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The Age of Globalization and Regionalism

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The enlargement of the EU toward Central Europe
and
the Role of the Japanese Economy

Foreign Direct Investment in Central Europe amid "Globalization"

-Truths and Tasks-

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The views expressed in this paper are those of the author and not those of the institution to which the author belongs.

1. The Ghost of "Globalism"

1.1 What does "Globalization" mean actually?

It is a common held view that since the collapse of the socialist system the world has been moving towards the globalization of capitalism. A similar school of thought maintains that the large amount of capital inflow from multi-national companies into transforming national economies will result in the subordination of the transforming country to the capitalist countries. These ideas are flawed by some common defects: on one hand the classical and virtual dichotomy of capitalism and socialism strongly dominates their logic, and on the other hand the two types of investments, i.e. portfolio investment and direct investment are not clearly distinguished between and are understood as one mixed vague concept: capital, as if it were evil or a "ghost".

When we observe that the globalization of the market economy has been continuing for hundreds of years, and that the inflow and outflow of direct investment has been extremely active over the past two decades, it is then very curious that the media (as well as economists) are only now starting to talk of globalization.

What is essentially addressed under the topic of globalization in the 1990's is the globalization of financial transactions and institutions. As is the case in Japan, where manufacturing companies have already been doing business according to global standards for many years, on the contrary, financial institutions have become accustomed to the local business rules and practices. These are largely effective only in Japan and do not transfer to international competition. As was widely talked about during the Asian crisis, one of the most pressing issues is to what extent should the freedom of capital flow be permitted under the conditions of universal integration of financial transactions, i.e. globalization? Clearly enough, what is being discussed regarding capital flow in this context is not direct investment, but portfolio investment.

As is naturally understood, it is essential for portfolio capital to minimize transaction time and costs in order to maximize profit. The immediate transfer of capital is a fundamental condition for the realization of the optimal transaction. Complete freedom of capital inflow and outflow is demanded by portfolio capital, and this is the contemporary issue of liberalization of capital flow in the world economy.

I have to point out that portfolio capital is really “lazy capital”, demanding maximum profit for minimum work and time and, in essential points, is different from capital used in direct investment. Investors themselves are fundamentally different in the two types of investments. One should not mix the two investors by putting them in the same glass.

On the other hand, direct investment is very tiresome and time-consuming work for investors; from selecting production sites through to accomplishing production lines to managing the company. As long as the company continues in business, investment risk prevails, and as a matter of fact, this type of productive activity truly creates economic value and forms real economy. However, people are under the illusion that portfolio investment creates economic value, and is in some way superior to tiresome direct investment in the sense of the superiority of brainwork to physical work.

We should clearly establish that direct investment is productive work and that portfolio investment is a money game. It is natural and rightful for governments to set various limitations on the inflow and outflow of portfolio money, but there is no reason to limit the inflow of direct investment which brings with it capital and technology carrying its own risk.

1.2 Pitfall in the Virtual Dichotomy of “Capitalism” and “Socialism”

Immediately after the collapse of the old system there emerged the viewpoint that the system transformation would be from socialism to capitalism, and subsequently towards the globalization of capitalism. Is it true that the so-called socialist countries were planned economies and that the so-called capitalist countries have been free-market economies? We should clarify in what sense the “socialist” economy was actually socialist and in what sense the “capitalist” economy is in fact capitalist. It is too much of an abstract purification of the actual economy and an overly simplified conceptualization existing only in the minds of academic researchers. There was no planned economy amongst the ex-socialist economies in the strictest sense of the word and also no ideal market economy has existed, at least after World War Two.

Nevertheless, researchers are too ready to use the terminology in the same way as journalists do. It is lazy of researchers to use such superficial terminology to characterize the system transformation of our age. If one is an academic researcher, then one should deeply analyze the most under current movement of human society in the 20th and 21st centuries (refer to my contributed paper).

According to the classical and most common viewpoint, foreign direct investment represents capital export in the form of economic imperialism. Even today, some are looking for the so-called “third way” towards a new system, neither capitalist nor socialist, which saves the country in question from degenerating into a mere wage-earning subcontracting country. I would label this approach as “the Imaginary Third Way”, which is also trapped into the classical and virtual dichotomy of “capitalism and socialism”.

The opinions expressed by governments and people also vary according to the country being dealt with. In Russia, contrary to the superficial welcoming lip service, both the government and the people firmly believe that foreign capital comes in especially to exploit cheap Russian labor (**A Naive Feeling of Exploitation**). Consequently, various governmental institutions attempt to exploit foreign companies and expatriates at every step, hindering the entry of foreign companies to Russia.

In Poland, the country which suffered for many years from the heavy burden of external debt, there firmly exists a continuing distrust of foreign capital irrespective of whether it is portfolio investment or direct investment (**Fundamental Distrust**).

In the Czech Republic Mr. Klaus, a proud Czech, abolished preferential terms for foreign capital in 1993 when the Czech-Slovak Republic was separated. He believed that highly reputable Czech companies could compete with foreign companies* and therefore they should be put under the same conditions as foreign companies (“**Over Self-Confidence** ”).

* When Matsushita Panasonic established a Color TV manufacturing company in Plzen, the initial local content was 2%, and the present one is 6%.

Nowadays, all the transforming countries including the Czech Republic have an incentive system in place for attracting foreign direct investment. Reluctance towards FDI has disappeared, at least on a governmental level. Both Poland and the Czech Republic are undertaking aggressive policies with the aim of facilitating foreign direct investment, representing a radical change in policy.

1.3 The Russian Crisis: Victim of Globalization?

According to those who believe in the stereotyped “anti-Globalism”, the Russian crisis in 1998 was also a product of “Globalization”, and thus since Russia suffered severely from the crisis it is an innocent victim of “Globalism”. This is quite a one-sided and naive argument, and is overly influenced by the ghost of “Globalism”. Everything which happened was not that simple, for capital inflow is not a natural phenomena of “Globalization”.

Both sides, the investors and the recipient countries have their own reasons and logic for doing business. As the state budget of the Russian Federation has been on the brink of bankruptcy for many years, the Russian government has had to find some way of financing the huge deficit. However, no one can supply credit to an almost bankrupt institution. Then came the well-known idea of opening the treasury bond(GKO) market for foreign investors, who are looking for high returns and would otherwise never invest in Russia. Thus, the Russian government began to become involved with tricky business to finance deficit and pay high coupons with the source of short-term portfolio capital invested. However, the government had to always increase the ratio of foreign investors in order to guarantee high returns, because the Russian economy did not recover at all and the state revenue remained at 8-10% of GDP. It was day to day management of money for Russian government, which inevitably runs into trouble before long.

From the beginning portfolio investment in Russia was a typical money game just like a card game. Not everyone, but many investors recognized that the value of papers held in the hands of investors would be absolute zero if default was declared at some future time and consequently that the risk was extremely high, i.e. the Russian bond is the “joker” once default is declared. However, it is usual for international financial institutions to promote the target market and to bring money there intentionally, for the potential risk decreases if the number of investors increases. Investors are more ready to invest if all the big-name players are participating in the game. Thus, a fairly large financial market was suddenly opened in Moscow and investment began under the logo of “promising emerging market with high return in the East-End of Europe”. Many participants came under the illusion that the Russian economy was firmly on the path to economic growth and prosperity as the financial wealth implied.

In contrast to the superficial prosperity in the financial field there were no signs of economic recovery at all, and capital inflow in the form of FDI remained at a very low level. The Russian government did not and still has not come up with any suitable policy to invite FDI into the Russian Federation. It is the Russian government and not “Globalism” which holds the responsibility of not succeeding in helping the real economy and thus of bringing about mere disorder after the money game was concluded.

The Russian crisis of 1998 clearly demonstrates that financial prosperity in itself does not bring prosperity to the real economy and that any financial booms not backed up by proper growth come, sooner or later, to an end. As K. Marx shows in the “*Das Kapital*”, only manufacturing industry produces economic value and forms the foundation of national economy.

It is an irony of history that the originator of the socialist system in the 20th century dropped into the trap of the money game by neglecting basic teachings of Karl Marx.

1.4 Direct Investment as Transfer of Civilization

It has been a fatal defect for Russian government not to succeed in introducing effective measures and environments for inviting foreign direct investment. On the contrary, what the government did is to invite short-term portfolio capital for the immediate aim with very short-sighted consideration and to neglect long term investment to reestablish industry in prospecting future of Russian economy.

For every ex-socialist countries, FDI is the absolute necessity for modernizing industry and economy, for only through transfers of capital, technology and management national economies can be reestablished. Besides these I have to emphasize that FDI is a type of transfer of civilization into the disabled economy and degenerated society. As shown in the contributed paper, the strongly concentrated redistribution system under the socialist regime resulted in the degeneration of social activities of people: de-civilization and degeneration of social normative are characteristic of ex-socialist societies. In this respect FDI contributes to the transfer of civilization, too.

Let us consider what the investing company has to do during initial stages of investment. They have had to teach workers extremely elementary practices: not to take the company's belongings and products home, not to use company telephones for private use, not to do side business during work, keeping work-shops clean and adhering strictly to maintenance rules, managing stocks of materials and products, keeping to delivery times and to try to win clients' confidence, etc. However elementary and unbelievable they are, it is realty and these are actual problems for investors in ex-socialist countries.

Thus, what an investing company confronts in transforming countries is working discipline and morals as described, which were entirely neglected during the old system. Before teaching work techniques, companies have to create working morals. Direct investment is a far-reaching project covering the teaching of discipline and technology to work training and management.

In this sense direct investment plays the role of transferring not only technology, but also work civilization to the country which is to be invested in. It is for this reason that currently almost all-transforming countries welcome FDI and have created incentive policy to entice foreign companies. However, their policies are still not sufficiently developed and are far inferior to those of developed countries on various points(described later).

2. Historical Trends of FDI

2.1 The First Half of the 1990's

Reflecting the initial stances held by governments toward FDI in Central Europe, Hungary enjoyed the largest inflow of FDI in this region, since only Hungary was free of prejudice against FDI in the first half of 1990's, though in fact the absolute amount of capital received was not that large.

Table 1 FDI in the First Half of 1990's and a Forecast in Million US Dollars

	1994	1995	1990-1995 Accumulation	Country Allocation,% (regional、%)	Forecast for 1996-2000 (country allocation、%)
Hungary	1,146	4,400	11,200	31.38 (44.29)	12,968 (13.07)
Poland	1,875	2,500	7,148	20.03 (28.26)	21,969 (22.15)
Czech republic	878	2,500	5,666	15.87 (22.40)	15,466 (15.59)
Slovakia	187	200	775	2.17 (3.06)	2,150 (2.17)
Slovenia	87	150	501	1.40 (1.98)	3,052 (3.08)
Central Europe	4,173	9,750	25,290	70.85 (100.00)	55,605 (56.06)
Albania	53	75	205	0.57 (11.08)	583 (0.59)
Bulgaria	105	150	412	1.15 (22.27)	1,428 (1.44)
Romania	340	400	933	2.61 (50.43)	4,017 (4.05)
Yugoslavia	120	100	300	0.84 (16.22)	2,210 (2.23)
CE and Balkans	4,791	10,475	27,140	76.03 (100.00)	63,847 (64.37)
Baltic states	430	400	1,280	3.59 (14.96)	1,890 (1.91)
Russia	1000	2,000	4,400	12.33 (51.44)	26,960 (27.18)
Ukraine	91	113	574	1.61 (6.71)	1,400 (1.41)
Other CIS	640	800	2,300	6.44 (28.89)	5,085 (5.13)
Total	6952	13,788	35,694	100.00 (100.00)	99,186 (100.00)

Notes: *Economic Intelligence Unit*, April 1996.

Table 1 shows the forecast made by *The Economist* regarding the inflow of FDI in the second half of the 1990's. The main predictions of the forecast are as follows.

(1) Total FDI inflow to the ex-Soviet Union and East European countries in the coming years (1996-2000) will amount to about 100 billion US dollars.

(2) In the same period both Poland and Russia will receive more than 20 billion US dollars. The two countries will be the leaders in FDI inflow among ex-socialist countries.

(3) The weight of Central Europe in the share of FDI will decrease as a result of the large inflow to Russia.

(4) Within Central Europe the weight of Hungary will decrease and that of the Czech Republic will increase.

2.2 The Second Half of the 1990’s

Shocked by the large inflow of FDI to Hungary, the governments of Poland and the Czech Republic changed their attitude towards FDI and began to initiate positive policy in order to appeal to FDI. The two governments established PAIZ (Poland) and CzechInvest (Czech Republic) as advertising bodies to invite FDI into their countries. Contrary to the official stance, the Klaus government even offered several individual preferential measures to large investments.

Table 2 FDI in the Second Half of 1990’s in million US dollars

	1996	1997	1998	1999	1996-1999 (total) (regional allocation、%)	1990-1999 (total) (country allocation、%)
Hungary	2000	1700	1500	1600	6800(18.57)	18000(16.60)
Poland	2800	3000	6600	6500	18900(51.62)	26048(24.03)
Czech Republic	1400	1300	2500	3500	8700(23.76)	14366(13.25)
Slovakia	251	177	508	500	1436(3.92)	2211(2.04)
Slovenia	178	295	154	150	777(2.12)	1278(1.18)
Central Europe	6629	6472	11262	12250	36613(100.00)	61903(57.10)
Albania	97	42	45	43	227(2.23)	432(0.40)
Bulgaria	100	497	401	700	1698(16.70)	2110(1.95)
Romania	263	1224	2040	1345	4872(47.91)	5805(5.35)
Yugoslavia	535	868	1129	840	3372(33.16)	3672(3.39)
CE and Balkans	7624	9103	14877	151178	46782(100.00)	73927(68.19)
Baltic states	639	973	1716	900	4228(16.30)	5508(5.08)
Russia	1700	3800	1200	3500	10200(39.32)	14600(13.47)
Ukraine	500	600	700	600	2400(9.25)	2974(2.74)
Other CIS	1971	2507	2543	2089	9110(35.12)	11410(10.52)
Total	12434	16983	21036	158267	72720(100.00)	108414(100.00)

Notes: Balance of payments data.
Source: EBRD, T*ransition Report 1999*, London 1999.

As the privatization of Hungary came to an end by the middle of the 1990’s, Poland with the largest domestic market became the next target for FDI in this region. Thus, Poland became the main recipient of FDI in the region in the second half of 1990’s. On this point the forecast of *the Economist* was right.

On the other hand, FDI to the Russian Federation has been stagnating. *The Economist*’s forecast was entirely wrong in the case of Russia. Although the weight of Hungary has been decreasing, the Czech Republic has not been able to catch up with the level of Hungary, mainly because of the failure of voucher privatization.

3. Motives of FDI and Unbalance of FDI Inflow among Countries

3.1 The Two Main Motives

There are two main motives for multi-national companies to invest in transforming countries.

One motive is to transfer their production base from the West to the East or establish a second production base in Europe. By utilizing cheap labor, multi-nationals are able to reduce production costs and maintain their competitive position on the market. Despite 10 years having past since the beginning of system transformation, the wage level in Hungary remains at one-seventh or one-eighth of that in Germany.

The other motive is for companies to widen their sales base, since a large consumer market is now open to multi-nationals in Central-East European countries. Providing effective demand exists, the potential exists to establish production and a sales base specific to the given country.

The two targets sometimes overlap. However, the basic strategy of the two targets is different depending on whether specializing in exports or in domestic sales.

Then, the main decision for investors to make is whether they should buy out existing companies or establish new companies. So far, generally speaking, buyout investments have been observed in consumer goods industries, while green field investments are dominant in high-tech industries. Even in the case of the takeover of existing companies, sooner or later, new investment in productive equipment becomes necessary in many cases and sometimes the amount of new investment is larger than that the initial cost of a takeover.

Poland has been chosen as a FDI target from the standpoint of its large domestic market, while Hungary has been a FDI target from the standpoint of being an export production base. The delay of real privatization in the Czech Republic so far limits the inflow of FDI. Although it is certain that the Czech republic will draw in more FDI in the future, the geographical position of the Czech Republic in itself confines FDI flow to targeting its export base towards the East. On this point the role of the Czech Republic is different from Hungary's, since Hungary can play the role of meeting point between East and West.

3.2 Hungarian Case

The Hungarian domestic market, with its population of 10 million, is not at all attractive for multi-national companies. Therefore, those who invested in Hungary neglect to take its domestic market into account and see its role as an export base. The reasons Hungary received almost half of the FDI inflow in the first half of 1990's are the following.

(1) Hungary is traditionally friendly to foreign investment and offered preferential measures for FDI.

(2) The market infrastructure for industry is better than in any other transforming country and therefore it is relatively straightforward for investors to enter Hungary.

(3) From Hungary's point of view, it was an urgent task to sell off state companies and to lessen the burden of external debts. Almost every company in every sector has been up for sale.

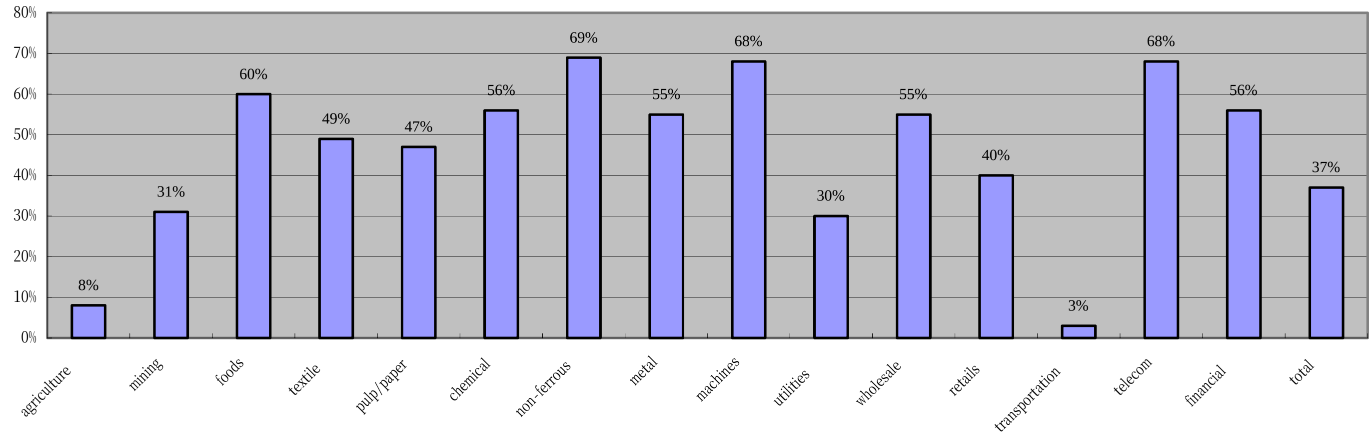
(4) Historically Hungary has held a close relationship with Austria and Germany. Consequently, Austrian and German companies have had few problems in coming into Hungary.

(5) Much of Southern and Eastern Europe came under the reign of Hungary in the era of the Habsburg Empire. Hungary can play the role not only as a production base for the West, but the role of a hub for the South and the East as well.

Thus, during the early years of system transformation, Hungary was a model for FDI to ex-socialist countries. Even now, Hungary is a model country for privatization of the banking and utility sectors via FDI.

As can be seen in the Figure 1, except for agriculture and transportation, the rates of occupation of foreign capital in Hungarian industries is exceptionally high compared not only to transforming countries, but also to developed countries.

According to statistical data, companies with foreign capital created more than half of the value added produced by whole industries in Hungary in 1998. At the same time, about 70% of Hungarian exports have been attributed to companies with foreign capital.



Note: The rate of foreign capital occupied in gross capital of each industry.
Source: ECOSTAT.

Figure 1 Foreign Capital in Hungarian Industries(at the end of 1998)

3.3 The Polish Case

A large domestic market in itself is an attractive proposition, even for multi-nationals whose primary aim is not the domestic market to be invested in. Furthermore, the existence of a market near the production base is a vital condition for small-medium size companies in taking the decision whether to invest in transforming countries or not. From this point of view, Poland with its 40 million population earns exclusive merit compared to other Central European countries. Moreover, if production is confined to the domestic market, then the newest technology is not necessary, which also makes the decision easier. Even if foreign capital acquires companies by way of privatization, new investment required will be of a minimum level.

In spite of these merits, during the first half of the 1990's Poland was not able to receive satisfactory FDI inflow, because of the absolute limitation of effective demand set by its low-income level. However, the steady growth of the national economy and the consequent increase in individual income make Poland a possible target as a selling market. FDI inflow to Poland has been increasing during the last three years thanks to the progress of the privatization process, to the extent that Poland is now the leading FDI recipient not only in this region, but also among all ex-socialist countries.

On the other hand, the Polish type of FDI inflow, as Asian experiences show, is likely to put Poland's trade balance and balance of payments in chronic deficit. In order to correct the external imbalance in time, the Polish government periodically has to take restrictive policy-measures, which will make its currency unstable. Among Central European countries Poland most resembles the Asian type of economic development.

4. Tasks for the Japanese Investors and Central European Countries

4.1 Japanese Investment

According to research carried out by the Nomura Research Institute in Sept. 1997, out of about one thousand companies listed on the stock market, 310 companies showed interest in future investment towards the ex-Soviet and Eastern Europe region. Among those who considered investing in Central Europe, more than 50% of the companies intended to establish production and export bases, and only 35.7% of the companies

Table 3 Target Country for Japanese Investment (Sept. 1997)

Poland	33.40%	Hungary	26.40%	Czech Republic	18.40%
CIS	6.80%	Slovakia	5.80%	Others	9.20%

Source: Nomura Research Institute.

intended to establish sale bases for expanding their own products into this region. These rates are entirely different in the case of investment in developed countries, where the main aim is to generally expand sales of their own products.

The cumulative investment of Japanese companies during the last 10 years in Central European countries is estimated to amount to 1.5 billion US dollars. Japanese investment appears to be quite small in relation to its economic size. However, we should remember that not only its presence in Central Europe, but also its presence on the entire European continent is small, mainly because European markets are highly divided and not sufficiently attractive to giant Japanese companies which are primarily interested in scale merit. This explains why only those companies which have their own European strategies have come to Central Europe, for it is an urgent task for these companies to establish competitive production bases in Eastern Europe if they intend to be strong competitors in Europe.

Of the 1.5 billion US dollars, roughly estimating, 0.9 billion dollars went to Hungary, 0.4 billion to Poland and 0.2 to the Czech Republic. Each country has its representative investment from Japanese companies: Suzuki in Hungary, Isuzu in Poland and Matsushita in the Czech Republic.

Although Hungary has received several large scale investments such as from Denso, Sony, TDK, and Clarion etc., the other two countries have not succeeded in receiving successive investments from Japan.

There are several reasons why Japanese companies choose Hungary as the best country to invest in. Besides the factors already described, Hungarians are rather flexible in negotiations, which is a very important business practice in Japan, and there is little fear of labor disputes in Hungary. The image of the country to the Japanese is different in each case: Poland has a reputation for labor struggles and debt-cancellation, from which Japanese banks suffered, and the Czechs have strong national pride and are rather stubborn in negotiations (comparable to Germans).

Overall Japanese companies are, first of all, seeking production bases, and from this point of view favor a good geographical location and good infrastructure with flexible response to their demands.

4.2 Problems of Receiving Countries: What should be done?

It is not enough for the receiving country to simply announce its preferential system to investors. The business of attracting FDI has become very competitive among transforming countries, especially in Central Europe. If the government is not sufficiently sensible in reviewing its invitation system, it will lose the opportunity. The following are typical problems for investors in transforming countries.

(1) Although government proclaims to welcome FDI, facilities to receive foreign representatives are not well established: obtaining residence and work permits is too complicated.
(2) The level of personal income tax is extremely high in every country in question. The income of foreign representatives quickly reaches the highest taxation bracket. In this aspect, Holland has well-designed lessening-measures of personal income tax for foreign representatives.
(3) There is no counter-service for high tax paying foreigners, who have to pay additionally for health care and education of their children.
(4) As employers' contribution to social security and personal income tax is so high, labor costs are not as low as official statistics suggest.
(5) Living costs are not cheap as once thought, because imported consumer goods are at the same price level as in developed countries, and value-added tax is also high, ranging from 22% to 25%.
(6) Legal changes occur rather frequently, complicating life and confusing management.
(7) The customs system is badly organized, and therefore time and money needs to be spent on smooth custom clearance.
(8) "Hungry spirit", i.e. hard work for the sake of living, is not present in workers of Europe's transforming countries, which makes difficult for Japanese investors to understand the way of thinking and the behavior of workers.

4.3 Tasks for Japanese Companies

European society is different to Asian society in many aspects. In a word, Asia is a massively over-crowded society with a large population and conflict between people, and therefore Asian society needs firm rules and organizing units to be able to integrate society. Poverty in a crowded society is also a typical Asian phenomena, which drives people to work hard, sacrificing their own individual interests in favor of work.

On the contrary, Europe is a scarce scattered society and people like to avoid interference and prefer to live in a calm manner pursuing individual interests. Even being poor in the sense of current income, people do not sacrifice their interests and time for work, which is quite a difficult concept for Asian people to comprehend.

The main merit that Japanese companies found in Central Europe is relatively low labor costs with favorably good quality of workers. However, there are dual mistakes in their understandings.

First, although the level of wages is low enough according to official statistics, nobody lives only with the average income that statistics suggest. Actual living needs double or triple the average income, and therefore workers simply leave their jobs or take sick-days if the company sticks to ensuring only average income for them. This happens even in cities with high rates of unemployment, which is again quite difficult for Japanese managers to understand.

Another typical mistake made by Japanese companies is that they choose Central Europe simply because they see it as a low wage zone, which is only partly true. However, as long as Japanese companies evaluate Central Europe only on the value of physical workers, they will not fully utilize the potential work power of Central Europe. As shown by Nokia and Ericcson, who established large scale research institutes in Hungary, European companies are well aware of the high level of brainpower in this region. In fact, as plans of the German government show, IT engineers of Central Europe are the target of German companies. It is a universal problem and a task for Japanese companies to utilize foreign brainpower for fulfillment of their international strategies.

As for Central European countries, the so-called “brain drain” is a big loss for the countries. Therefore, it is an important task for governments to retain IT engineers as R & D manpower in home countries, irrespective of domestic or foreign ownership. One option is to encourage R & D activities within joint-venture companies with preferable policy measures for both the country and companies.