environment (Z. Wysokińska 2002, J. Witkowska 2002). Although the sample of firms with foreign participation was too small to enable us to treat the research as a *case study*, the results are interesting nonetheless. Almost $\frac{3}{4}$ of surveyed companies claimed that their company applied the same standards of environmental protection in Poland as they did in their home country. Most companies investing were from countries which were members of the OECD. This means that they have implemented as strategy of centralization with regards to environmental protection, which is beneficial to Poland as a country awaiting accession. All of the companies surveyed employed a strategy of avoiding damage to the environment from the very start of the production phase, in other words a strategy which is sensitive to the whole production process and the products themselves and not merely to particular processes (the so-called „end of the waste-pipe strategy”). They also had made investments in imports of environmental protection stock and imported technology or products which prevented pollution of the environment. 60% of the firms surveyed claimed that they now met EU standards with regards to environmental protection.

The domination of the Polish banking sector by foreign capital may prove to have an unfavorable impact on the process of adapting to EU membership. Although the injection of foreign capital has led to an improvement in efficiency in this sector, at the same time it may make it difficult for Polish companies, particularly small or medium-sized ones, to access capital. The danger of foreign investors crowding out local companies from the finance market has been noted (UNCTAD 1999). In Poland we can observe the emergence of a serious barrier in access to credit for small and medium-sized companies, which is not only connected with interest rates but also with difficulties in simplifying procedural requirements („Rzeczpospolita” 2003).

5. Inward direct foreign investment to Poland in the context of EU accession - an attempt to project

Accession will exert an influence on every segment of the capital-finance market, which will have significant consequences for businesses. Particular effects will make themselves felt to a varying extent. Poland will be able to participate in both investment creation and transfer. It will also be able to take advantage of its location thanks to accession, becoming an increasingly attractive country for investors from the EU member states as well as from other non-EU countries. The extent to which the FDI flow is stimulated will first and foremost depend on a growth in GDP. The close correlation between FDI flow and GDP growth is well-known. In highly-developed countries, over longer periods a rise (or a drop) in of GDP in real terms by 1% was accompanied by a growth (or a fall) of FDI in real terms of 3.4% (D.A. Julius 1990). Even if this relationship differs somewhat in the case of less developed countries, there can be no doubt that a mechanism with a similar factor of multiplication, which can go up or down, will take effect. If we add to the scenario a suitable policy towards foreign investors at the member-state level, and a strengthening of the existing advantages of Poland's location, the inflow of FDI may remain significant for the Polish economy. This would also strengthen the position of existing firms with foreign participation in the Polish economy, as these will have adapted to the conditions of the single market and be capable of competing. Along with the gradual slowing-down of privatization, the flow of FDI would mainly take the form of *greenfield investment*, in other words the indirect creation of new jobs in the economy by co-operative and secondary interaction within an environment in which firms are making investments.

The enlargement of the group of countries undergoing integration will encourage firms operating within this area to look for optimum location.. In Poland's case, this may mean incoming investment in mature industries which offer a cheap and skilled workforce, as well as in advanced technological industries where these have been able to grow up in so-called *clusters*. This latter situation requires the support of technology and educational policies to help create a co-operative network. On the other hand, classic investment which avoids export tariffs from non-EU countries will probably not take place where there are conditions of low export tariffs on manufactured goods and even less protection of the Polish market towards non-EU countries after Poland has adopted the external export tariffs. As for agricultural products and foodstuffs, investments which avoid export tariffs may occur once Poland implements the Common Agricultural Policy. There may be a long period of aggressive

investment instead of imports as a reaction to the dynamic effects of the internal market such as economic growth and the enlargement of market specifications.

As part of the process of an enlarged group of countries undergoing integration, processes of reorganization and the rationalization of direct foreign investment will also take place. Transnational companies, in the face of the enlarged group of new member states, will once again be forced to reorganize their international production. In Poland's case this may mean that some affiliates and regional offices owned by transnational corporations will have to be closed down. The process of withdrawal from the Polish market by some large transnational corporations has been indicated at this stage (see Appendix 1). The cause of this phenomenon may be, it is believed, not merely the slowing of economic growth in Poland but a slowdown on a global scale, which has led some transnational corporations to rethink their global strategies („Rzeczpospolita” 2003). This means that the prospect of Poland joining the EU is a less important factor for some foreign investors, as it is only a counterbalance to some factors which make investing in Poland less attractive.

In the long run Poland might benefit from rationalized investments, i.e. from non-EU countries, to the extent the dynamic effects of the single market - such as a reduction in costs in the medium to long-term, and benefits from gains in efficiency - become apparent.

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Appendix 1**Operational reorganization of some transnational corporations in Poland**

During the first half of 2000 it has been noted that several significant foreign investors have withdrawn from the Polish market. The French energy company **Alstom** has sold two factories in Świebodzice and Mikołów with 360 employees in total. **ABB** which has been reorganizing its operation for some time has recently pulled out of some areas of business (such as energy production), concentrating instead on power distribution and automation. **Bank Gesellschaft Berlin**, the Korean **LG**, **Bank of America** and the **Zurich** insurance company have also pulled out of the financial sector in Poland. Changes in ownership have also been noted in the retail trade – the German firm **Edeka**, **HIT** and **Jeronimo Martins** have also pulled out.

The American company **Greenbrier**, which owns Wagony Świdnica - one of the largest factories producing railway rolling-stock - has also announced plans to cease its operations in Poland. Plans by the construction firm **Skanska** to withdraw from the Polish market have not yet been confirmed officially.

It is thought that the reasons for these operational reorganizations are diverse: the slowdown of economic growth in Poland and globally, changes in global strategy by global corporations, a decline in the attractiveness of Poland as a place for doing business, a drop in profitability in some sectors, as well as strong competition.

Source: Based on A.Michalski, *Spółki sprzedają polskie oddziały*, „Rzeczpospolita” 2003, No. 61, s. B1.

Table 2. FDI inflows into Slovakia, the Czech Republic, Hungary and Poland, 1988-2001 (Mln USD, %)

Year	Slovakia		The Czech Republic		Hungary		Poland	
	Millions USD	Previous year=100	Millions USD	Previous year=100	Millions USD	Previous year=100	Millions USD	Previous year=100
1988-1993^{a)}	111 ^{b)}	-	502 ^{c)}	-	1033	-	478	-
1994	245	220,7	869	167,1	1146	110,9	1875	392,3
1995	195	79,6	2 562	294,8	4453	388,6	3659	195,1
1996	251	128,7	1 428	55,7	2275	51,1	4498	122,9
1997	220	87,6	1 300	91,0	2173	95,5	4908	109,1
1998	684	310,9	3 718	286,0	2036	93,7	6365	129,7
1999	390	57,0	6 324	170,1	1944	95,5	7 270	117,8
2000	2075	532,1	4 986	78,8	1 643	84,5	9 342	128,5
2001	1475	71,1	4 916	98,6	2 414	146,9	8 830	94,5

a) Annual average,

b) Annual average from 1990-1993,

c) Annual average from 1989 to 1993.

Source: UNCTAD and own calculations.

