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**POLAND, THE LARGEST NEW EU COUNTRY**



**LAPPEENRANTA UNIVERSITY OF TECHNOLOGY**  
**Northern Dimension Research Centre**  
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## Foreword

The Northern Dimension Research Centre (NORDI) is a research institute run by Lappeenranta University of Technology (LUT). NORDI was established in the spring of 2003 in order to co-ordinate research into Russia.

NORDI's mission is to conduct research into Russia and issues related to Russia's relations with the EU with the aim of providing up-to-date information on different fields of technology and economics. NORDI's core research areas are Russian business and economy, energy and environment, the forest cluster, the ICT sector, as well as logistics and transport infrastructure. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics.

LUT has a long tradition in making research and educating students in the field of communist and post-communist economies. From the point of view of these studies, LUT is ideally located in the Eastern part of Finland near the border between EU and Russia.

This fourth volume in the series of NORDI deals with Poland, the largest new member of the EU. Poland is a very interesting transitional economy, and this study concentrates on aspects of its economic growth and living standard. The enterprise sector plays a significant role in the transitional process and thus the influence of foreign direct investments and foreign firms on Polish economy are also dealt with in this volume.

I want to express my gratitude to the EU's Interreg IIIA programme and the cities of Lappeenranta, Imatra and Joutseno for their financial support towards NORDI. I also give my sincere thanks to Ms Piia Vahvanen from the Department of Industrial Engineering and Management in LUT, who has edited and finalised the book.

Lappeenranta, January 2004

Professor, Ph.D. Tauno Tiusanen  
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## 1. The Polish economy

### 1.1. Country profile

The Poland of today stands out as one of the most successful and open transitional economies. The privatisation of small and medium state-owned companies and a liberal law on establishing new firms marked the rapid development of a private sector now responsible for 70% of economic activity. In contrast to the vibrant expansion of private non-farm activity, the large agricultural component remains handicapped by structural problems, surplus labour, inefficient small farms and lack of investment.<sup>1</sup>

Geographically, Poland lies on the southern shore of the Baltic Sea and has borders with the Russian Federation (Kaliningrad District) in the North, Lithuania in the North-East, Belarus in the East, Ukraine in the South-East, Slovakia and the Czech Republic (CR) in the South and Germany in the West. It is roughly four times bigger than the CR both in area (312.683 km<sup>2</sup>) and in population (38,6 million). Warsaw, the capital of Poland, counts about 1,7 million inhabitants. Poland is the largest country in Central and Eastern Europe, which comprises the transitional economies excluding the former Soviet Union.<sup>2</sup>

The country consists mainly of flat plains, most notably in the vast central lowlands. Significant highlands are situated in the South-West (Sudeten Mountains) and South-East (the Tatra Mountains, the northernmost part of the Carpathian range). Only 3% lies above 500 meters, while about 90% is situated below 300 meters. Poland also has a beautiful, wide lake region above the central lowland. It is dotted with lakes and occupies about 10% of the surface area. A dominant continental climate reigns year round, but considerable winter snow and fog from maritime air currents occur. Summers are less humid with occasional showers and average annual precipitation is about 600 millimetres with peaks in the mountain area.<sup>3</sup>

Poland contains many regions of unspoiled natural beauty, such as the Bialowieza forest - the last virgin forest of the European mainland and home to the largest surviving herd of the European bison. However, the forest suffers from air pollution and the resulting acid rain.

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<sup>1</sup> The World Factbook – Poland, 1999.

<sup>2</sup> Tiusanen, T. & Talvitie, K. The Czech Republic. Business opportunities in a successful transitional economy. Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1997.

<sup>3</sup> Poland, a country study. Library of Congress, Federal Research Division, 1992. Available in Internet: <http://leweb2.loc.gov/frd/cs/pltoc.html>.

Hazardous and industrial waste, water and air pollution also pose some environmental problems.<sup>2</sup>

The bulk of the population is ethnic Polish (97,6%), who belong to the same western group of Slavs as the Czechs and the Slovaks. The rest of the inhabitants consist of Germans, Ukrainians and Belorussians. Religion has always been very important to the Polish and 95% are Roman Catholic (about 75% practising). Thus, the Roman Catholic Church can be considered as a powerful element of the Polish national identity.<sup>2</sup>

## **1.2. Some historical background factors**

Among the countries of the Soviet bloc, Poland was unique in maintaining a limited system of private ownership of certain means of production, including agricultural land. Because private ownership of land was allowed within the Polish communist system, the rural economy in Poland has had - theoretically - a relatively easy transformation in the post-communist era.

However, the vulnerability of Polish private farmers under the communist system was obvious. Farmers had little ability to control their farms on the goods they produced, since they were forced to sell the bulk of their produce to the state for a substantially discounted price. The result was a large decline in agricultural output, as well as a decrease in rural income. In addition, the government harassed private farmers by making hiring of employees and purchasing of equipment very difficult. Sale or transfer of land was made virtually impossible.

Therefore, Poland was one (among others) of the centrally planned economies (CPEs) in Eastern Europe. In CPEs, the invisible hand of the market was uprooted by the visible hand of the party-state apparatus. Rationing through markets and prices was largely replaced by administrative allocation, giving special privileges to those in charge of shortages management. The economy became fused with the party-state and the latter displaced objective economic criteria with subjective political ones. While competition, profits and fear of bankruptcy “compelled” firms in a market environment to seek ways of improving microeconomic efficiency, central planning required a strong centralised power to assure compliance of enterprises with norms and tasks detailed in plans. With the growth of information complexity in the economy and its inability to deliver material abundance, promised in communist ideology, the capacity of central planners to develop realistic plans and implement them became more and more limited.

Before the collapse of the communist system in Eastern Europe in 1989-1990, changes in the economic system consisted of three important steps:

- I. modification of the administrative mechanism used for the purpose of planning;
- II. replacing directive physical commands with financial instruments and;
- III. creating a limited market environment.

Each step represented a different stage in economic reforms and not all communist countries reached the second or the third step.

During the last few years before the collapse of communism, the Hungarian and Polish authorities introduced changes, effectively handing over some important components of the central planning, indicating their willingness to move to a market economy. Thus, it can be stated that, in these two reform-minded countries, there had been some movement towards “defusing” the economy from the state.

However, also in these two most reformed CPEs, the movement towards market economy was too slow and too narrow in scope in order to fill in the institutional blanks that set central planning apart from a market economy. In both cases, reform evolution was interrupted by a revolutionary (systemic) change.

The transition programme introduced in Poland in January 1990 became known as the “big bang” or “shock therapy” alternative. This programme was based on the premise that harsh measures were required to forestall hyperinflation, while simultaneously setting Poland on course toward a well-functioning market economy. “Third roads” between socialism and capitalism were dismissed as waste of time: the destination was a western-style market economy and it was to be reached as quickly as possible.

The near-hyperinflationary conditions in which the Polish transition began were highly unfavourable and resulted in an understandable emphasis on macro-economic stabilisation. The government budget was brought into surplus as part of the original shock. Monetary growth slowed and interest rates increased in real terms. The share of subsidies in GDP was brought down to a minimum. Stabilisation also relied heavily on tax-based income policies founded on prohibitive taxation of excessive wage growth. Not surprisingly, austerity policies were accompanied by rapid increases in unemployment, by large initial declines in real output and wages and by increases in poverty rates.



It is important to note that these negative effects of the early transition were not avoided in any transitional economy (TE). The slump in the immediate post-communist period can be traced to certain background factors. The liberalisation of prices and enterprise activity led to the “creative destruction” of productive capacity that had previously been employed in value-subtracting activities. TEs were also hit by external shocks in the form of reductions in intra-Comecon trade (trade within the communist bloc).

It is not possible to cover all details of the very interesting early period of Polish transition. It suffices to point out here that Poland was the first TE that came out of the systemic change shock causing declining output. This is a remarkable achievement.

In the early period of Polish transition, a considerable external factor played a role in the Polish success story. Communist Poland became credit-unworthy in the 1980s. The international financial community appreciated Poland's bold shock therapy programme and gave an exceptionally favourable financial package to support the Polish transition. In April 1991, Poland signed a major debt reduction agreement with the Paris Club of Creditor governments, according to which the governments holding the lion's share of Poland's foreign debt would forgive half of this debt (some USD 15 billion), provided that Poland carried through the economic reform programme. A similar agreement with the London Club of Poland's commercial bank creditors was concluded in March 1994, according to which 45% of their debt (some USD 13 billion) would be forgiven. In return, Poland agreed to fully service the country's remaining debt obligations.

The debt reduction agreements connoted the international financial community's explicit approval for Poland's transition programme. Nothing equivalent has been done in order to help other TEs in their struggle to achieve market economy. Thus, Poland is a special case in this respect. In other TEs, e.g. in Hungary, where the communist time debt burden was relatively high, the special treatment given to Poland has caused some jealousy. Poland's economic miracle of the 1990s has this important background factor of external support, which is unique in post-communist Europe.

### **1.3. Economic growth in the 1990s**

In springtime 1999, Poland, Hungary and the Czech Republic joined NATO. This historical event, which brought three previous members of the Warsaw Pact into the Western military alliance, is an important milestone in post-communist Europe.

The Czech Republic (CR) and Hungary are used here to compare economic performance in these two important TEs with that in Poland. In the 1990s, Poland was very clearly the strongest performer in economic growth within this group of three TEs.

In the early transition, Poland, as all TEs, experienced a very deep slump. Polish GDP (Gross Domestic Product) fell by almost 20% between 1989 and 1991. Growth rebounded from 1992 onwards on behalf of the strength of consumption. Then, in 1994, a significant change in the balance of demand took place, as investment and exports replaced consumption as the driving force of recovery. Without going into details, Poland's transitional recession was overcome very rapidly. In the CR, recession continued in 1992 and in Hungary still in 1993.

In the mid-1990s, Poland was the fastest growing economy in whole Europe. It clearly outperformed its main TE-rivals, Hungary and the CR.

**Table 1. Economic development of selected transitional economies**

	Real GDP growth				Index 1998 (1989=100)
	1995	1996	1997	1998	
Poland	7,0	6,0	6,8	4,8	117
Czech Republic	6,4	3,9	1,0	-2,6	95
Hungary	1,5	1,3	4,6	5,2	95

Source: WIIW.

As shown in the table above, Polish real growth has been some 5-7% annually in the second half of the 1990s. Thus, Poland is the first TE that has reached and exceeded the last communist-era-year's (1989) level of economic activity. When 1989 is marked as 100, Polish GDP was no less than 117 in 1998, while the CR and Hungary find themselves slightly below their respective 1989-performance level.

In the table, it is visible that Polish economic growth has been moderately decelerating, while Hungary shows a rather strong acceleration of real growth. The CR experienced a recession in 1998 with GDP decreasing in real terms.

In 1998, Russia suffered a very severe economic crisis with a remarkable depreciation of the rouble. Even if CEECs (Central Eastern European Countries) are not heavily dependent on Russian markets anymore, the deterioration of the export market in the largest TE was a blow for all post-communist societies. In Poland, Russia's share in the total export business was

7,4% in 1998 (8,4% in 1997). The equivalent figure in Hungary was only 3% in 1998 (5,1% in 1997), and 2,5% in the CR (3,4% in 1997).

In the communist era, the bulk of foreign trade in CEECs, both in imports and exports, was with the Soviet Union (50% or even more). Now in the post-communist period, the dependency of CEECs on the Russian market is amazingly low. Therefore, the Russian crisis in 1998 has had very little direct influence on the overall economic growth picture in the three TEs under review in this chapter. Some negative impact has been felt in the food and food processing sectors, in which the decreasing Russian demand has harmed Polish, Hungarian and Czech exporters.

In the Polish growth process, the investment component has been a decisive driving force. Gross fixed investment has increased much faster than GDP in the second half of the 1990s.

**Table 2. Gross fixed investment**

	Real growth (%) compared to previous year				Index 1998 (1989=100)
	1995	1996	1997	1998	
Poland	17,1	19,2	22,2	14,5	186,8
Czech Republic	21,0	8,7	-4,9	-3,7	114,3
Hungary	-5,3	5,2	8,5	10,2	107,3

Source: WIIW.

As can be seen in the table above, investment in Poland increased by an annual rate of no less than 15-22% between 1995 and 1998. The speed of growth has been even substantially faster than in Hungary and the Czech Republic. In the CR, there has even been a negative tendency in investment in 1997-1998 after a strong boom in 1994-1996.

When the last year of the communist era (1989) is marked with 100 in the index of real investment, the figure in 1998 was 187 in Poland. This signifies that real gross investment almost doubled in the first decade of the Polish transition. The CR and Hungary have also exceeded the initial 100-points mark, but the Polish investment boom has been substantially stronger than in the two other TEs under review. This very rapid investment growth is the core point in the Polish economic miracle of the 1990s.

Unfortunately, labour productivity has not grown as fast as investment in the Polish transitional process. However, the productivity trend has also been clearly positive thus far.

**Table 3. Labour productivity in industry**

	Change (%) compared to previous year				Index 1998 (1989=100)
	1995	1996	1997	1998	
Poland	6,3	9,1	11,2	5,8	149,5
Czech Republic	10,6	8,6	9,2	5,1	119,4
Hungary	10,2	9,4	13,7	12,0	170,9

Source: WIIW.

In the productivity table above, Hungary clearly claims victory. It has been able to increase its labour productivity figure in the first transitional decade by more than 70%. The equivalent figure in Poland is also very positive with some 50% increase. In the Czech Republic, the productivity growth with about 20% has been rather modest, but still positive.

In investment decisions, it is essential to compare unit labour costs (ULCs) in different locations. It is a well-known fact that gross wages in nominal terms are very low in TEs as compared to the West. At the same time, however, productivity in TEs is substantially lower than in the West or in the mature economies of Western Europe and North America, as well as in Japan. When actual labour costs are compared, then unit labour costs must be taken into consideration.

The Vienna Institute for International Economic Studies (WIIW) permanently calculates unit labour costs in TEs. In WIIW's index figures, Austria is marked with 100 and unit labour costs (ULC) in TEs are compared with the Austrian level, taking into account the adjustment for purchasing power parity (PPP).

**Table 4. Unit labour costs (ULC)**

	Austria=100, PPP-adjusted			
	1995	1996	1997	1998
Poland	28,9	33,4	37,7	40,6
Czech Republic	22,4	26,3	28,9	31,5
Hungary	22,2	22,9	25,6	25,7

Source: WIIW.

The ULC table shows that in the 1990s TEs provided cheap labour costs even when the productivity is taken into consideration. In 1998, ULCs were essentially more advantageous in the best TEs than in Austria, which is a mature EU-country.

The ULC figures above have some interesting features. Between 1995 and 1998, ULCs have remained relatively stable in Hungary, where the productivity development was - as mentioned before - very favourable, while the CR and Poland both show a clear increase in ULC. Poland's ULC already reached 40% of the Austrian level in 1998, which is essentially more than in 1995 (less than 30%). Thus, Poland was clearly more expensive for potential employers at the end of the 1990s than the Czech Republic and Hungary. In Hungary, the unit labour cost amounts to only about a quarter from the Austrian level (PPP-adjusted).

#### 1.4. Economic equilibrium

In economic policy-making, there are four traditional aims: reasonable economic growth, relative price stability, relative full employment and relative equilibrium in the balance of payments on the current account (CA). It is very important that a suitable economic policy mix is found in TEs, in which all of these four objectives are taken into consideration.

In the mid-1990s, it was customary to call the three countries under review “transitional or East-European tigers”. With this slogan, it was indicated that Poland, Hungary and the Czech Republic had been able to find a sustainable economic growth path with decreasing inflation rates, an improving labour market and without any dangers of disequilibrium in the external balance. This harmonic picture suffered a considerable blow, when the Czech Republic fell into a devaluation trap with a recessionary effect in 1997.

The price inflation trends in the three countries under review have, generally speaking, shown favourable tendencies. Inflation has been basically decelerating.

**Table 5. Consumer price inflation (change in % compared to previous year)**

	1995	1996	1997	1998
Poland	27,8	19,9	14,9	11,8
Czech Republic	9,1	8,8	8,5	10,7
Hungary	28,2	23,6	18,3	14,3

Source: WIIW.

The inflation table shows that the Czech Republic has been the most stable country under review in 1995 to 1998 with one-digit inflation rates for the three first years of the period. However, the CR had to abandon the fixed exchange rate policy in 1997 and, with a floating

exchange rate, its currency (koruna) experienced a clear depreciation. In the aftermath of the currency devaluation, an acceleration of the inflation rate took place <sup>4</sup>.

The inflationary picture is pretty similar in Hungary and Poland, which have both experienced a remarkable deceleration of price hikes in 1995 to 1998. However, in 1998, both countries still had double-digit inflation rates, meaning that no ultimate equilibrium was reached in the 1990s.

"Under the communist system, everybody pretended doing some work and the state pretended paying the workers", this old saying was customary in all centrally planned economies.

The original shock of transition caused considerable turmoil on the labour market. In Poland, labour market changes were especially profound with the early shock therapy treatment of the economy. The unemployment rate was close to 20% in the early nineties.

**Table 6. Unemployment rate (%)**

	1995	1996	1997	1998
Poland	14,9	13,2	10,3	10,4
Czech Republic	2,9	3,5	5,2	7,5
Hungary	11,7	11,4	11,0	9,6

Source: WIIW.

The labour market figures give an extremely diversified picture. The Czech Republic (CR) was very reluctant to restructure the industrial base in the early period of transition. At the same time, there was a considerable boom in tourism, when the opening up took place: the tourism sector created many new working places.

With the devaluation crisis and the consequent slump, the unemployment rate has shown an increasing tendency. The unemployment rate has gone up - one can say - dramatically between 1996 and 1998. Obviously, only now, a delayed restructuring of many industrial enterprises is taking place in the Czech Republic.

Hungary and Poland have experienced very strong economic growth in the second half of the 1990s. This boom has affected the employment situation somewhat positively, but the

<sup>4</sup> For details, see Tiisanen, T. & Talvitie, K. The Czech Republic. Business opportunities in a successful transitional economy. Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1997.

unemployment rates do not show any fundamental improvement. Under market conditions, costs are obviously calculated very carefully without overmanning of new enterprises.

In the three countries under review, there are relatively high social costs in hiring labour force (taxes and social security payments are a big part of the gross wage). Therefore, there is a high incentive for moonlighting<sup>5</sup>. This means that the official labour market statistics only tell part of the story. Actually, in the best TEs, there is a relative scarcity of labour in metropolitan areas. Real unemployment is a problem in some remote areas only.

Many emerging markets were confronted with a balance of payments on current account (CA) problem in the 1990s. In the economic growth process, emerging markets easily enter a phase in which import needs exceed export capability. The gap in the external balance can only be financed to a certain extent. If the CA deficit becomes too wide, unpleasant measures must be taken. The bitter pill usually is devaluation.

There is no universal measure showing us when the emerging market CA is in unbearable disequilibrium. Normally, it is regarded as critical when the CA deficit is about 7 to 8% of the emerging market GDP. 10% or more is regarded as excessive.

The Czech Republic had an increasing CA deficit in the mid-1990s. Unfortunately, this problem was ignored, so that, in 1997, the deficit exceeded 8% of GDP, which was not financable anymore. The fixed exchange rate policy had to be abandoned and replaced with the floating system, which depreciated the local currency and caused an economic slump.

It is dangerous for an emerging market to run a higher inflation than its competitors. The danger of a relatively high inflation combined with a fixed exchange rate regime is obvious: the country starts facing difficulties in exports and economic agents back home start favouring import goods. High inflation combined with inflexibility of the external value of money means appreciation of the local currency in real terms. This appreciation of the real value of a currency hurts exports and boosts imports, causing an insurmountable CA problem sooner or later.

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<sup>5</sup> For details, see Tiusanen T. & Vinni, S. Hungary in the 1990's. Business opportunities in a successful transition economy. Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1999.

In the exchange rate (ER) policy, there is one very rational method for emerging markets: the crawling peg. This system has been applied in two TEs, namely Hungary and Poland <sup>5</sup>. There are clearly positive results from this experiment.

Hungary and Poland have been well aware that they have relatively high inflation rates that must be taken into account in the external economy. This means in actual fact that the ER is permanently adjusted with a monthly devaluation.

In the crawling peg system, the median exchange rate is fixed but adjusted every month (the median rate slides down to absorb the excess inflation). In the system, the so-called “creeping band” is also determined: the market flexibility can work within certain boundaries.

In the mid-1990s, Poland determined that the creeping band is  $\pm 7\%$ . It means that the zloty, the Polish currency, can fluctuate 7% up and down around the central rate, which goes down every month with a pre-determined percentage. The crawling peg rate was 1,9% in 1994 and has been reduced regularly with the deceleration of the Polish inflation. For the year 2000, the Polish crawling peg rate is set on a very low 0,3%.

This means that the zloty median rate (fixed against a basket of dollar and euro) is reduced by 0,3% on a monthly basis. The market supply and demand can affect the zloty exchange rate (ER) daily within the  $\pm 7\%$  limits. These limits have been widened to  $\pm 10\%$  in the meantime. This combination of administrative guidance and market activity is supposed to secure an optimal solution.

There have not been any serious CA deficits in either Poland or in Hungary in the 1990s. Thus, the crawling peg applications have been clear successes.

**Table 7. Current account (% of GDP)**

	1997	1998	1999
Poland	-3,0	-4,4	-5,1
Czech Republic	-6,2	-1,9	-2,0
Hungary	-2,1	-4,8	-5,5

Source: WIIW.

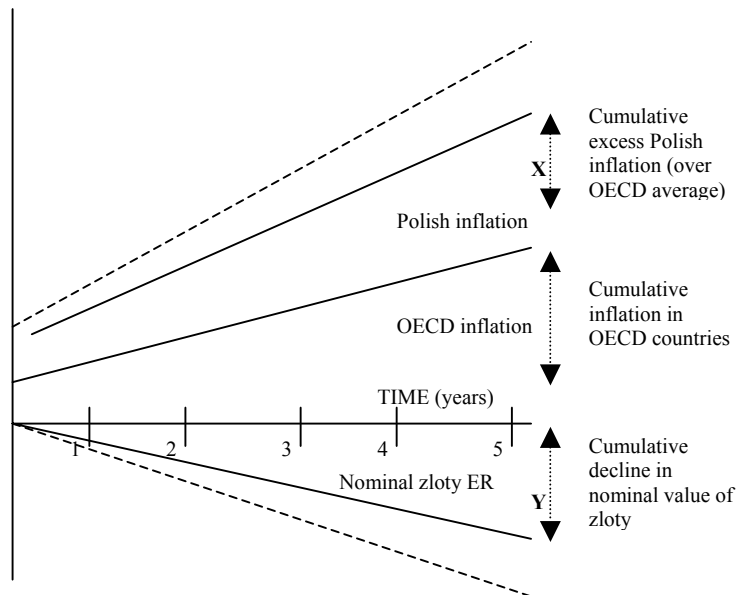
In the Czech case, post-crisis (1997) floating of the ER has brought about relative equilibrium in CA. Hungary and Poland both show increasing CA deficits that are not yet especially critical in magnitude. However, manipulation of the crawling peg system may become



necessary. With expanding CA deficits, crawling peg rates must eventually be increased. Naturally, the crawling peg system can be abandoned and replaced with a floating ER regime.

The “real” exchange rate problem can be illustrated with the following figure.

**Figure 1. The “real” exchange rate (ER)**



If  $X = Y$ , the real ER of the zloty is unchanged

If  $X > Y$ , the real ER of the zloty appreciates

If  $X < Y$ , the real ER of the zloty depreciates

## **2. Some structural aspects of the economy**

In the 19<sup>th</sup> century, Poland was partitioned. The Polish lands were occupied by Russia, Prussia and Austria. Everyone of which had different currencies, economic legislation and customs. There was no uniform transport system.

After the World War I, Poland regained independence (in 1918). After that, the Polish government started to unify territories that for more than a century had been partitioned. The Eastern part of the country, formerly ruled by the Russian empire, was backward agricultural “hinterland”, while the Western part, once belonging to Prussia, was urbanized and rather well industrialized. However, industrial structures were very badly damaged during the war. The immediate post-war reconstruction was badly hampered by instability: inflation in the early 1920s was rampant.

However, the period between two world wars was a favourable one from the point of view of Polish industrialization, even if in the early 1930s Poland - like other European countries - suffered from the Great Depression. Industrial revolution reached parts of the Eastern region, which under Russian rule had been almost completely rural terrain.

The World War II had really devastating effects on the Polish economy. Wartime destruction included six million killed people and vast amounts of physical capital. Economic difficulties were intensified by large migration of rural population from the former Eastern part annexed by the Soviet Union.

In the post-war period, Poland changed her political system. The ruling team of communists rejected the free market system which was replaced by central planning of soviet type. In the post-war reconstruction phase, the ruling communist authorities rejected the financial aid offered by the USA (Marshall Plan), which enabled main parts of Western Europe to rebuild their economies devastated by the war.

The core of the communist ideology was that all means of production (as well as bank, trade and other services) must become the property of the state, which maximizes the investment in heavy industry. This strategy of central planning was carried out in Poland, as well as in other Eastern bloc countries in the post-war period. The most important monument of this policy in Poland was the Lenin Metallurgical Works, a huge steel-mill near the city of Cracow. A variety of new industries came into being, including shipbuilding, energy turbines, mining

machines, automotive industries, machine tools, etc. Several hard coal and lignite mines were constructed.

In the 1950s it became obvious that the strategy of forced industrialization by central planners was not necessarily bringing up optimal economic results. The absence of consumer articles on the market and insufficient investment in agriculture caused dissatisfaction and a revolution in Hungary 1956, which was brutally suppressed by the Red Army. In the same year, there was plenty of turmoil in Poland. These events had very little impact on the continuation of the overall industrialization policy of communist Poland.

The prominent Hungarian economist, Janos Kornai, has in his numerous books excellently described why maximal economic growth pursued by communist central planners is not bringing optimal results from the point of view of living standard. Endless “investment hunger” in the forced industrialization process always contains allocative inefficiency and economic waste. Kornai’s research shows that centrally planned economies continuously had overproportional growth rates in investment <sup>6</sup>.

**Table 8. Growth of GDP and capital investment: international comparison  
(average annual growth rates, 1950-79)**

	GDP	Gross fixed capital investment
<b>Socialist countries</b>		
Bulgaria	5,43	10,89
East Germany	3,77	8,52
Hungary	3,64	8,85
Poland	4,12	9,70
Romania	5,81	11,33
Soviet Union	4,95	8,02
<b>Capitalist countries</b>		
Australia	4,54	4,43
Canada	4,57	4,36
Finland	4,48	4,54
Italy	4,92	4,79
Netherlands	4,58	5,10
Norway	4,15	4,93
Sweden	3,69	4,18

Source: Kornai, J. *The Socialist System. The Political Economy of Communism*. Oxford, 1992.

<sup>6</sup> Kornai, J. *The Socialist System. The Political Economy of Communism*. Oxford, 1992.

It is often stated that the economic crisis of Polish central planning started in the mid-1970s and lasted more than a decade: the systemic change took place in 1989. The key points of the new system are as follows: privatisation of state property and creation of capital markets to allocate resources effectively; free competition; convertibility of the currency (zloty); dismantling the state monopoly of foreign trade. These are the core elements of the market in which prices are self-evidently free.

It is not possible to discuss here all details linked with the systemic change. Only certain aspects of the privatisation will be taken up here. In the common market of the European Union, market forces are supposed to be the guiding force within the Union. Thus, state ownership ought to be minimized in order to avoid market distortions. The privatisation of post-communist Poland has been an extremely complicated process.

Under communist rule in Poland, there was some flexibility concerning the private sector. Small family firms were allowed, for example, in handicrafts sector. Obviously, these firms were continuously walking on a tightrope: it was difficult to obtain (state controlled) material inputs, tax rates were high and unstable, etc.

“Polonia” sector was one of the oddities of communist Poland. In the 1970s, rules were created for small enterprises which were established by emigrant Poles. People, who had collected experience and capital abroad, were able to open small economic units in communist Poland. The idea was to improve consumer goods supplies. However, also the “Polonia” sector was an ideologically alien element in the communist environment, and thus, policy toward this sector was erratic and unstable.

In the 1980s, a hybrid legal structure concerning “cooperatives” came into being. It was made known that cooperatives founded by individuals are allowed. New cooperatives could be established by a group of no fewer than ten founding members, who were required to submit an official statement of purpose. After that, local authorities approved the registration. This form of enterprise created some leeway for private initiative used especially in trading activities.

It is not possible to discuss all details of Polish communist-time enterprise forms here. It suffices to state that there was some diversity in the enterprise sector. In the rural community, private farms were predominant which was exceptional in the communist bloc.

**Table 9. State and private employment in Poland, 1989-93 (% , at the end of year)**

	1989	1990	1991	1992	1993
Total	100	100	100	100	100
State sector	53	50	44	41	40
Agricultural private sector	23	25	26	26	26
Non-agricultural private sector					13,1
Including cooperatives	24	25	30	33	34
Excluding cooperatives	10	14	19	26	30
Total employment (in millions)	17,6	16,5	15,9	15,9	15,7

Source: Kramer, Mark. Polish Workers and the Post-communist Transition, 1989-93. *Europe-Asia Studies*, vol. 47, No. 4, 1995, 669-712.

In the year of the systemic change (1989), almost one quarter of the active population (24%) was involved in the non-agricultural private sector, almost as big a share as in the private agriculture (23%). More than half of the total employment (53%) was in the state sector, which in 1989 involved 9,3 million people.

Privatisation of state-owned means of production is the most important institutional task of transition. The problem in this context has been the same in every TE: what is the best method to move assets in large scale from state to private ownership? Two options are open: to sell to private buyers or allocating the assets to citizens without payment. In the first case, the state naturally gets revenue for her budget. In the second case, social justice (equal chances for everybody) is the main background factor.

In Polish privatisation process, various methods have been used. In the first phase of transition, the so called “liquidation” of small and medium-sized enterprises (SMEs) has taken place involving both leasing to insiders as well as sale of assets of liquidated firms. In the mid-1990s, this method declined rapidly reflecting a shrinking pool of easily leasable or saleable enterprises. Many state-owned enterprises (SOEs) established in the communist era were too big to be “liquidated” easily.

The second method of converting SOEs into private firms is called “capital privatisation” involving sales of large units. This category has involved outside (foreign) strategic investors who have bought Polish assets, for example, in car manufacturing and in cigarette-making. These big deals have been an important source of budget revenue.

The third way of converting the socialist ownership structure into private hands in the 1990s was called “Mass Privatisation Programme” (MPP). This method involved the so called voucher scheme, in which all Polish adult citizens were entitled to receive one “share

certificate” for a nominal (low) fee. In this context, 15 National Investment Funds (NIFs) were created by the state managed by Polish and foreign participation. Each NIF holds a strategic stake of 33% in a number of companies. NIF managers have the aim to improve the corporate governance in those enterprises, in which they have a strategic stake. Investment vouchers were converted into shares of NIFs, which have become “engines” of wide distribution of ownership.

This rather complicated privatisation process, which cannot be dealt with in detail here, turned Polish ownership structure radically upside down in the first decade of transition. This can be seen from the figures of private-sector employment changes between 1989 and 2001.

**Table 10. Private-sector employment (% of total employment by sector; end-period)**

	1989	2001
Agriculture	79,0	98,8
Non-agricultural economy	14,0	63,1
Industry	14,7	76,6
Construction	26,9	93,6
Transport	5,6	48,2
Trade	8,0	98,4
Total	33,3	73,2

Source: Economist Intelligence Unit (EIU).

In the early 21<sup>st</sup> century, almost three quarters of the active population in Poland was involved in private sector, while the equivalent figure in 1989 was only one third: the difference is striking.

Really striking detail in the Polish economic structure can be observed in the sphere of agriculture. This sector contributes only less than 4% of the Polish Gross Domestic Product (GDP), but employs more than a quarter of the active population in 2001.

**Table 11. Gross domestic product by sector  
(% of GDP; at factor cost; current prices)**

	1988	2001
Agriculture, forestry and fishing	13,1	3,8
Industry excl. construction	41,7	24,1
Construction	10,7	7,3
Services	34,5	64,8 <sup>a</sup>
Trade & repair	13,7	20,5

<sup>a</sup> Of which, marketed services account for 48,7% of GDP at factor cost.

Source: Economist Intelligence Unit (EIU).

In the late 1980s, industry was the dominant contribution of GDP with a share of about 42%. In 2001, the equivalent figure was less than one quarter. In the transitional period, service sector has rapidly gained importance; in the last years of communist power, the service sector represented only one third of GDP, and in 2001 already about two thirds of the overall economic activity.

The rapid relative decline of agriculture's importance in GDP is not reflected in the employment statistics: this sector employs over 26% of active people in 1989 and in 2001. In the same period, industry's relative figure has declined by eight percentage points.

**Table 12. Employment by sector<sup>a</sup> (%; annual av)**

	1989	2001
Agriculture, forestry and fishing	26,7	26,3
Industry	28,8	20,8
Construction	7,8	5,7
Trade	8,6	14,2
Transport & communications	5,8	5,3
Other services	22,3	27,7
Total	100,00	100,00

<sup>a</sup> Includes self-employment.

Source: Economist Intelligence Unit (EIU).

In the light of these simple structural statistics it can be stated that Poland has an unusual economic structure in European framework. Agriculture has a “normal” contribution to local GDP (4%), but is overproportionally represented in the employment table. This unusual structure is inherited from the communist past, during which the big bulk of farming units were already in private hands.

There are about two million farms in Poland giving livelihood to no less than 4,3 million people. The average size in the early 21<sup>st</sup> century was just over eight hectares per farm. It is estimated that around half of all farms are run on a subsistence basis with very little mechanisation, and hardly any marketable surpluses.

Thus, there is a need to solve problems facing the rural economy in Poland. Obviously, rationalisation of the farming sector calls for creation of large farms. Consolidation of the rural economy has been very slow in the transitional period. In the urban economy, there has not been a lot of demand for industrial labour force. Therefore, incentives to move from the countryside to industrial centres have been rather limited in the transitional period. Restructuring can only be a slow process.

Poland is traditionally an important producer of coal with an annual output of hard coal of some 200 million tonnes annually in the late 1980s. In the transitional period, this figure has roughly been halved to a bit over 100 million tonnes in 2002. The annual production of brown coal (lignite) is about 60 million tonnes.

In the transitional period, coal mining has become unprofitable. This sector employs about 7% of the industrial work force, but contributes only about 3,5 % of the overall industrial production. Thus, rationalisation in this sector ought to take place, but also in this traditionally important sphere restructuring seems to be rather slow. Under present circumstances, Poland produces more coal than it needs exporting the surplus production. Poland imports about 18 million tonnes of crude oil a year. Coal mining has received state subsidies in the transitional period.

State sector in transitional Poland is rather modest. Budget revenue in 2002 was zloty (zl) 143,5 billion, or 18,6% of GDP (zl 772,2 billion). Expenditure in state budget was in 2002 zl 182,9 billion, or 23,7% of GDP. Budget deficit in 2002 was zl 39,4 billion, or 5,1% of GDP.

Total tax revenue as per cent of GDP was about 50 in both Sweden and Denmark in 2002 <sup>7</sup>. These two Scandinavian welfare states are on the top of the list of EU-countries in relative tax burden figures.

In the autumn 2003, a meeting between Scandinavian and Baltic political leaders took place to discuss the EU enlargement. Scandinavian representatives maintained that new members of EU try to attract investment from old EU-countries by low tax policy, while the old EU-members must subsidize the new ones.

The low level of public sector involvement in Poland naturally reflects the low level of living-standard. Poland cannot - so to speak - afford Scandinavian-type welfare state with high taxes and generous redistribute system via public sector. These structural differences between old and new EU-states pose a serious problem and cause potentially conflicts between rich and poor. The state's share of GDP in Polish case is really very modest, especially in Scandinavian comparison. State budget revenue in Poland is less than one fifth of the GDP.

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<sup>7</sup> The Economist, October 25<sup>th</sup>, 2003.



In the foreign trade figures there is no visible advantage from the rather abundant resource base of Poland: the country imports more raw materials - including fuels - than it exports. In foodstuffs (food, beverage, tobacco) imports and exports are virtually on the same level.

**Table 13. Foreign trade 2002 (USD m)**

<b>Exports of goods, fob</b>	<b>41,010</b>
Food, animals, beverages & tobacco	3,094
Raw materials excl. fuels	1,011
Fuels etc.	2,041
Chemicals & related products	2,608
Manufactured goods classified by material	9,753
Machinery & transport equipment	15,411
Miscellaneous manufactured articles	7,071
Other	21
<b>Imports of goods, cif</b>	<b>55,113</b>
Food, live animals, beverages & tobacco	3,067
Raw materials excl. fuels	1,636
Fuels etc.	5,039
Chemicals & related products	8,184
Manufactured goods classified by material	11,362
Machinery & transport equipment	20,699
Miscellaneous manufactured articles	4,868
Other	258
<b>Trade balance</b>	<b>-14,103</b>

Source: Economist Intelligence Unit (EIU).

In the transitional period, trade balance has had the tendency to be in deficit in Poland. However, Poland has not experienced any severe crisis of the balance of payments on current account (CA) in the post-communist period.

Far the most important trading partner of Poland is the neighbouring Germany which counts for one quarter of Polish imports and about one third of her exports.

**Table 14. Main trading partners 2002 (% of total value)**

<b>Exports to:</b>		<b>Imports from:</b>	
Germany	32,3	Germany	24,3
France	6,0	Russia	8,4
Italy	5,5	Italy	8,0
UK	5,2	France	7,0
Netherlands	4,5	UK	3,9

Source: Economist Intelligence Unit (EIU).

Some 62% of Polish foreign trade in 2002 was with EU-countries: the share in both export and import was almost the same.

In the Polish current account (CA) there is an interesting category: net cross-border trade contributes over USD 4 billion to the CA. This means that so called shuttle-traders come from the former Soviet Union, mainly from Ukraine and Belarus, to buy merchandise from the Polish market which has an ample supply of first-hand and second-hand bargains. This colourful market has an amazingly high turnover annually. This special trade obviously mitigates supply bottlenecks in neighbouring countries.

### **3. Some aspects of living-standard**

It was pointed out above that the rural economy in the communist era was mainly run by private farmers. However, participants of agro-business were neither able to set their own output prices nor their inputs under market conditions. Thus, the farming community had no real chance to take a “normal” path of mechanisation and rationalisation in the era of Polish control planning.

This communist “ownership scheme” in the rural economy helped the early period of transition in one respect: farmers had the big bulk of farmland in their possession when the market system was established. In other TEs restructuring of agriculture was more difficult than in Poland. In many TEs, landed property was restituted (farmland was given back to previous owners) which is a very difficult process.

The communist legacy in the Polish countryside has also a negative aspect: over four million people were to a big part almost entirely excluded from industrial-urban development. The majority of this rural society lived in dire poverty and self-sufficiency.

This important historical fact must be taken into consideration when macro-economic figures of Polish living standard are represented.

In the macro-level living standard comparisons it is usual to take GDP figures per capita converted into US dollars or euros. These figures are grossly misleading, because official exchange rates do not reflect different price levels in various countries correctly. The correct basis of comparison involves GDP figures per capita at current PPPs (purchasing power parity), which are easily available for TEs, for example, from the Vienna Institute of International Economic Studies (WIIW).

**Table 15. GDP per capita at current PPPs (EUR/ECU)**

	2002	EU(15) average = 100 2002
Czech Republic	14.836	63
Hungary	12.615	53
Poland	9.805	42
Slovak Republic	12.382	53
Slovenia	17.159	73
Bulgaria	7.645	32
Romania	5.980	25
Estonia	10.380	44
Latvia	7.987	34
Lithuania	9.121	39
Germany	24.864	105
Greece	16.555	70
Portugal	17.508	74
Spain	20.412	87

Source: WIIW.

GDP per capita calculated in euros (PPP adjusted) was in 2002 just below € 10.000 (9.805) which is 42% of the EU average (15 countries). This is clearly less than in the richest TE, Slovenia (€ 17.159), where the living standard is higher than in Greece (€ 16.555). The Czech Republic, Hungary and Slovakia are better off than Poland. Estonia and Poland are virtually on the same living standard level.

GDP per capita figures (PPP adjusted) can be easily extrapolated. In the calculations below, constant PPPs are used. Three growth scenarios are involved.

**Table 16. GDP per capita at PPP (euro-based)**

	2010	2015
Annual growth of 2%	11.486	12.678
Annual growth of 4%	13.416	16.320
Annual growth of 6%	15.623	20.905

Source: Extrapolated from the 2002 figure, GDP = € 9.805.

In the first growth scenario with only 2% annual growth, the Polish living standard will be in 2010 roughly on the same level as it was in Greece in 1995 (€ 11.924 in Greece). The Polish figure of 2015 with 2% growth rate is € 12.700 which corresponds to Portuguese figure in 1995 (€ 12.800).

If the Polish economy will grow with an annual rate of 4%, GDP per capita (PPP adjusted) will be € 13.400 in 2010, which equals roughly the Greece figure in 1998 (€ 13.700). In this scenario, Poland will reach € 16.300 in 2015, the level of Greece in 2002.

Annual growth rate of 6% would catapult Polish GDP per capita in 2010 to € 15.600 which is the equivalent of Greece level in 1999. If this rapid speed of economic growth is maintained in the second decade of the 21<sup>st</sup> century, Poland will have a GDP of € 20.900 in 2015, which slightly exceeds the living standard of Spain in 2002.

In the interpretation of these growth scenarios it is important to underline that calculations above are purely mechanical: actual GDP-2002 level is extrapolated with 2, 4, and 6% growth rates without any assumed changes in the economic environment. With this numerical game it can be shown that Poland will reach the GDP per capita level of EU average in the year 2002 in 15 years time (in year 2017) assumed that a 6% yearly growth rate can be maintained.

WIIW Handbook of TE-Statistics (2002) gives some figures in stock of durables. In 1990, there were 137 telephone subscribers per thousand in Poland; in 2002, the equivalent figure was roughly double, 282. Car density shows similar development, from 138 (per thousand) in 1990 to 272 in 2001. In the same context, the figures of university students are given: in 1990 the number was 105 (per thousand) and in 2001 already 443, an increase of factor four. It is stated that evening and correspondence courses are included, as well as students of the ministries of internal affairs and of defence. These three time series give evidence of successful transition.

Living standard differences are closely connected to productivity levels. Labour productivity (output per working hour) is directly linked to the production and diffusion of technology. An economic environment that limits opportunities for exploiting new technologies is suboptimal from the point of view of productivity development, and thus, of improving general welfare.

Living standard measured in GDP per capita (PPP adjusted) reflects different productivity levels. However, productivity differentials are not explaining everything in living standard gaps. Relatively low level of living standard may be associated with low level of working hours (active part of the population may in one country have longer holidays and/or more sick leave than another). There are differences in relative shares of active and passive parts of population. If country A has a lower employment relative to total population than country B, the latter has higher GDP than the former, even if both countries have exactly the same level of productivity (output per man-hours).

The Conference Board (which is a non-profit organisation) published an interesting research report on productivity development <sup>8</sup>. This paper deals mainly with OECD-countries (Organisation of Economic Co-operation and Development). OECD comprises traditionally the “rich countries” of the world. In 1996, OECD was enlarged by five new members, three of which are TEs (the Czech Republic, Hungary, and Poland, as well as Mexico and South Korea outside of TE-region).

**Table 17. Labour productivity growth (GDP per working hour)**

	1990-1995	1995-2002
USA	1,1	1,9
EU	2,5	1,3
Japan	1,8	1,8
New OECD members	1,9	3,3
Eastern Europe	2,9	3,9
Czech Republic	-0,6	2,6
Hungary	3,0	2,6
Poland	4,9	4,8

Source: The Conference Board.

There are several interesting points in the above table. EU outperformed the USA in the first half of the 1990s in productivity competition, but 1995-2002 it was vice versa. In that period, new OECD-members were far superior in comparison to both EU and USA in productivity growth.

Within the group of new OECD-members, Eastern Europe shows excellent results in both periods (2,9% in 1990-95, and 3,9% in 1995-2002) outperforming other units listed in the table. Thus, transitional period can be labelled as a success.

Within the TE-group of new OECD-members, Poland has far the highest marks in both described periods. Annual productivity improvements of almost 5% are exceptionally high, clearly better than in Hungary and the Czech Republic. In the latter, productivity even decreased in 1999-95 (by 0,6% annually).

<sup>8</sup> The Conference Board. Performance 2002. Productivity, Employment, and Income in the World's Economies.

**Table 18. Growth in total working hours (average annual growth, %)**

	1990-1995	1995-2002
USA	1,2	1,4
EU	-0,8	1,0
Japan	-0,4	-0,9
New OECD members	0,9	0,8
Eastern Europe	-2,5	-0,5
Czech Republic	-0,3	-1,0
Hungary	-5,2	1,2
Poland	-2,6	-0,8

Source: The Conference Board.

The number of working hours has grown in the US economy moderately in 1990-95 and 1995-2002. In EU, there was a small decline in the first period and a moderate increase in the second.

Eastern Europe's OECD-countries show a clear decline in working hours in 1990-95 (-2,5% a year) and a very moderate drop in 1995-2002 (-0,5%). Poland reduced working hours in the early period of transition (1990-95) clearly (-2,6% annually) and in 1995-2002 moderately (-0,8%). In the second period, Hungary increased working hours by 1,2% a year, unlike the Czech Republic and Poland.

The same Conference Board report provides an interesting table on labour productivity and income in 2002 giving GDP (PPP adjusted) per hour worked.

**Table 19. Labour productivity and income 2002 (GDP per hour worked)**

	In US dollars	As % of USA
USA	38,83	100,0
Greece	23,73	61,1
Portugal	20,47	52,7
Hungary	19,25	49,6
Czech Republic	16,87	43,5
Korea	14,17	36,5
Mexico	13,30	34,3
Poland	13,25	34,1
All OECD	30,32	78,1
All OECD, excl. U.S.	26,92	69,3
All OECD, excl. U.S. and new members	31,44	81,0
Eastern Europe, Korea, and Mexico	14,02	36,1
European Union	35,58	91,6

Source: The Conference Board.

In the USA, GDP per hour worked brings almost USD 40, which is marked with 100 in the above table. EU reaches about 92% of the US level with USD 36. All OECD has 78% and USD 30, respectively. The equivalent figures for new OECD-countries (Eastern Europe, Korea, and Mexico) are 36% and USD 14.

Mexico and Poland are more or less on the same level with an hourly pay of USD 13 which is a bit more than one third of the US level. In Hungary, GDP per hour worked is with USD 19,25 essentially higher than in Poland reaching almost half of the US figure. The Czech Republic is not far away from Hungary with USD 16,87 and 43,5% of US level.

It can be assumed that the peculiar economic structure of Poland provides a partial explanation to her low position in the above table. The large number of small farmers with low income press the average income figure down. If the agricultural sector could be excluded from the above comparison, Poland's relative position would improve.



#### 4. Current economic trends

In the 1990s, Poland was often called “TE-tiger” which obviously was justified because of rapid economic growth. Poland was the first TE to come out of the post-communist slump. GDP after 1992 was about 5-6% in real terms.

In the turn of the century, Polish economic miracle started to lose steam. The speed of economic growth has decelerated. However, Polish economy has not entered a period of severe crisis.

**Table 20. Selected economic indicators (growth per annum, %, in real terms)**

	1999	2000	2001	2002
GDP	4,1	4,0	1,0	1,3
Gross fixed capital formation	6,8	2,7	-8,8	-7,2
Employment	-2,7	-2,3	-0,6	-0,2
Gross wages	4,7	1,0	2,5	0,5
Retail trade	4,0	1,0	0,2	1,7
Export	2,3	33,6	17,4	7,0

Source: WIIW.

In the boom period of 1990s, there was an unusually strong investment cycle, during which gross fixed capital formation roughly doubled. In 1996-97, annual investment growth figures were about 20%. This strong investment wave started to abate in the late 1990s, and clearly negative growth (decline) was observed in 2001-2002. GDP growth decelerated from 4% in 2000 to 1% in 2001.

The value of Polish export has more than doubled between 1996 and 2002 from € 19,5 billion to € 43 billion. In 2000, export enhanced by no less than 34% and 17% in 2001.

This vigorous export growth indicates that Poland has been able to enhance quality of her exportables. Relatively convenient price and wage level has enabled Polish companies to get new deals in contract manufacturing, for example, in timber and wood products (especially furniture), as well as clothing, both of which are relatively labour intensive branches. However, growth rates in the range of 20-30% in export business can hardly continue year after year.

One of the most surprising features of the Polish transition can be found on the labour market. Amid economic boom, employment has decreased clearly since 1999. Employees in industry

are less and less in need: this branch has cut number of workers by about 5% a year since 1999.

In 1996, there were 2 360 000 persons registered unemployed. In 2002, the equivalent figure was already 3,2 million. Unemployment rate (according to ILO definition) was no less than 20%.

In the above table it is visible that average gross wages have kept on going up with decelerating rate. Obviously, increasing wages have started to pose a problem for Polish economic development. Unit labour costs are in the early 21<sup>st</sup> century on a rather high level in TE-comparison.

Retail trade has been on a growth path every year since 1999. The growth has not been vigorous lately.

**Table 21. Economic equilibrium**

	1999	2000	2001	2002
Consumer prices, % p.a.	7,3	10,1	5,5	1,9
Current account, % GDP	-7,5	-6,3	-3,9	-3,6
Budget balance, % GDP	-2,0	-2,2	-4,3	-5,1

Source: WIIW.

Poland, like other TEs, had strong inflationary tendencies in the early period of transition. Consumer prices increased in 1996 still about 20%.

In the turn of the century, however, there has been a deceleration of inflation. In 2002, consumer prices increased by less than 2%. In 2003, inflation has come close to zero.

With decreasing inflationary expectations, the crawling peg exchange rate regime was dismantled and zloty started floating freely.

The crawling peg system (monthly devaluation) was able to keep Polish current account in relative equilibrium. In 1999, CA deficit increased to 7,5% of GDP causing serious concern. However, the strong export boom in 2000-2001 has brought CA deficits to very low level. CA deficits of 3-4% of GDP are not worrying.

Balancing the books of the public sector seems to be the main headache of the Polish economy. In the second half of the 1990s, central government budgets were relatively well under control, with deficits not exceeding 2,5% of GDP. With decelerations of economic growth, fiscal policy became “expansive”: deficit of (central) government budget was 4,3% of GDP in 2001, and even higher (5,1% of GDP) in 2002.

According to Polish constitution, public sector indebtedness is not allowed to exceed 60% of GDP. Basically, this is the same rule put forward in Maastricht defining the rules of common currency (euro). Poland has expressed her intension to join the monetary union (euro-area) in 2008. Therefore, there is internal as well as external pressure to create discipline in public sector bookkeeping. The second important Maastricht criterion is that budget deficits are supposed to be under 3% of GDP every year.

Obviously Polish debt is very close to the 60% limit, and budget deficits in 2002-2004 seem to be about 5% of GDP a year. Alarm bells ought to be ringing. However, it seems to be politically difficult to cut budget deficit for 2004, even if economic growth in 2003 shows clear acceleration to 3-4%.

The Polish currency (zloty) appreciated very strongly against euro between 1999 and 2001. However, this process did not cause any serious deficit in Polish CA.

**Table 22. Zl/euro exchange rate (annual average)**

1999	2000	2001	2002
4,23	4,01	3,67	3,86

Source: WIIW.

In 2002, zloty depreciated against euro by some 5%. In that year, the euro-based exchange rate deviation index (ERDI) was almost 2 (1,9) indicating that zloty is still clearly undervalued against euro <sup>9</sup>. Thus, Polish exportables are continuously rather competitive in the EU-market. In July 2003, one euro was about zl 4,40 showing strong devaluation of zloty in the first half of 2003.

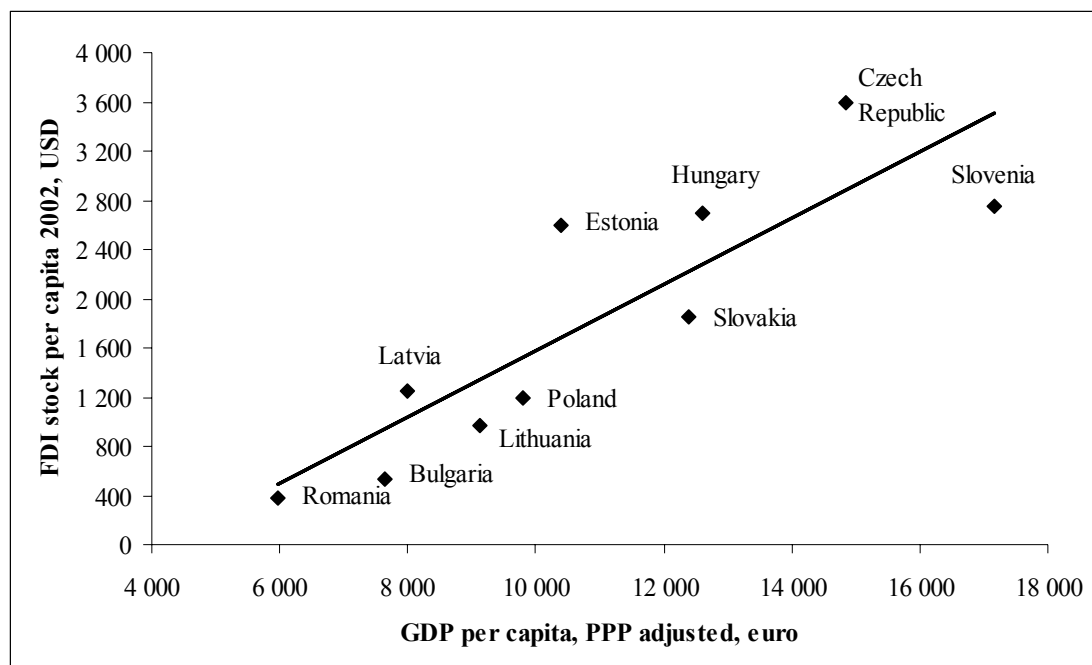
<sup>9</sup> For details, see Tiisanen T. Pan-European Integration. EU's Eastern Enlargement. Lappeenranta University of Technology, NORDI Publication, no 1, 2003.

## 5. Foreign direct investment

Foreign direct investment (FDI) in TE-region has increased extremely rapidly after the collapse of communist central planning. Multinational companies (MNCs) have taken the risks and opportunities in the emerging market economies of the former Soviet bloc.

There has not been an even distribution of FDIs in the TE-region: the opposite is true. When FDI stock is measured in relative terms (per capita of local population), it can be observed that the wealthiest TEs have been able to attract more FDI than the less well-off ones. This can be illustrated with a graph.

**Figure 2. FDI/GDP per capita**



Source: WIIW.

The horizontal axis measures living standard in ten TEs (GDP per capita, PPP adjusted in euro, 2002). The vertical axis measures FDI stock per capita, in US dollars in 2002.

The graph shows a clear positive correlation. In the North-Eastern corner of the graph are the Czech Republic (with the highest FDI stock per capita), Slovenia, the richest TE, and Hungary. Slovakia is roughly as rich as Hungary, but has a lower FDI stock (in relative terms). Estonia is clearly behind these four countries (Slovenia, Slovakia, Czech Republic, Hungary) in living standard, but has a FDI stock close to that in Hungary and essentially more FDI than Slovakia.

Poland and Estonia are virtually on the same level in living standard competition, but Estonia's FDI stock per capita is twice as high as that in Poland. Bulgaria and Romania are in the South-Western corner of the graph with low living standard combined with low relative FDI stock.

The uneven distribution of FDI cannot be explained with one or two factors. Estonia and Hungary had both a very clear strategy of privatisation: state-owned assets were sold as quickly as possible without any voucher system involved. In this asset sale, foreign companies were invited for bidding. Thus, in the early period of Estonian and Hungarian transition, many local firms were bought by MNCs. Estonia and Hungary show high FDI figures.

Greenfield option (establishing new capacities) has been given in all TEs during the transitional period. Acquiring local firms is only one possibility in the FDI-process. A multitude of factors are always taken into consideration in FDI decisions. Local infrastructure is obviously always one important factor. The richer the country, the better is the local infrastructure likely to be. Thus, the North-Eastern corner on the graph is favoured.

### **5.1. FDI in Poland, general features**

Poland has far the largest population of the new EU-members. Actually, Polish population with almost 40 million is larger than in other TEs joining EU taken together. That is a very important factor for many foreign investors, for example in the sphere of retail trade.

Polish labour market is not tight, that is, there are ample resources to be used. Probably, this will be an attraction for investors in the future.

It is rather often assumed that FDI in TEs concentrates in labour intensive manufacturing. That is not the case. According to WIIW-data, only 41% of FDI in Poland is in manufacturing. Two big acquisition deals in car manufacturing took place in the early period of Polish transition. One of them was made by South Korean Daewoo, which gave up car production in 2000, and sold its production units to General Motors. The Polish production unit, however, was not part of that deal. Thus, the fate of the FSO-Daewoo plant in Warsaw is unclear. Car production in Poland decreased rapidly in 2001-2002. FSM-Fiat, the second largest car maker in Poland has suffered from declining sales of her Italian mother company. However, in 2003 there were signs of recovery in Polish automotive industry.

Almost one quarter (23,1%) of FDI in Poland is in financial intermediation. A big bulk of banking in Poland is in foreign hands.

Wholesale and retail trade is with a 11,4% share well represented in FDI statistics of Poland. Transport and telecommunications is not far away with 10,7% share of FDI stock.

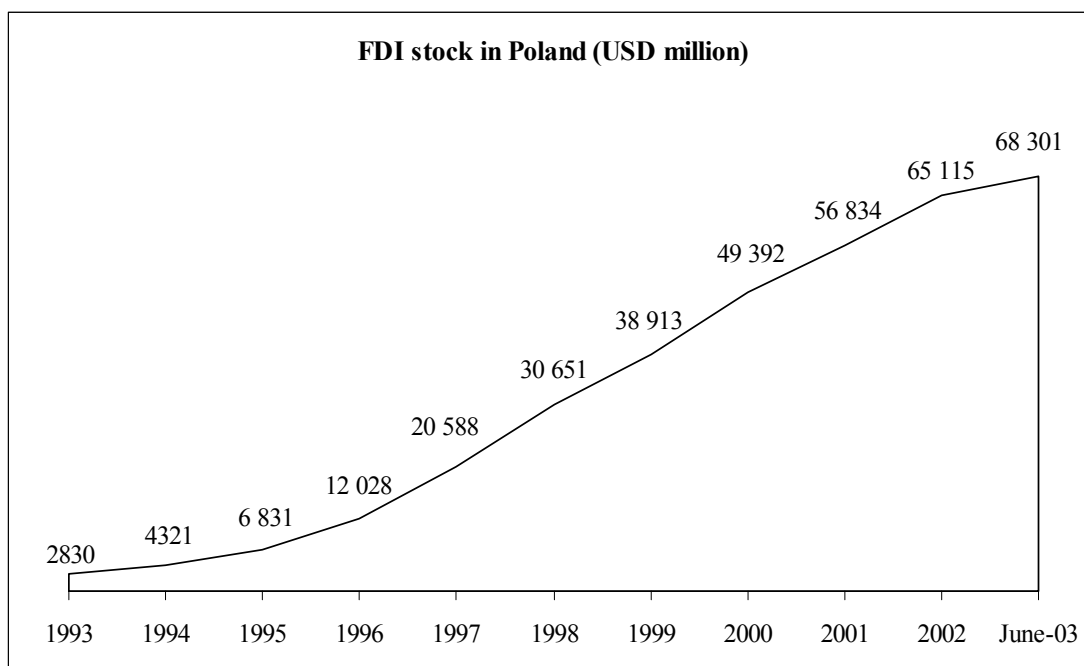
In this sector, the big bulk of FDI is obviously in telecom sphere. In the communist time, telecom sector was strictly in state hands with fixed-line monopolies in every country. In communist Poland, this monopoly was Telekom Polska (TPSA).

This monopoly has experienced a transformation. In 1998, 15% of TPSA's shares were floated in the market. In 2000, a 35% stake of TPSA was sold to a consortium of France Telecom and KH, a Polish company, for USD 4,3 billion. One year later, this consortium bought a further 12,5% stake in TPSA for USD 825 million. The first big deal was done during the global high-tech boom with high share prices. Thus, France Telecom is on the top of the FDI list in Poland (with USD 3,2 billion invested).

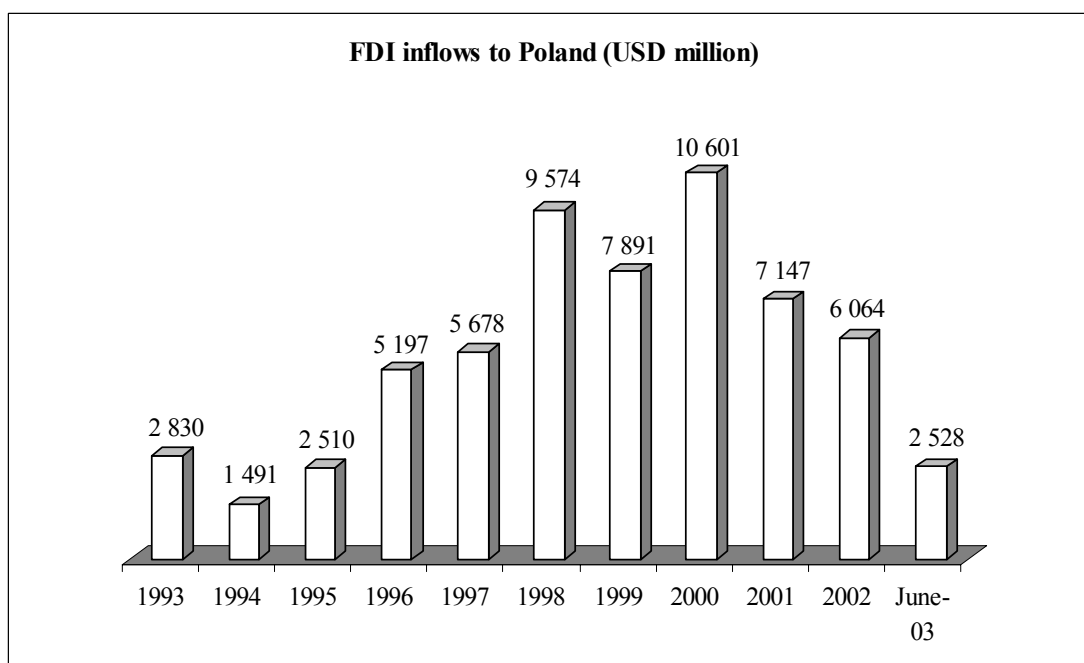
Mobile phone market in Poland has had an astronomical growth since the mid-1990s, when first cellular phone systems were created. Centertel, a joint venture between France Telecom and TPSA had 4,7 million subscribers in 2002. This first mobile phone operator in Poland is, however, behind Plus-GSM (4,8 million clients) and Era (5,2 million subscribers) in early 2003. Obviously, these three operators are going to share the market, because new licenses will not be immediately given.

The inflow of FDI peaked in the turn of the century with an annual figure of USD 10,6 billion in 2000. This is not necessarily surprising. Telecom sector can hardly attract fresh money in large scale. Retail sector is carefully counting profitability after fierce inflow of FDI in the late 1990s. In the banking sector big FDI deals have already been done. In manufacturing, big FDI deals are not taking place frequently.

According to the official Polish source (the Polish Agency for FDI, PAIZ), FDI stock in Poland was USD 68 billion in the mid-2003. This stock of foreign money has had an enormous impact on Polish economic development. Obviously, this positive influence will not disappear, even if the FDI-inflow decelerates.

**Figure 3. FDI stock in Poland**

Source: The Polish Agency for FDI (PAIZ).

**Figure 4. FDI inflows to Poland**

Source: The Polish Agency for FDI (PAIZ).

Many market research institutes have made studies on motives of foreign investors active in TE-region. Normally these studies, which are based on interviewing investors, maintain that the big bulk of FDI in TE-region is in the market-seeking sphere. Sourcing investors looking

for cheap production costs are also active in the TE-region. Research reports monitoring factors in FDI-decision making are available in Poland.

The largest studies of factors leading to the initiation of business activities in Poland by foreign investors were conducted in 1993, 1995, 1997, 2000, and 2003 by INDICATOR Centre for Marketing Research, on behalf of PAIZ (the Polish Agency for Foreign Investment). A comparison of the results obtained makes it possible to define the changes that took place in the hierarchy of importance of individual factors. Such a comparison indicates that five of the factors shown in the diagram have remained unchallenged at the top of the importance ranking since 1995. Their order has been subject to insignificant change.<sup>10</sup>

Economic growth prospects, in third place in 1993 and 1995 made it to second place in 1997, and to first place in 2000 and 2003. Labour costs in the last two years made it to second place, whereas the size of the Polish market made it to third place.<sup>10</sup>

Considering that the significance of the “economic growth prospects” factor mainly comes down to expectations related to the internal economic situation, and in particular of its market aspects (economic growth leads to desirable changes in demand), one can assume that these studies also confirm the primacy of market factors.<sup>10</sup>

**Table 23. The most important factors behind the initiation of economic activities by foreign investors in Poland**

	1993		1995		1997		2000		2003	
	Ranking	% of resp.	Ranking	% of resp.	Ranking	% of resp.	Ranking	% of resp.	Ranking	% of resp.
Economic growth prospects	1	53,5	3	48,7	2	52,6	1	49,8	1	62,1
Labour costs	3	44,7	1	60,8	1	57,6	2	46,4	2	61,5
Size of Polish market	2	47,5	2	49,1	3	47,3	3	44,6	3	59,4
Possibility of reducing production costs	5	31,6	5	37,2	5	40,0	5	38,0	4	53,9
Availability of labour	4	33,9	4	44,4	4	42,1	4	39,3	5	52,5

Source: UNIDO. How to do business in Poland.

The analysis of the results obtained during this research, whose aim was to identify the motives behind the initiation of economic activities by foreign investors in East-Central Europe, indicates that cost and market-factors were dominant. This is borne out by the

<sup>10</sup> UNIDO. How to do business in Poland. UNIDO ITPO, Warsaw, 2003.



majority of studies, notwithstanding significant methodological differences such as a different approach, the formulation of questions, sample selection, the number of respondents, etc. Foreign investors thought market-related factors more important than cost-related ones. Motives of a political nature and supply-related ones proved less important.<sup>10</sup>

Labour costs are on the second place in the latest (2003) survey. Therefore, it is important to investigate whether Poland is an advantageous location from the point of view of labour costs. Average gross wages per month calculated in euros show striking differences within the TE-group of countries.

**Table 24. Average gross wage/month (euro)**

	1995	2002	Growth (%) 1995 - 2002
Czech Republic	230	511	115
Hungary	239	502	110
Poland	220	591	169
Slovakia	187	317	70
Slovenia	731	1039	42
Bulgaria	87	138	59
Romania	107	175	64
Estonia	160	373	133
Latvia	131	292	123
Lithuania	93	298	220

Source: WIIW.

In the 7-year period covered in the above table, wage increases can be in many TEs called as frog leaps. The steepest hike took place in Lithuania, where wage grew by more than factor three between 1995 and 2002. Poland has the second fastest growth of almost 170%. The average monthly earning in Poland (2002) was, however, almost double (€ 600) of that in Lithuania (€ 300).

In the same period, Hungary, the Czech Republic, Estonia and Latvia, more than doubled their earning level. However, in 2002 the Czechs and the Hungarians earned clearly more than the citizens in the Baltic States.

In 2002, Slovenia was far ahead in the wage scale with a monthly pay of more than € 1.000. In the richest TE, wage growth in 1995-2002 was relatively moderate, 42% only. Bulgarians and Romanians are the worst earners in the table with rather modest growth rates (59% and 64% respectively). Slovakia has a modest average income of € 317 a month with rather modest growth of 70% in seven years.

The difference between the best wage, in Slovenia, and the lowest pay (Bulgaria) is striking: Slovenians earn about 7,5 times more than Bulgarians when nominal wage is considered. Average gross pay in Finland in 2002 was about € 2.200 a month.

In investment calculations multinational companies compare unit labour costs (ULC) in various locations. This indicator is more important than nominal wage. Naturally, ULC may play a decisive role when labour intensive activities are relocated.

WIIW publishes ULC figures, PPP adjusted in index form, in which Austria equals 100. Using this data, ULC development in TEs under review can be analysed.

**Table 25. Unit Labour Costs (PPP adjusted), Austria = 100**

	1995	2002	Growth% 1995 - 2002
Czech Republic	20,9	40,9	95,7
Hungary	21,3	38,1	78,9
Poland	27,9	58,6	110,0
Slovakia	18,6	25,5	37,1
Slovenia	49,7	59,9	20,5
Bulgaria	11,8	17,1	44,9
Romania	18,9	29,7	57,1
Estonia	23,7	38,7	63,3
Latvia	23,2	38,5	66,0
Lithuania	15,0	33,4	122,7

Source: WIIW.

Unit labour costs in TEs were in Western comparison generally very low in the mid-1990s. Thus, labour intensive activities were obviously attracted to the TE-region. From the investors' point of view, the scene has changed rather rapidly during last years: ULC in TEs show steep increase.

The fastest ULC growth is registered in the above table in Lithuania, where costs of labour per production unit grew by no less than 127% from 1995 to 2002. After this huge increase, Lithuanian ULC level was, however, only one third of Western (Austrian) level.

In the same table Poland also shows more than doubling of her ULC figure (110%). In 2002, Poland had roughly the same ULC level as the richest TE under review, Slovenia: these two countries offer unit labour costs, which are only 40% below the Austrian level. In the Czech Republic ULC relative figure almost doubled between 1995 and 2002, while Hungary had an

80% increase in the same period. Estonia and Latvia belong virtually to the same category with the Czech Republic and Hungary: in all four countries the ULC advantage in Austrian comparison is about 60%. In Estonia and Latvia the ULC growth rates 1995-2002 have been somewhat more moderate than in Hungary.

Slovakia shows amazingly low ULC level, only roughly one quarter of the Austrian figure, in 2002. Also Slovakia's ULC growth is moderate, less than 40% in 1995-2002. In the list of TEs, only Bulgaria offers more convenient ULCs than Slovakia: about 6 Bulgarians can be employed with the price of one Austrian (using ULC as a basis of calculation). In Romania the equivalent figure is a bit more than 3.

Labour market trends in TE-region have some rather odd features. Even if there has been a strong boom in CEECs since the mid-1990s, unemployment shows an increasing tendency. However, in this sphere development has been rather uneven.

**Table 26. Unemployment**

	In 1000 persons		Rate (%)	
	1995	2002	1995	2002
Czech Republic	153	377	2,9	7,3
Hungary	496	239	11,7	5,8
Poland	2.629	3.449	14,9	20,0
Slovakia	333	498	13,1	19,0
Slovenia	127	63	14,5	6,4
Bulgaria	424	592	11,1	17,8
Romania	998	946	9,5	9,0

Source: WIIW.

This Vienna table does not cover the Baltic States. According to Statistical Bulletin, Riga, 2002, Estonia had 67.000 people unemployed with an unemployment rate of 10,3%. The equivalent figures (for 2002) were 135.000 and 12,0% in Latvia and 224.000 and 13,8% in Lithuania. Thus, in the Baltic States some 430.000 people were out of work in 2002.

Hungary and Slovenia show similar positive tendencies: both countries have been able to roughly halve the number of unemployed persons and the unemployment rate between 1995 and 2002. The rate in these two countries is about 6%.

In the Czech Republic unemployment rate in 2002 was rather modest, only 7,3%. However, the rate has more than doubled since 1995. Unemployment rates in 2002 were on critically

high level in Poland (20,0%), Slovakia (19,0%) and Bulgaria (17,8%). All these TEs show a strongly increasing tendency in unemployment rate since 1995.

Especially strong increase in unemployment has taken place in Poland where amid an economic boom the number out of work has increased by almost one million. Obviously, the previous table on ULC delivers a strong background factor for the deterioration of the employment: rapidly increasing labour costs per production unit do not favour creation of new working places.

Altogether, over 6 million people were out of work in CEECs in 2002. About 1,5 million of them live in Bulgaria and Romania.

In the Baltic States over 400.000 people were unemployed. Thus, in EU accession countries there were about 5 million people out of work. The unemployment rate of eight TEs with EU accession was in 2002 about 12%.

In the light of the labour market figures, there is plenty of labour force available in Poland. However, for sourcing investors looking for cheap inputs Poland is not necessarily an optimal location in the early period of the 21<sup>st</sup> century. Unit labour costs have increased rapidly since the mid-1990s. Many other TEs offer more moderate ULCs for investors active in labour-intensive branches.

The rapid increase in average gross wages in Poland has evidently enhanced the attractiveness of the country in the eyes of market-seeking investors. A variety of grocery products are presently manufactured in Poland by Western companies. There has been an outright invasion of Western large retailers in Poland including such giants as Metro (Germany), Carrefour (France), Ahold (Netherlands), and Tesco (Great Britain). These and other international retailing companies have invested in various forms of distribution (hypermarkets, supermarkets, shopping centers) in Poland.

This development, which can be called retail revolution, is understandable: Poland is far the most populous country in Central Eastern Europe. In the table covering the wage comparisons, Poland is on the second place after Slovenia. Thus, within the group of TE-countries Poland is extremely attractive location for big retail outlets.

According to PAIZ, out of 52 private commercial banks operating in Poland, foreign shareholders control no less than 45. Foreign investors account for over two thirds of the total

assets of the Polish banking sector, in which the state still has a stake of 15%. Obviously, in this sector FDI opportunities are more or less completely exhausted.

In the sphere of telecommunication, FDI-inflow has been considerable. No big FDI deals can be expected in the near future in telecom operators' field.

As shown above, the FDI inflow reached its peak in 2000 when the sum exceeded 10 bn dollars. The FDI stock is likely to continue growing, but highly likely in decelerating speed.

In the next section, some examples of FDIs are represented. The selection of investment cases below provides a variety of activities. No attempt is made here to give a complete picture of foreign companies active in the Polish market. Information involved is collected during the transitional period from various sources. The aim is to find out why certain multinational companies active in grocery products, consumer durables, retailing, banking, etc., have invested directly in the post-communist market of Poland.

## **5.2. Examples of FDIs in Poland**

The household appliance industry consists of a fairly large number of products, including kitchen appliances such as cooking ranges (gas and electric), refrigerators, freezers, microwave ovens, dishwashers and laundry products such as washing machines and dryers. The basic technologies and designs for most of these products, except for the microwave ovens, were developed before World War II. Over the last half century, technological advances in this branch have focused on the development of new features, improving energy efficiency, product standardisation and the exploitation of new materials.

In the rich part of the globe (USA, EU, Japan), penetration levels in household appliances are very high, especially as far as cookers, refrigerators and washing machines are concerned. Microwave ovens are not necessarily standard equipment in every household yet. Obviously, also in dishwashers and freezers, the penetration rate is not yet close to 100%.

This means that, in this branch, there is very little leeway for growth in affluent markets, where replacement demand is a dominant factor. Consumer durables are supposed to be durable, which means that, with improved technology, the lifetime of every item is supposed to increase. At the same time, it is obviously rather difficult to have revolutionary changes

carried out in the appliance business, which would outdate the present stocks and cause a need to acquire new and highly modernised devices before the old ones are physically falling apart.

Thus, there cannot be too much dynamism in the market of white goods in the “mature” societies. New markets are welcome to Western producers.

In the communist era, the centrally planned economies created their own appliance production units, which were basically only producing for the home market and not competing on the international level. When living space was allocated by the system, a kitchen was normally equipped with a cooker and a refrigerator. Washing machines were rather easily available. Dishwashers, on the contrary, were regarded as a luxury, while microwave ovens were basically unknown devices in communism.

The quality of communist-time goods was rather questionable in general. It means that the white goods stock in TEs was in questionable shape already in the early stage of transition. The first decade of post-communist capitalism has naturally worsened the situation: replace demand focusing on modern household appliances is very high.

In many issues, there is an exception on the rule. The former Yugoslavia was a special case with relatively liberal rules in the economy. In present-day Slovenia, which is a state of the former Yugoslavia, there is a white goods producer, Gorenje, which was (and still is) competitive. This case is in many senses extremely interesting <sup>11</sup>.

In the post-war period, the appliance industry was characterised by a high level of fragmentation. In the reconstruction period of Western Europe, the appliance industry was regarded as a high-tech branch with an almost endless demand on the market.

During the last two decades of the 20<sup>th</sup> century, the appliance industry in the West was evolving towards increasing concentration, while the post-war boom was over. In the United States, Western Europe and Japan, markets show very clear oligopolistic patterns. In this game of few participants, there are a handful of big global players.

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<sup>11</sup> For details, see Tiisanen, T. & Talvitie, K. The Czech Republic. Business opportunities in a successful transitional economy. Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1997.

The main players are Electrolux (Sweden), Whirlpool (USA) and Matsushita (Japan). Some short comments on Electrolux and Whirlpool are required here, when the European market of white goods is discussed.

In the 1970s and 1980s, Electrolux (EL) went through a dramatic transformation with an aggressive strategy of expansion via acquisitions. In the beginning, EL concentrated on acquiring firms in the Scandinavian countries, its traditional market. In the 1980s, two especially important acquisitions were completed: EL took over Zanussi in Italy and White Consolidated in the US.

In the early 1990s, EL had an extremely strong position as a global player who had completed more than 200 acquisitions in no less than 40 countries, comprising 280 manufacturing facilities. Thus, the EL-group has few equals in the appliance business. EL is using several brand names in the global market, which means that labels of many acquired companies have been maintained. In the 1990s, EL acquired AEG of Germany. AEG belonged to the “crown jewels” of the German industry for a very long time. Thus, the brand name is well worthwhile to be kept intact after the takeover.

In many ways, Whirlpool is a similar case in North America as EL is in Europe. In the late 1980s, Whirlpool made a very important move towards Europe by acquiring the appliance business of Philips with a very strong market position in Europe. Both EL and Whirlpool have been active in TEs.

In the second half of the 1990s, EL announced a far-reaching restructuring scheme, which was completed at the turn of the century. The programme involved total personnel cutbacks of about 11.000, or 11%, as well as the shutdown or divestment of 23 plants and 50 warehouses, corresponding to 15% of the total of these facilities. With this new restructuring scheme, the focus has shifted to pro-active investments in customer care and product management in order to generate growth. Between 1990 and 1999, sales more than doubled from SEK 59 billion to SEK 120 billion (about USD 14 billion). This corresponds to an annual growth of 8%. In 1999, EL announced that its operating margin increased to 6,2%, against 5,2% in the previous year.<sup>12</sup>

Given the consistently modest or even zero-rate growth in the overall appliance industry in recent years, competition has become particularly fierce and average profitability poor.

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<sup>12</sup> New Europe, February 29, 2000.

Producers who have been unable to achieve competitive cost positions or to create special niches have found it difficult to survive. An additional feature of the industry has been the increasing importance of distribution in the total cost structure, resulting from increasing concentration in distribution channels and a general shift of bargaining power from the manufacturers to the distributors and retailers. At the same time, there are relatively high transportation costs for most products of the appliance industry.

Even if this industrial branch has not been going through a dynamic phase lately, it has attracted some new players with global ambitions, especially from South Korea (Samsung and Daewoo, for example). These newly internationalised companies seem to have aggressive pricing policies that create plenty of pressure on the oligopolistic market. As pointed out above, traditional global players, like EL, must pay decisive attention to cost-cutting and restructuring in order to maintain a reasonable profit rate and a leading market position.

Quite obviously, appliance production is a branch in which economies of scale play a dominant role. It cannot be profitable to produce refrigerators or washing machines on a small-scale basis. Thus, heavy concentration in this branch is more than understandable.

However, the concentration is not 100% yet. In Europe, there are some medium-sized companies that have survived the difficult decades of the 1980s and 1990s. Some of them can be listed here: Merloni (Italy), GEC-Hotpoint (Great Britain), Miele (Germany), Bosch-Siemens<sup>13</sup> (Germany) and Brandt (France). It can be assumed that companies in this category are extremely interested in TE-markets as a new playground with fresh demand. In the newly opened TE-markets, it is of utmost importance to create a presence and establish the brand image.

The run to the East started in the early stage of the transition. Electrolux made one of the first big acquisition deals in Hungary by taking over Lehel, the local refrigerator factory. EL started producing with the brand name Zanussi in that TE. Whirlpool commenced manufacturing washing machines in Slovakia.

Merloni Elettrodomestici (ME) is an interesting unit in the European appliance game. ME was established in the 1970s, when there was still plenty of dynamism in the appliance sector in Europe. In the decisive years of the eighties, ME believed that, in the long run, its adopted formula of centralised large-scale production in low-cost Italy (at that time) with decentralised

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<sup>13</sup> Siemens is a large German conglomerate active in a multitude of branches. In white goods production, which is not Siemens' core business, the German giant is a relatively modest player.



and differentiated marketing efforts in the different national markets would provide a superior - to both the national player and the integrated global producer - business strategy.

To support this strategy, Merloni acquired Indesit in 1987, a large but financially weak Italian producer, who had a strong market presence in a number of neighbouring countries. In the same period (in the late 1980s), Merloni's Italian arch-rival, Zanussi, was acquired by Electrolux. The Zanussi take-over and the subsequent acquisition of White Consolidated in the United States catapulted EL to the top of the list in the household appliance business. In the 1990s, Merloni with its three brands (Ariston, Indesit, Scholtes) remained a viable competitor claiming about 10% market share in Europe.

It can be assumed that, in the 1990s, ME has had a hard time to find a long-term role for itself in the appliance business. The slump in the early years of the decade hurt the whole branch, while increasing competition, especially from some relatively new players in Europe (e.g. Korean companies), exercised high pressure on prices.

ME started looking to the East already in the early period of transition, realising that the appliance market in TEs has annual growth rates of 25 to 30%. Business in the TE-region started with direct exports from Italy. However, very soon ME realised that local production had to be seriously considered to be competitive. In early 1998, ME announced its investment plans in Russia: a combined cooker and washing machine plant just outside of Moscow involving USD 64 million investment <sup>14</sup>.

Actually, ME started its Eastern investment spree in Poland by setting up a stove factory in Łódź. In this context, Mr Vittorio Merloni, the CEO of ME, mentioned two main reasons for the Polish action. Firstly, Poland still offers low-cost labour in comparison to the West: the average manual worker in Italy earns no less than eight times more than his Polish counterpart. Secondly, the vast growth potential in the TE-region is an attractive factor: ME points out that risks in investing in Russia and Ukraine, the biggest TE-markets, are still extremely high. Thus, Poland is an optimal location within the TE-region.

The Warsaw Voice mentions that Merloni's stove factory in Łódź went on-stream in October 1999 and will produce about 700.000 Indesit stoves annually. The total value of the investment reaches USD 60 million. The factory will provide jobs for 700 people and

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<sup>14</sup> For details, see Tiusanen, T. & Talvitie, K. & Vinni, S. Russia in the 1990s. Western investors in large transitional economy. Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1999.

companies co-operating with the factory will hire another 300. Consequently, the project is of major importance for the Łódź region, which is struggling with high unemployment.

ME's decision to open a factory in Łódź results from the city's location at the crossing of east-west routes. This is important because most of the stoves manufactured there will be exported: it is planned that only 20% of the factory's output will be sold on the Polish market, while the rest will be sent to other European markets.

The Merloni Elettrodomestici Poland factory was set up in refurbished facilities previously used by the Bistona and Legler companies. The factory is capable of producing 180 stoves per hour. Individual stages of production are fully controlled by computer and programmed logic controllers (PLCs), which makes the factory one of the most modern in Central and Eastern Europe.<sup>15</sup>

After setting up the Polish production unit, ME stopped making stoves in Italy. Demand in Western Europe will be covered by the Polish capacity. Satisfying local demand with local production has thus only a marginal importance.

In 1999, France's largest appliance maker and home appliance arm of Italy's El.Fi Group, Brandt, paid the State Treasury zł 142,4 million, or zł 27 per share, for a 36,9% stake in Polar, Poland's leading white goods maker. Very soon afterwards, Brandt bought Polar shares on the market and had 90% of Polar's stock in its hands at the turn of the century.

It is estimated that Polar, which is situated in the city of Wrocław, has about one quarter of the appliance market in Poland. This dominant position on the local market is a very clear advantage in this acquisition. An obvious disadvantage is the heavy overmanning in Polar, which is usual for formerly communist enterprises: after the take-over, Brandt announced that it would cut Polar's staff rather rapidly from 4.700 to 3.300. This sounds like a normal procedure when Eastern companies change hands and Western owners make the profitability calculations.

Brandt has announced its strategy for Polar by declaring that the acquired company's products will be sold on the Polish low- and medium-price market with the Polar brand name. At the same time, the upmarket segment is reserved for Brandt's Western-made products, which are to be marketed under Brandt's flagship brand, "De Dietrich".

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<sup>15</sup> The Warsaw Voice, October 24, 1999.

Since the brand name Polar has already been registered by another company in the West, Brandt will have to sell Polar products under the Brandt brand name, if it wants to export appliances from Poland to Western Europe.

Merloni and Brandt are not the only foreign investors in the Polish appliance business. Bosch-Siemens recently set up a washing machine factory with an annual capacity of 400.000 units in Łódź. Electrolux produces yearly 200.000 top-loading washing machines in its Swiatowit factory in Myszkow that currently produces enamelled dishes. On the other hand, according to the Warsaw Voice, two Spanish companies, Fagor Elektrodomesticos and Mandragon Corporation Cooperativa, also bought a combined 76% of Wrozamet, a stove producer in Wrocław.

However, there have also been unsuccessful attempts to corner the Polish household appliance market. One such attempt was made by South Korea's Daewoo, which promoted its advanced technology “bubbling” washing machines. Their production was to be launched in Poland, but after two years of imports, the product found little popularity among Polish consumers.

Amidst this exciting restructuring of the Polish white goods business, there seems to be one major local player that is still in local hands: Amica Wronki. It controls 50% of the stove market, about 20% of the refrigerator business and 5% of the washing machine market. Amica invested heavily in a new washing machine unit that went on-stream in the summer of 2000.

Amica has inherited its strong market position from the communist era. Under transitional circumstances, Amica has been attempting to develop its export business, which is difficult, however, since the company has no brand known to customers in the West. The company sells its products under different brand names, most of them invented by German retailers, including mail-order companies. This mode of operation can be called contract manufacturing: Western retailers contract Amica to manufacture according to given specifications. It is obvious that a low retail price is the most significant sales argument in this business segment. Therefore, this sort of business (own or private label products for retailers) cannot be very profitable for the producer. No mark-up for the brand name prestige can be harvested.

In the meantime, it is highly likely that the Polish appliance market will remain very dynamic for several years to come, even if the equipment density is, at least partially, very high, especially in refrigerators. Microwave ovens and dishwashers are still a rarity in Polish households. Replacement purchases are expected to be on an unusually high level, because a big part of the appliance stock was acquired in the communist time or in the early years of transition, and is, thus, partially worn out or outdated.

The high potential demand must be somehow financed. It is important to bear in mind that the income level in Poland, as shown before, is still relatively modest. At the same time, new houses, cars, appliances, etc. ought to be acquired rapidly. This means that households have accumulated a heavy debt burden in the second half of the 1990s.

Appliance prices have dropped remarkably in the late 1990s, even if the overall inflation figures have been rather high. This phenomenon is quite understandable, because - as we have seen - competition has remarkably intensified. At the same time, the quality of the offered appliances has improved. Imported and locally produced offers must have a convenient price-quality relationship from the point of view of the consumer.

At the beginning of the 21<sup>st</sup> century, it was estimated that the appliance supply in Poland outstripped the local demand by no less than 50%. This means that, with the described restructuring with heavy foreign involvement in the Polish white goods sector, there is an obvious need to find export markets. There are hardly any easy market niches around.

Thus, it is interesting to see whether still more action will take place in the Polish appliance sector. At the turn of the century, there has been plenty of excitement in that branch in Poland and in TEs in general.

The appliance business in Europe has many interesting features:

- In the immediate post-war period in Western Europe, there was a golden era for white goods manufacturers. Reconstruction created an almost unlimited demand for appliances;
- With the continuously high demand, an extensive supply network came into being in Western Europe;
- The golden era suffered a considerable blow during the first oil crisis. The inflow of foreign workers started to dry up. The construction boom linked to the appliance demand started to cool down;

- Thus, in the 1980s, it became evident that there is an overcapacity in the white goods branch. A period of rationalisation started to take shape in Western Europe;
- In the appliance industry, it is understandable that economies of scale exist. Big units with global ambitions started to emerge;
- Electrolux expanded its activities through a series of acquisitions and became the most dominant player in Europe;
- Amidst the acquisition spree, the difficult brand name of Electrolux was not strongly advanced. The Swedish company kept many brands of the acquired units alive;
- In the concentration process of the European appliance business, some medium-sized companies remained in the market;
- In the communist part of Europe, parallel structures were built up in the appliance branch. Average households had stoves and refrigerators when they received accommodation;
- According to anecdotal evidence, communist countries copied Western appliance models many times. However, this copying was hardly permanent and systematic;
- In the early period of transition, people in the East realised that their appliance stock is not necessarily modern. Thus, there has been a high potential demand for state-of-the-art appliances;
- Some of the appliances, especially dishwashers and microwave ovens, were as good as unknown in centrally planned economies. These devices started to flow into post-communist countries immediately after the systemic change;
- Thus, there has been a high potential demand for white goods in the TE-region, while the demand growth in the West has been very limited;
- It is, therefore, not surprising that it is possible to see a wide selection of appliances in TE-capitals' showrooms, including prestigious Western brands;

- In the 1990s, it became very obvious that the appliance business in TEs is a very competitive branch. Prices were affected via increasing supply, which naturally is good news from the consumer point of view;
- In the intensifying competition, Western companies have been forced to look for cost savings. One potentially advantageous solution is to move production to TEs;
- One route open for Western companies is acquisition: communist-time companies are taken over, modernised and rationalised. At the same time, Western, locally produced brands have started to appear in TE-markets;
- In this restructuring process, it is quite obvious that many TE-appliance manufacturers have disappeared from the market, if they have not been able to react on the market pressure;
- Electrolux made an early acquisition in Hungary, where the Swedish giant took over Lehel, the local refrigerator manufacturer. Zanussi white goods have thereafter been produced in Hungary (Zanussi is an Italian company acquired by Electrolux in the eighties);
- Electrolux carried out a heavy restructuring programme in the 1990s, cutting over 10.000 jobs world-wide. This operation signals that there is a global overcapacity in appliance-manufacturing;
- Under the present circumstances, every player of the white goods game must plan Eastern operations carefully, keeping a close eye on competitors' moves;
- For the relatively small European players, like Merloni and Brandt, the TE-region offers a new opportunity of expansion. This opportunity must be taken, even though certain risks are included;
- In the early period of transition, it was essential for Western appliance companies to establish their brand images in TEs, all using the same arguments (Western-made, Western technology, Western design, Western reliability, Western brand prestige, etc.);

- Obviously, in the early period of transition, Western white goods marketing in TEs was aimed at upper income earners only. The prestige of the brand was more important than the price;
- In the best performing TEs (the transitional tigers), a broad demand for appliances started to take shape rather early. At the same time, an increasing supply affected the price level: skimming in prices became difficult;
- Therefore, Western producers were forced to pay attention to their cost structure. Obviously, TE-presence with local production started to become a must for many firms in the branch;
- Still in the 1980s, Merloni thought that it could focus on production in its home base (Italy). In the meantime, Italy has become a relatively expensive country, so that a new strategy for the nineties was needed;
- In the late 1990s, Merloni invested in production units in both Russia and Poland. The real internationalisation of the company thus starts from the TE-region;
- Merloni's Polish daughter has one interesting feature: stove production was stopped in Italy and the Western demand is now covered by the Polish production. It is worth noticing that it is absolutely necessary in this case to have a state-of-the-art capacity in Poland;
- Merloni praises the Polish wage level, which is much more convenient than its Italian counterpart. However, the old production lines were not moved from Italy to Poland. Cheap labour goes hand in hand with modern technology in the Polish production unit;
- Merloni maintains that Poland has a stable investment climate that is better than in the large TE-markets such as Russia and Ukraine. Thus, the company obviously concentrated its TE-production in Poland;
- In the white goods business, it is obviously not necessary to have production units in all TEs. Economies of scale can be harvested with only a few production sites;
- Brandt made an acquisition in Poland and received a big market share of the mass market;

- When acquiring companies in TEs (Western companies taking over post-communist companies), new owners are almost certainly facing a situation of overmanning. This is a general rule and Polar, which was acquired by Brandt, was no exception;
- Massive firing of the workforce must be done with care. In TEs, the atmosphere in this context is always delicate: extremely rude methods can create bad-will against the Western company;
- Brandt intends to use the local brand for the local mass market, while the up-market segment is reserved for Brandt's original brands. This method has often been used in various branches when acquisitions in TEs have taken place; cheap products with familiar names is a useful combination;
- At the beginning of the 21<sup>st</sup> century, there is hardly anything left in the Polish appliance market to be acquired. Some local companies could not compete under the new market circumstances and withered away;
- Amica seems to be the only one surviving. It has an interesting export strategy producing “own (or private) label” appliances for Western retailers. Normally, in this business (contract manufacturing for retailers), prices paid are low or even extremely low. The retailer must offer the best possible price for customers who are not interested in the prestige of the brand. Thus, manufacturers face a fierce price competition from the ordering retail houses;
- Polish households have been enjoying a nicely increasing income in the boom years of the 1990s. At the same time, however, personal credits have had an even higher speed of growth. Therefore, it must be assumed that there will be a continuous high pressure on prices of all consumer durables. Favourable terms of payment (instalments) may be a very decisive factor in every appliance deal.

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The most visible revolution in the post-communist era has taken place in the sphere of retail trade. Centrally planned economies of shortage with empty shelves have been replaced with markets of abundance with Western suppliers heavily involved in the retail trade. Previously,



there was plenty of purchasing power chasing for meager supplies, while in the transition of TEs shopping malls and hypermarkets offer almost everything, while the availability of money has become the limiting factor.

According to several opinion polls, citizens of TEs generally appreciate FDIs. The Polish weekly *The Warsaw Voice* (April 8, 2001) points out that 56% of Poles believe that FDIs contribute to upgrading production technologies. About half say that FDIs create new jobs. Other advantages related to FDIs include better supply, improved quality of goods and services, and a gradual elimination of the gap between Poland and Western Europe.

The same source points out that there is ambivalence of public opinion concerning FDIs in the sphere of hypermarkets. A total of 71% of those polled appreciate the benefits of these centers for customers, but 74% of them think that hypermarkets are unfavorable for producers and 62% think they are detrimental to the local economy. The same weekly points out in this context that the German-owned Metro, which runs the largest number of hypermarkets in Poland and has invested zł 2,5 billion, sells mainly Polish products: 95% of the foodstuffs are Polish and 85% of non-food articles are locally made. Presently Metro cooperates with 3.000 Polish companies. Polish goods have been gradually included in the list of products offered by trade chains abroad. Thus, foreign retailers offer new distribution channels for Polish exports.

In this context, it is essential to note that many Western consumer goods producers in food, beverage and tobacco as well as in non-food sphere have moved to Poland in the early stage of transition. Many multinational firms with production units in Poland aim at cost reductions by using local (cheap) supplies. Thus, local retailers are able to offer a magnitude of internationally-known branded goods made in Poland. In this sphere, there are plenty of really exciting examples.

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One of them is the well-known multinational company Unilever, which is very active in several transitional economies. In Poland Unilever hit the “brownfield” route already in 1991 by acquiring a former state owned detergents plant Pollena. This transaction took place in a period during which all Western companies launched imports of international brands in detergents (such as OMO, Lux, Domestos, Sunlight, Cif and Vim, and in personal products Signal, Axe, Denim and Rexona, all by Unilever).

Rather soon it became obvious that many non-food brands, which had been out of reach for decades, were bought out of curiosity. However, the mass purchasing power was missing in Poland to consume Western detergents and toiletries permanently and in large scale. In this early period of transition, the Polish washing-powder alternative Pollena in the low-price category became the spearhead of Unilever action in Polish detergent business.

In the foodstuff branch Unilever acquired a Polish edible oil producer (SZPT) in 1992, and started producing margarine brands Rama, Kasia, Bona and Planta in two factories. In addition, Unilever started in the first half of the 1990s to produce Iglo fish fingers, Lipton tea and Algida ice cream in Poland. In many spheres of Unilever's Polish business, premium brands are on offer for the upmarket, while in many cases there are also value-for-money alternatives available. This same strategy is used by a number of MNCs.

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Coca-Cola is the best-known brand in the world. It has launched an extremely rapid and expensive operation in TE-region. In communist time, its main rival, PepsiCo, was clearly more active in the formerly centrally planned economies.

In Poland, Coca-Cola invested already in the first half of 1990s no less than USD 1,5 billion in building up bottling plants, distribution centers and supply chains. This huge investment spree has taken place by using Coca-Cola's franchisees. In TE-region, especially Coca-Cola Amatil, an Australian-based bottler (49% owned by Coca-Cola) has been involved in the investment spree.

Even in Coca-Cola's case with an extremely high image of the label, it is important to adapt price to the local purchasing power. Thus, Coca-Cola tries to reach a high level of local content in TEs. In the soft drink business, sugar is the largest cost factor for bottlers. In Coca-Cola's case with a multitude of products (Coca-Cola, Cherry Coke, Fanta orange, Fanta lemon, Fanta exotic, Fanta wildberry, Sprite, Kinley tonic, Kinley ginger-ale, Bonaqua rich, Bonaqua mild, Cappy orange, Nestea lemon, Lift grape, Lift apple, Powerade mountain blast, Powerade orange) sugar has to meet high standard (ECL), which no refinery produced in Poland in the early 1990s.

In that period, British Sugar made a partial acquisition by buying 51% of the shares in a state-owned refinery (Cukrownie Turunskie). This joint venture became the main sugar supplier of Coca-Cola Polska in 1993 meeting the required quality requirement.

Coca-Cola Polska buys also labels, crowns, carbondioxide, glue and glass bottles from Polish companies. With the high local content of the end products, costs are kept under control.

In the food, beverage and tobacco branch there is a myriad of Western involvement in Polish transition. Chocolate and sweets production provides evidence for that.

In 1991, PepsiCo outbid dozens of the world's other big food companies to purchase a stake in E Wedel, the famous 150 year-old Polish manufacturer of chocolate and sweets: it offered USD 25 million for all the preferential shares, which represents 40% of the company and 75% of the company's voting rights. At the same time, it made a commitment to invest USD 56,2 million over a five-year period to build up the business. In an increase of share capital in 1993, PepsiCo Finance (UK) boosted its equity in the company to 61,5%.

After this deal, Wedel family members filed a court action to preserve the right to the name, claiming that the name was part of their family legacy and, due to a legal technicality, not part of the property that was sold to PepsiCo. However, PepsiCo will be able to sell its Polish products under the name Wedel, since the Polish Ministry of Justice blocked the court decision against the company. This decision cleared the way for PepsiCo to continue with its plans to upgrade Wedel production plants.<sup>16</sup>

According to J. Rutkowski, managing director of E Wedel, the production of his company grew by a factor of five between 1990 and 1993. In 1993, the net profit was USD 16,3 million (no tax was deducted since the Polish government granted the company a three year tax holiday in 1992). Exports amounted to only 5%, as Wedel's prices on the Western European market were not really competitive.<sup>17</sup>

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Cadbury-Schweppes (UK) is a major player in the global chocolate market. Its products are very well known in Western Europe.

In October 1994, Cadbury began construction of its greenfield project in Poland at a cost of USD 50 million. Eleven months later, this ultra-modern production facility in Kobierzyce,

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<sup>16</sup> East/West Commersant, September 30, 1994.

<sup>17</sup> The Observer, Supplement on Poland, September 1994.

near Wroclaw, went on stream. It has a capacity to produce 12.000-13.000 tons of chocolate a year and employs about three hundred local people.<sup>18</sup>

Cadbury is the first Western confectionery producer to build a factory in Poland from scratch. At the opening ceremony of the new factory, it was mentioned that one of the decisive factors in setting up a production unit in Poland was the high customs duties that make it difficult to bring finished products into Poland. In addition, the proximity to the CIS-market contributed to the investment decision.

According to Cadbury's market research, the average Pole consumes only one third of the average amount of chocolate eaten by Western Europeans. Still, Poland's almost 40 million consumers eat about 1,6% of the global chocolate production. Thus, Poland ranks twelfth in the world in terms of chocolate consumption. In 1994, the domestic industry was not able to meet the rising demand.<sup>19</sup>

In 1993, Cadbury bought an East-German chocolate-maker called Piasten. The new plant in Poland received the name Cadbury Piasten and not Cadbury Poland, as expected by locals. Cadbury Piasten in Poland is one of the most modern confectionery factories in the world and churns out chocolate from recipes that the company has guarded carefully for some hundred years. In addition to old Cadbury products, the new factory also makes Piasten chocolate bars that are cheap and well known in Eastern Germany. The aim is obviously to get a foothold in the low-price market, which is important because of the relatively low disposable income in Poland.

Cadbury, which is a well-known brand in the West, is not very familiar to Poles. Therefore, the company has started an aggressive advertising campaign and built up its own distribution network with representatives in all major Polish cities. The company has stated that it is not counting on a fast return on the USD 50 million invested in Poland.<sup>20</sup>

In the late 1990s, Cadbury-Schweppes (CS) made considerable rearrangements in its business strategy. In December 1998, CS announced that it had agreed to sell its soft drinks brands outside the USA, South Africa and France to the Coca-Cola Company for USD 1,85 billion. The agreement included the Schweppes, Dr Pepper, Canada Dry and Crush brands plus certain regional trademarks.

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<sup>18</sup> Central European Business Weekly, May 12-18, 1995.

<sup>19</sup> The Warsaw Voice, March 5, 1995.

<sup>20</sup> The Warsaw Voice, April 9, 1995.

In September 1998, CS announced the acquisition of Wedel from PepsiCo, a significant addition to CS's existing start-up operation in Poland. With this take-over, CS became the market leader in the chocolate business in Poland.<sup>21</sup>

In this context, PepsiCo announced that production of sweets is not its specialty and that Wedel was the only confectionery factory of the company. After this USD 80 million deal, Pepsi pointed out that it would focus on producing soft drinks and salty snacks in Poland. The company has built a potato chip factory (Frito-Lay) in Poland and has conquered an enormous 45% market share in that sphere.<sup>22</sup>

Production of sweets in the TE-environment obviously calls for quick reactions:

- Western confectionery products were (or some of them were) available in hard currency shops in the communist period. Thus, they were all regarded as luxury items in the old system;
- Communist countries produced their sweets all right, but the quality was rather questionable;
- Some old brand names survived the communist time. Wedel was a respected company in the pre-communist period in Poland, so central planners maintained this brand of high esteem;
- In the early period of transition, Wedel had a high market share in Poland. Therefore, the acquisition by PepsiCo obviously was a bargain;
- CS chose the greenfield route in Poland and erected a state-of-the-art capacity. In a modern food processing facility, the share of labor in overall costs is rather low;
- Thus, cheap labor was obviously not the main motive in CS's Polish strategy. In the food sector, customs tariffs played an important role in the early period of transition;
- CS was not well known in Poland before it came in with a production unit. Therefore, the company had to spend plenty of money on getting market penetration for its brands;

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<sup>21</sup> CS Annual Report, 1998.

<sup>22</sup> The Warsaw Voice, November 1, 1998.

- CS made a very clever move by launching its East-German brand Piasten in the low-price category. The low-market segment is of extreme importance considering the still modest purchasing power in Poland;
- Before acquiring Wedel from PepsiCo, CS had a market share of only 4-5%. With Wedel, the share is about one quarter;
- Pepsi gave up Wedel, even if it was nicely profitable. However, confectionery is not part of Pepsi's core business and, thus, selling off Wedel makes sense;
- CS maintains that it will use Poland as a bridgehead to CIS-markets. However, CS has established its own production unit in Russia;
- The chocolate market in Europe is dominated by a handful of big companies. Nestlé (Switzerland), KJS (owned by Philip Morris), Mars (USA), Stollwerck (Germany) and Cadbury all have high market shares in Western Europe;
- These dominant players are all active in the TE-region. In this oligopolistic market, there has been a rush to TEs, not only in selling but also in producing locally;
- Western companies in the sweets business have used both acquisition and greenfield methods. Purely local competitors in TEs are squeezed out of the market or are put under heavy pressure;
- As Western retailers are invading Poland on a rather massive scale, it is essential for food manufacturers, like CS, to find space on the shelves of the major supermarket chains. The link to the heart of the consumers goes via retailing, which more and more clearly decides what is the best chocolate on the market;
- This means that there is not too much leeway for Western brand goods producers in pricing in TEs;
- Good quality products must be offered at reasonable prices via big retailers. If the dominant retailers are not happy with one product or the other, there is always the option to launch own (private) label alternatives.

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The beer industry in Poland is a sector with a high potential. Poland is seen as a very promising market for the "liquid gold": its per capita beer consumption of 53 liters (late 1990s) is still low by European standards, so it is no wonder that foreign investors are attracted to the Polish beer-brewing sector.

There are currently around 80 breweries operating in Poland, with a slight geographic overweight in the southern and eastern areas that were formerly under German or Austrian control. Most of them operate on a small-scale basis and have a production under 100.000 hectoliters per year. At the other end of the scale, there are a handful of large breweries producing over 1 million hectoliters per year. Most of these companies are in foreign hands: the larger Polish breweries have been gobbled up by foreign multinationals since the beginning of the privatization.

In the medium term, many of the small producers are expected to disappear, since they lack the capital to invest in new equipment and advertising. This will leave the market to be divided even further among a couple of mighty foreign investors.

The main foreign players in the field are Heineken, South African Breweries and Carlsberg. Netherlands-based Heineken, is definitely the number one beer producer in Poland. It owns three of Poland's major breweries, thereby serving about 40% of the national market.

The Żywiec brewery was the first to be privatized and Heineken did not miss the opportunity to buy it. It has proved to be a chicken with golden eggs: after a series of investments, it has become Poland's largest brewery with a present capacity of around 6 million hectoliters a year.

In June 1998, Heineken acquired a 9,6% stake in Brewpole, owner of the Polish breweries Elbrewery, Warka Brewery and Lezajsk Brewery. The acquisition of the shares was part of the plan to merge Brewpole and Zywiec, in which Heineken holds a 75% stake (Heineken will sell any shares tendered exceeding the 75% level, as agreed with the Polish Securities Commission).

As described in the Warsaw Voice, in December 1998, the merger of Poland's two beer giants, Żywiec and Brewpole, was completed. This took place after a new issue of 3,4 million

shares by Żywiec (at that time Poland's second-largest brewery) for zł 1,6 billion. Herbin BV, the majority owner of Brewpole, subscribed for nearly 2,5 million new Żywiec shares, paying zł 1,1 billion. Heineken subscribed for about 950.000 shares of Żywiec, paying zł 441,6 million. Żywiec consecutively used the zł 1,6 billion in new share revenue to buy Brewpole. Heineken steered the merger and owns 50% of the merged company plus one controlling share. The merged company serves about 39% of the Polish beer market.<sup>23</sup> The merger involved eight Polish breweries with a total 1997 sales volume of nearly 7 million hectoliters, 3.500 employees and a net turnover of more than zł 1 billion (USD 300 million). In the meantime, common production should be around 10 million hectoliters.

South African Breweries (SAB), through SAB International (SABI), has extensive brewing interests in sub-Saharan Africa (outside South Africa, where it is the undisputed market leader with a 98% market share), China and Central and Eastern Europe. SABI became one of the world's top beer producers by acquiring Miller in the USA in 2002.

SAB entered the Polish beer market in 1996 by concluding an agreement with the Polish company Euro Agro Centrum SA (EAC). The goal of this arrangement was to bring together the resources and strengths of a major international brewer with the expertise and connections of a local operator in the field. EAC had a controlling investment in the Lech brewery.

Until recently, SABI Europe, together with EAC, had control of two Polish breweries: the Lech Browary in Poznan and Browary Tyskie in Silesia. On April 1, 1999, both companies were merged to form one company with a single distribution system for both the Lech and Tyskie brands. Combined, the beer giant has an annual production capacity of 4,8 million hectoliters. The concern is controlled by SABI Europe (54% stake) together with EAC and was renamed into Kompania Piwowarska. It currently controls about 20% of the market.

Aside from being the number two beer producer in Poland, South African Breweries is extremely active in Central and Eastern Europe. It also owns production sites in Hungary, the Czech Republic, Slovakia, Romania and Russia. In 1999, the company took over Pilsner Urquell and Radegast from Nomura International (a Japanese financial company), the leading brewers in the Czech Republic, which gave SAB the status of market leader with about 44% of the market. In addition, it has a strong position on the Hungarian and Romanian market due to its ownership of the national leading brands (Dreher and Ursus, respectively). In Slovakia,

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<sup>23</sup> The Warsaw Voice, January 3, 1999.



SAB serves about 14% of the market after acquiring Saris, the second largest brewery in the country, in January 1997.

The Danish Carlsberg concern is the third largest beer producer in Poland. It took a 30% stake in the Okocim brewery in April 1996 and consecutively invested heavily in modernization. In May 1998, the stake in the Polish brewer was raised to 42,3%. Nowadays, the brewery is one of the five biggest breweries in Poland with an annual capacity of 2,5 million hectoliters per year. The Okocim group also counts two smaller breweries, each producing around 100.000-200.000 hl per year.

In February 2000, Austria's Brau Union AG said that it had agreed to buy the Browary Warszawskie SA brewery, maker of Królewskie beer, as part of its strategy to become the leading brewing group in Central Europe. "The management board of the Browary Warszawskie SA will support the Brau Union AG executive purchase decision and have agreed to inform their shareholders of this future-oriented step towards further growth in a general meeting recommendation", the Linz-based firm said in a statement. Brau Union, which is the brewing arm of the BBAG beverages group, bought 100% of Polish brewery Van Pur SA.

Beer is supposed to be cool, but the beer market in TEs is hot. It is especially hot in the CR, in which the beer consumption per capita is one of the highest in the world:

- Czechs consider beers made in the towns of Budweis (Ceske Budejovice) and Pilsen (Plzen), which have been copied around the world in the last two centuries, matters of national pride. The Czech state-run brewer Budejovice Budvar n.p. has fought numerous trademark battles with the world's largest brewer, US-based Anheuser Busch CosInc (BUD.N), over the use of the Budweiser label in individual markets around the world;
- In the 1990s, Anheuser Busch failed in its attempts to acquire a stake in Budvar, which has been successful in keeping the US brewer from selling under the Budweiser label throughout much of Europe;
- Plzensky Pivovary, makers of the original Pilsner Urquell, which has been acquired by South African Breweries, claims that it is the only true Pilsner beer;
- Polish beer does not have the same legendary fame as the Czech one. Thus, in the transitional period, there have been less emotions involved in the Polish beer market;

- On the Polish market, there is plenty of potential: per capita beer consumption is only about one quarter of the neighboring Czech figure;
- Polish breweries have no brand names that are famous and, thus, disputed on the international market;
- Brewpole is an Australian company, which got involved in the early period of the Polish transition (1991);
- Brewpole launched an investment program with a total value of USD 40 million, which was completed in 1997;
- Obviously, Brewpole is combining forces with Heineken. This alliance seems to be the strongest player on the Polish market;
- At the beginning of the 21<sup>st</sup> century, the Polish beer market has very clear oligopolistic features with a strong Dutch, a strong Danish, a strong South African and a strong Austrian player on the field;
- Newcomers will certainly have an extremely hard start, if they want to get involved in the struggle in the next years.

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Marlboro cigarettes supplemented with cowboys, mountains and horses certainly symbolize Western capitalism at least as well as hamburgers. Cigarette smoking, however, which is in the central stage in the cavalcade of capitalist freedom symbols, is getting less and less trendy in the West. Heavy regulations, lawsuits and health concerns have choked growth in Western Europe and the US.

Therefore, it is evident that all cigarette companies are looking for new opportunities in emerging markets, including TEs. It is estimated that in TE-region some 700 billion cigarettes are smoked, in comparison to 600 billion in Western Europe and 500 billion in the US. Poland

alone is estimated to have some 14 million smokers <sup>24</sup>. A World Health Organization survey found that 42% of adult Poles smoke.

Philip Morris (PM) and its Marlboro brand have had presence in Poland for more than twenty years. In 1973, PM signed a licensing contract with a Polish, state-owned tobacco factory, ZPT, to produce Marlboro cigarettes. Obviously, this communist product made with a Western recipe was a hybrid: it was at least partly made out of local harsh, dark, low-quality tobacco.

In the early 1990s, when Western marketers began to move rapidly into Eastern Europe, genuinely Western products dominated in many branches. Status-conscious consumers were ready to pay a price for their affinity for expensive imports. Obviously, people were overspending on Western brands relative to their household incomes. The privatization of the cigarette industry has been an emotional issue in TEs. There have been pressure groups, which have argued that the tobacco industry should remain a state monopoly and an important source of budget revenue. However, this line was rejected in Poland already in the early 1990s.

The first foreign player in the Polish tobacco production was R. J. Reynolds (US) which in conjunction with Austria Tabak applied successfully in the early 1990s for permission to produce cigarettes and began a greenfield investment with USD 33 million input in Poland. This new unit went on-stream in the summer of 1994.<sup>25</sup> In this context, it was pointed out that the Polish market with a consumption of 90 billion cigarettes a year is one of the highest per capita.

Another major player of the oligopolistic cigarette circus, BAT (UK), expressed its interest in acquiring a Polish production unit in the early stage of transition. However, delays in privatizing tobacco plants prevented BAT from buying a domestic label, so the company simply created one through a partnership with the state-owned tobacco plant PWT Augustow. The newcomer, Jan III Sobieski cigarette, is named after the 17<sup>th</sup> century king of Poland. After a year, Sobieski, which sells 20% lower than premium Western brands, had captured a remarkable 5% market share in Poland.

In 1995-1996, the big bang of privatization of Polish cigarette industry took place. PM took over one third of the stock in ZPT in Cracow for USD 227 million, and an option to purchase

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<sup>24</sup> Central European Economic Review, September 1995.

<sup>25</sup> Central European Business Weekly, July 8, 1994.

another 32% in the future. In this deal, in which PM took over its Polish licensee of Marlboro, the Western partner promised to invest USD 145 million to modernize production equipment, improve working conditions in the factory and support programs for changing tobacco strains cultivated in Poland. In this context, PM signed a package for Polish tobacco growers, promising to purchase tobacco every year in an amount no smaller than 45% of the total amount used in cigarettes destined for the Polish market.

In addition, PM signed a social benefits package with four labor unions operating at the Cracow factory, guaranteeing maintenance of the current 3.700-person workforce for two years, after which a 7% reduction is expected. PM also announced to increase wages by 30% and guarantee a threefold increase in severance pay to workers who choose to retire early. It was promised to introduce an additional pension system, while factory's other benefit programs will be maintained.

In 1995, ZPT produced 34 billion cigarettes. Thus, the company acquired by PM has a market share of more than one third in the Polish market.

When the Polish government decided to go ahead with the tobacco privatization scheme, it determined that in each case the strategic investor would be allowed to buy only 33% of the shares of cigarette producer units and another 32% after fulfilling given investment pledges. Thirty percent of the stock was decided to be set aside for employees and tobacco growers (15% each) and the remaining 5% for the state treasure. This scheme was applied in the PM-ZPT deal.

The same formula was practiced also in three other cases, which involve some of PM's oligopolistic rivals in the global market. The first plant to be sold was PWT in Augustow which was 33% acquired by BAT for USD 88 million, promising to invest another USD 70 million.

Reetsma (Germany) got involved in the great Polish cigarette sector sell-off when it bought a 33% stake in WWT, the second largest unit in the Polish market, for USD 131 million. After Reetsma delivers on its investment commitment of an additional USD 45 million, the company will have the option to buy another 32% of WWT.

WWT holds about 27% of the Polish cigarette market with a production of some 28 billion cigarettes a year. About 93% of this production were local WWT brands, while the remaining share was Reetsma's licensed products.

The French investment group Seita bought a 33% in ZPT in Radom. This Western player of the tobacco market acquired its original stake with USD 64 million, pledging to invest another USD 40 million. ZPT was said to produce 8 billion cigarettes a year.

The competition on the Polish cigarette market is now mainly in foreign hands. It is interesting to see in the future, how these implants will perform in the future:

- It is estimated that profit per pack of cigarettes is normally around USD 0,1-0,2, while in TEs it is estimated to be as low as USD 0,01-0,02.
- If the profit per pack is only one US cent, it takes about 22 years profits for PM to recover its USD 372 million investment (by producing 34 billion cigarettes which is 1,7 billion packs).
- It is said that there is in no other sphere of consumption with as much loyalty to a brand as among smokers: they want to have their own usual taste everywhere in the world.
- New Western brands have naturally upset the smokers' market in TEs via qualitatively better alternatives.
- However, old brands with local flavor (at old prices) have become important in their own right.
- New trademarks, like BAT's Sobieski cigarette (with a domestic sounding label), can capture a market niche.
- In the communist period, separate units of the state's tobacco monopoly produced same brands, as Klubowe. It is important for PM to get the exclusive rights for this brand, which is the fifth best-known trademark in Poland. Marlboro is only in the ninth place in the same list.
- There are strong anti-smoking lobbies in TEs. Thus, it is questionable whether overall cigarette consumption will increase.
- All TEs have started modernizing their cigarette industries with the help of Western giants. Thus, there is very little leeway for exports from Poland to other TEs.

- Cigarette-makers in TEs complain that extensive counterfeit production harms their business.
- The Polish state made good job in tobacco industry privatization; it was able to squeeze concessions from all four international companies participating in the acquisition round.

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McDonald's (USA) is the largest and best-known fast food chain in the world. In the early stage of transition, McDonald's (McD) decided to create a permanent and extensive presence in TEs. In September 1991, McD decided to establish new CEE-headquarters in Vienna (McD Central Europe). TE-operations are co-ordinated through this center.

According to Martin Knoll, marketing director for McDonald's TE-operations, it is necessary to start market research a long time before opening operations in a country. In his opinion, company representatives should talk to local people, look at prices in supermarkets and kiosks, check with local suppliers and look at the competitive situation. The idea is to find out what people would be willing to pay for a hamburger plus - what Mr. Knoll calls – “the McDonald's experience”. He states that the problem in TEs is that sufficiently low prices do not always provide the kind of margins to justify the investment. The cost of importing and working with low-volume local suppliers push up spending on raw materials. McDonald's attempts to avoid a situation of being seen as an expensive alternative. At the same time, they will never sell below cost.<sup>26</sup>

When the first McDonald's opened in Poland in 1992, only a quarter of the supplies were bought locally - mostly dairy products and fresh produce. The remainder came from the West, mainly from Germany. In this early stage of Polish operations, the company realized that it was facing stiff import duties, especially on meat, and thus nudged its ”made-in-Poland process” forward by encouraging foreign suppliers to expand into Poland. Obviously, this is a strategy that depends on being able to offer continuous and growing business opportunities to potential suppliers. Economies of scale are important in FDI decisions.

By April 1993, a German-Polish meat processing plant was in operation. By September of the same year, a local bakery that had received some financial help from McDonald's for

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<sup>26</sup> Business Central Europe, July-August 1996.

installing the required slicing machines and metal detectors was supplying the buns. And a Dutch company, in partnership with Polish partners on the Baltic coast, began a farm operation to both grow and process the Idaho potatoes for "long and lean" McDonald's fries.

During the communist years, Polish fishermen sold most of their cod catches to Denmark, where it was processed into frozen fillets for marketing in Western Europe. This product was not available in Poland where few individuals or retailers had freezers. The Danish firm Espersen was a major supplier of fish to McDonald's for the "Fish Macs" being served in Western Europe.

McDonald Polska persuaded Espersen to set up a JV in Poland, close to where the cod is caught. This new venture, which entailed a financial input of USD 2,5 million by the Danish partner, started operations in March 1995. Around 20% of the 1.000 tons of cod fillet production is earmarked for McDonald's Polska. In this labor-intensive activity the Danish partner has achieved clear cost advantages and is easily able to market the rest of the production from the Polish JV in Western Europe.

The supply chain created by McDonald's Polish operations does not necessarily involve foreign companies. The bentwood chairs for the first McDonald's Polish restaurant were imported from Austria. However, a local furniture manufacturer was consulted and subsequent chairs for McDonald's Polska came from them. They also provided chairs for other outlets of the company in several other TEs.

McDonald's Polska also hired a local interior design company when the first restaurants were decorated. This co-operation has functioned so well that the Polish company has been continuously used not only in McDonald's Polish expansion but in other TEs as well.<sup>27</sup>

Krzysztof Klapa, McDonald's-Poland's franchising manager, remarks that the principles of granting licenses are strictly defined and respected, resulting from the need for global uniformity. The franchisee (exclusively private individuals) has to go through a training course lasting 10-14 months to prove his ability to manage people and finances: franchisees must also possess personal capital of between USD 400.000 and USD 500.000. McDonald's decides where an outlet is to be situated and either they or the franchisee equip it according to McDonald's instructions.

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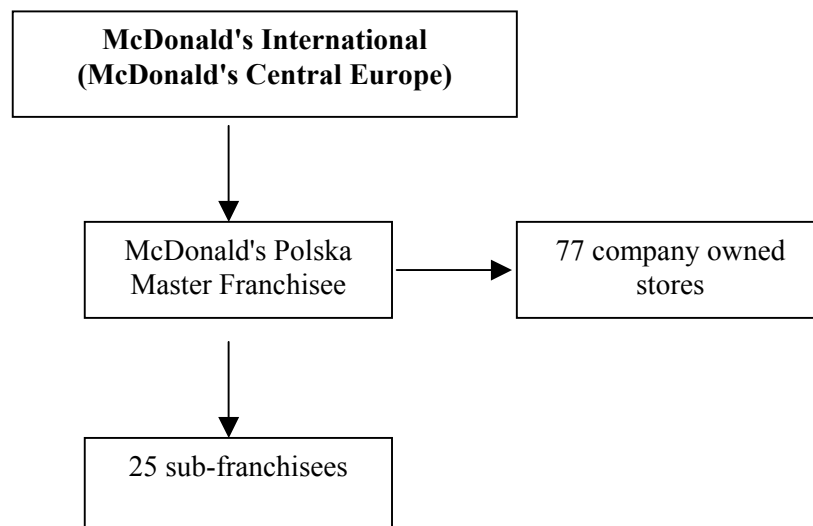
<sup>27</sup> Business Central Europe, May 1995.

A less expensive means of entering the franchise network has been designed especially for developing markets like Poland's: creating a joint venture in which the required investment is USD 60.000-80.000. "Loans are generally accessible throughout the world, but in Poland it is not easy to get them and the interest rates are high - hence our special deal", explains Klapa. He thinks the system benefits both parties, allowing the franchisee to develop without having to commit a lot of capital and enabling the franchiser to avoid covering the full cost of getting a business started. The security of running the operation is high due to the advantages offered by a well-known brand, permanent consultants, well-trying sales methods and an established network of suppliers. Worldwide statistics show that 80% of all small starting companies go bankrupt; the failure rate for franchisees, by contrast, is 5%.

McD obviously has country-specific models in various TEs. In a TE like Poland, it is rather difficult to find suitable franchisees. The American company established its own company in Poland, called McDonald's Polska, to which master franchise rights concerning Poland were transferred by McD's Vienna office.

McD Polska opened the first restaurant in Warsaw in June 1992. In 1998, there were over one hundred hamburger restaurants in Poland belonging to McD's empire.

**Figure 5. Organization of McDonald's Polska**



About three-quarters of the McD's retailing outlets in Poland are directly run by the company itself and the rest is managed by sub-franchisees. It can be assumed that McD Polska has occupied the best possible locations for its direct retailing operations and started allocating sub-franchising rights thereafter. Probably, the relationship between own direct retailing and sub-franchising will change with time: with the maturing of the Polish economy, it will be



easier to find suitable partners for the sub-franchising business, which is likely to increase in relative terms.

As mentioned above, McD has paid special attention to cost factors trying to maximize the local content of the end product. Some supplementary points in this context can be provided. The source of the information is Business Eastern Europe.<sup>28</sup>

In the early stage of McD's Polish operation, the company bought beef in Poland and exported it to Germany, where L+O (Germany), a long-time co-operation partner, processed it into hamburgers for shipment back to Poland. As this arrangement proved to be costly, L+O set up shop in Poland in 1992.

L+O has plenty of experience in vetting local partners. The German firm limited its search to Polish abattoirs with permits to export to EU and US markets. L+O experts inspected the slaughterhouses, taking a close look not only at production standards but also at the technical condition of buildings, the layout of production facilities and the hygienic conditions for staff. After a year, L+O experts repeated inspections of the abattoirs that got the highest marks. Wherever scores declined, inspections were repeated again in three months' time.

The next step was training for staff. Here L+O experts demonstrate how meat should be processed and explained the criteria the company uses to assess meat. The abattoir then delivers L+O a small sample to see if it is properly meeting company criteria. "The initial phase is long and arduous", says Waldemar Kowalkowski, an L+O manager. It pays off, though: not a single abattoir that has been through such intensive preparations has yet fallen short of L+O standards. Each slaughterhouse receives a report on how its meat scored against a variety of criteria, so any deficiencies can be identified and remedied. Constant feedback has helped to keep the list of suppliers stable, and L+O finds problems only a few times per month.

Similar training methods have been used by Espersen, the fish supplier. Here, the quality of the Polish catch was not an issue, but storing, sorting and slicing were. Espersen's experts prepared drawings on the spot to show, for example, how fish should be packed. They also distributed leaflets on fish processing to 30 suppliers. "It cost us time and nerves", says Andrzej Trojanowski, Espersen's supply manager. In addition, the firm sold used equipment at bargain prices to its Polish suppliers and extended loans for new machinery that could be

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<sup>28</sup> Business Eastern Europe, February 14, 2000

repaid in fish. Espersen has increased its daily processing from 7 tons to 130 tons of fish, but less than 1% is returned to suppliers because of inferior quality.

Alongside with L+O and Espersen, McD has started using Hochland (Germany), which provides cheese for the Polish daughter.

Investors seeking local suppliers should be prepared for a long uphill struggle. Hochland, a major cheese producer, relied on insider contacts to find a good Polish dairy, and the one it picked now supplies 80% of its needs. The company builds ties with the dairy by meeting frequently with its board, funding training programs and offering pre-payment. It has one-year contracts with another 20 dairies, but rotation is substantial. Six dairies have dropped out over the past four years, because they could not maintain the required quality. Local dairies often fall short on quantity, so Hochland finds it must still rely on imports as a fallback.

The fast-food restaurant business undoubtedly is one of the most exciting spheres in post-communist transition:

- Central planning failed very clearly in the sphere of private services: the supply was entirely inadequate to meet the increasing demand;
- Already in communist times, the first Western fast-food companies launched their corporations in the East, scoring points for capitalism in the ideological fight;
- In the transitional period, plenty of Western companies have realized the potential of TE-markets in serving food in a quick manner;
- In the early period of transition, it was anticipated that every Western concept is bound to be successful as soon as the local network is built up;
- In the mid-1990s, it became clear that purchasing power in TEs is a limiting factor for the boundless expansion of fast-food providers;
- This branch obviously is a price-sensitive one; it is not possible to have “monopoly prices” for a lengthy period in this activity;
- Thus, cost structure has become a dominant factor in the competition that is not abating. There are winners and losers;

- Eliminating expensive imports is a key factor in the branch under review. Cheap imports with a cheap end product price is a fatal combination;
- Local supplies are not necessarily cheap and easy to come by. Creating a local supply network with a permanently right quality-price relationship causes plenty of work;
- Poland is undoubtedly the most interesting TE in the CEE-region with its relatively large internal market and excellent economic growth performance.

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The Financial Times describes the dramatic transformation of the long-neglected and barely recognizable retailing sector that has taken place in the countries of Central and Eastern Europe <sup>29</sup>. It is being led by major western retailing groups, which have already established strong market presence in the region and are rapidly expanding their positions. Especially in the "economic tigers" of the CEE-countries (Poland, the Czech Republic and Hungary), the transformation has reached explosive proportions.

The fall of communism left Poland with a huge and chaotic retail structure, characterized by thousands of small shops and kiosks. Before 1989, retailing was purely a means of distribution to the end user.

Old trading and marketing monopolies were abolished under the 1990 market reforms and small shops went under the hammer or were restored to former owners under the privatization program. After that, small shops proliferated in cities and towns throughout the country, many run by redundant employees of failed state enterprises. In 1991, about 90% of retail trade had passed into private hands. The small retailers that proliferated after privatization are beginning to shrink in number and medium-sized local businesses have begun to rationalize their operations with increasing numbers of partnerships. They have a wide selection of goods on offer. The problem is that local retailers do not have the financial or operational experience to compete with the newcomers from the West.

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<sup>29</sup> Martin, Paul. Retailing in Central and Eastern Europe. Achieving success in new consumer markets. Financial Times, Retail & Consumer Publishing, London 1997.

After a relatively slow start, while companies gauged the success or otherwise of Poland's full-steam-ahead economic reform program, western retail chains are moving in force into the market. The influx of foreign companies was initially focused primarily on food retailing - traditionally the dominant sector, as non-food retailing lacked impetus for development. However, this gap is being filled quickly as well.

Supermarkets were the first to appear in Poland: Austria's Billa, Belgium's Globi (part of the GIB-group) and Norway's Rema 1000. After the supermarkets, the concept of the hypermarket became increasingly popular. Foreign supermarket and hypermarket chains have changed the image of Polish retail trade and have also reshaped consumer behavior. Consumers now do more shopping but less frequently and have learned to like weekend shopping in particular.

It is obvious that foreign investors all want a piece of the Polish pie and want to fight for their own share of the vast market potential. Western retailers that were pioneers in the CEE-markets generally chose the creeping-acquisition route for their entry strategies. This minimized risk provided a workable infrastructure, a supply and distribution chain to build upon, a customer base and a guaranteed transitional income to offset investment costs. It began slowly, but has begun to resemble something of a flood with major West-European companies such as Julius Meinl of Austria, Tesco of the UK, Tengelmann, Spar and Metro of Germany, Makro of the Netherlands, etc. All are expanding rapidly both nationally and regionally and have ambitious development plans.

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IKEA, a Swedish furniture retailer, was unknown outside Scandinavia two decades ago, but now it has become a global company with retail outlets in Europe, North America, and Asia. Starting in Sweden, IKEA expanded into Denmark and Norway in the 1960s, moved into other Western European countries in the 1970s and entered the United States and other non-European countries in the 1980s.

IKEA stores are distinctive in design and operation. Usually situated just outside a big city, these stores are large showrooms (about six times the size of the average supermarket) located next to vast self-service warehouses. To keep costs down and prices low, they sell unassembled furniture of simple Scandinavian design, offering a large selection of colors, styles, and materials. Customers are met at the door not by salespersons but with catalogues,

tape measures, pens, and notepaper. They then move through a store layout allowing them to look at merchandise, get information, and make purchase decision.

The key selling tool is a catalogue with prices and specifications of all items on sale. Also, each furniture piece is graded on an A-B-C scale. Appealing to young householders, IKEA staff takes care of young children in a playroom and even warms baby bottles. Each store has a restaurant and snack bar, featuring Swedish specialties at low prices. These services encourage browsing by customers. One service that IKEA does not provide is home delivery: customers pick up purchased items in the warehouse.

Traditionally, IKEA does little manufacturing: to keep prices down, it designs its furniture for low-cost manufacturing and distribution, contracting out production to suppliers located in some 70 countries. It has close co-operation with suppliers in material sourcing and production efficiency. Because orders for the global market are very large, suppliers are able to cut costs through economies of scale.

IKEA follows certain principles in its global marketing plans. Firstly, it tries to address universal needs with a core product assortment that consumers want around the world. Secondly, it tries to act locally by allowing store managers to add local products to the core product assortment and to adapt store operations to make shoppers feel comfortable. Third, IKEA believes in starting small and expanding gradually. All in all, IKEA has demonstrated that it is possible to differentiate even such a mature business as furniture retailing and to achieve global success with that differentiation.<sup>30</sup>

Ingvar Kamprad, the founder, formulated IKEA's mission as "to offer a wide range of home furnishings of good design and function at prices so low that the majority of people can afford to buy them." The principal target market of IKEA, which is similar across countries and regions in which IKEA has a presence, is composed of people who are young, highly educated, liberal in their cultural values, white-collar workers, and not especially concerned with status symbols.

IKEA follows a standardized product strategy with an identical assortment around the world. Today, IKEA carries an assortment of thousands of different home furnishings that range from plants to pots, sofas to soup spoons, and wineglasses to wallpaper. The smaller items are carried to complement the bigger ones.

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<sup>30</sup> New York Times, April 25, 1993; Management Review, April 1991.

Manufacturers are responsible for shipping the components to large warehouses. The distribution centers then supply the various stores, which are in effect mini-warehouses. The final distribution is the customer's responsibility. IKEA, however, does co-operate with car rental companies to offer vans and small trucks at reasonable rates for customers needing delivery service.

Although IKEA has concentrated on company-owned, large-scale outlets, franchising has been used in areas in which the market is relatively small or where uncertainty may exist as to the response to the IKEA concept.

IKEA offers prices that are 30 to 50 % lower than fully assembled competing products. This is a result of large-quantity purchasing, low-cost logistics, store location in suburban areas, and the do-it-yourself approach to marketing. IKEA's prices do vary from market to market, largely because of fluctuations in exchange rates and differences in taxation regimes, but price positioning is kept as standardized as possible <sup>31</sup>.

IKEA's links with TEs go back a long way. In the 1950s, the company started purchasing cheap items from some countries of the former communist bloc. In the next decade, it started to build up a network of manufacturing in Eastern Europe. After the collapse of communism, IKEA wasted little time in entering the TE-market with retail operations. Bringing the IKEA concept to as many people as possible - which is the official company policy - suddenly got a new dimension.

In the outskirts of Budapest, a big store of 12.600 square meters was established in 1989, inaugurating IKEA's activities in Eastern Europe. In the Polish market with almost 40 million inhabitants, the company launched a rapid expansion drive. Already in 1990, the first Polish shop was opened in Warsaw achieving instant success. Similar stores were opened a year later in Poznan and Gdansk. The Poznan outlet was replaced by a bigger one (6.600 square meters). The largest IKEA store was inaugurated in Janki, near Warsaw, some years ago <sup>32</sup>.

IKEA's operations in the former Czechoslovakia started with two stores, one in Prague and the other in Bratislava. After the split-up of the federal state, IKEA had stores in both newly born states, in the Czech Republic and in Slovakia. The first furniture shop in Prague was

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<sup>31</sup> Crossborder, Winter 1994.

<sup>32</sup> Tiisanen, T. Poland in the 1990's. Business opportunities in a successful transition economy, Lappeenranta University of Technology, Studies in Industrial Engineering and Management, 1997.

only a temporary solution, while IKEA planned a huge shopping park with an area of some 140.000 square meters comprising 50.000 square meters of retail space. This complex, in which IKEA has a retailing space of no less than 20.000 square meters for its own business activities, was opened in October 1996. The rest of the facilities was leased to other retailers.<sup>33</sup>

The development, financing and leasing of a shopping center is not the only new feature in IKEA's business strategy in the 1990s. The company has been manufacturing an increasing share of its own products since 1991, when it acquired Swedwood, the furniture-making subsidiary of Hexagon, the Swedish industrial group. Since the acquisition, the turnover from Swedwood's 27 factories has increased eightfold<sup>34</sup>. IKEA has traditionally spurned ownership links with its suppliers, preferring strictly arm's length relations.

Obviously, one of the most important background factors in the new production-oriented business strategy can be found in the changing ownership relations in TEs. Many Western furnishing groups - especially from Germany - have started moving in and buying up furniture factories.

Thus, IKEA has been forced to take direct financial stakes in suppliers situated in TEs. At the same time, IKEA has realized that it must take advantage of low costs of raw materials and labor in TEs. Shortly after the acquisition of Swedwood by IKEA, the Swedish furniture manufacturer established a daughter company in Poland.

In 1992, Swedwood Poland, owned by IKEA, purchased three Polish furniture factories. Swedwood Poland became the main stockholder in a local sawmill company. In July 1994, a glue board factory was established in Resko.

In July 1995, IKEA invested in a new furniture factory to produce veneered furniture frame board construction in Lubawa. Then in June 1995, IKEA began to work on a new furniture factory in Goleniow to make solid wood furniture. So far, IKEA has invested over SEK 250 million installing the latest technology for a high-processed final product.

In its TE-operations, IKEA is not only trying to minimize manufacturing costs but retailing costs as well. At the Polish Janki store, cost-cutting is evident: the huge retail space has fewer toilets than equivalent outlets in the West, no air-conditioning, Spartan flooring and only

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<sup>33</sup> Prague Post, October 21, 1996.

<sup>34</sup> Financial Times, October 17, 1997.

rudimentary electrical systems permitting the simplest lighting for furniture displays. Some office and warehouse areas will not have hot water. These and other measures add up to a 35% saving.

Janki's best sellers are do-it-yourself kitchen cabinets, wardrobes and other products that offer more efficient storage in tiny, crowded homes and apartments. The Janki store was a test of whether IKEA could adapt its high-volume, mass-market retailing formula to Eastern European conditions.

The intense appetite for western goods, despite of the apparent lack of cash, has spawned some unusual retailing patterns. Mr. Musiolik, IKEA's manager in Poland, notes that many Polish customers are accumulating silverware and dinnerware gradually, one spoon or a single teacup at a time. "It means that we have to be careful about changing product ranges not too often", says Mr. Musiolik.<sup>35</sup>

The transitional period in CEECs and IKEA are made for each other. Car ownership, home decoration and travelling are the three most important categories of consumption mentioned in numerous opinion polls and market studies made in TEs. IKEA offers a wide range of items meant to improve the beauty of households and everything on offer is meant to be sold at affordable prices:

Poland offers the best possible location in the CEE-region for IKEA with its large population and rapidly increasing living standard:

- At the beginning of the 21<sup>st</sup> century, IKEA already had retailing outlets in Warsaw, Wroclaw, Gdansk and Krakow, as well as two large shopping centers in Janki and Poznan;
- In its extensive Polish operations, IKEA presents only a quarter of the items available in IKEA's Western outlets. However, the Janki center already offers 6.000 products which is about half of the normal Western selection;
- "Do-it-yourself" products are best-sellers in the TE-market where purchasing power is lower than in the West;

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<sup>35</sup> Martin, Paul. Retailing in Central and Eastern Europe. Achieving success in new consumer markets. Financial Times, Retail & Consumer Publishing, London 1997.



- Poland has also been selected as an important location in the supply chain of IKEA. Naturally, Polish production units must meet very high standards and produce according to the IKEA design;
- It is stated that almost 15 % of IKEA's supplies nowadays come from Poland;
- According to IKEA, costs of raw materials and labor will remain cheaper in TEs than in Western Europe for the next quarter century;
- IKEA has traditionally used the method of outsourcing production. Contract manufacturing is the rule in this business. In Poland, IKEA owns production units, and has, thus, direct control over local supplies;
- In 1999, IKEA announced that it would build a distribution center for CEE-operations at a cost of about USD 50 million in Piotrkow, Trybunalski. Thus, Poland will be the focal point of IKEA's TE market strategy;
- IKEA's Polish operation is a convenient investment from the Polish macroeconomic point of view; Polish supply units export to IKEA's Western outlets on a large scale, about USD 500 million a year.

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When communism collapsed in Eastern Europe, it was assumed that many Western firms would start investing in TEs in order to use local cheap labor. However, there has not been a massive inflow of Western manufacturers in the clothing-branch. Obviously, Western clothing is manufactured on an extensive scale in TEs, but mainly on a contract-manufacturing basis.

At the same time, many Western retailers active in apparel business have entered the TE-market with their brand goods. In many cases, the products sold in TE-capitals are not locally produced. Levi Strauss (US), however, has started both production and retailing in Poland.

During the communist period, jeans were regarded as a symbol of Western imperialism. In extreme cases, it was even prohibited to wear denim at schools, e.g. in East Germany (GDR). At the same time, wearing Western-style jeans became a symbol of dissidence. In the 1970s,

some communist countries started producing jeans out of locally made cloths. These products had very little to do with "the real thing" made in the West.

Levi Strauss had already started producing its brand products in Hungary in the 1970s and has since then intensified its business in that country<sup>36</sup>. Levi's began planning a new strategy in Poland shortly after the collapse of communism. It wanted to produce locally both to take advantage of Poland's low costs and to avoid import duties.

In the early 1990s, Levi's advertised in Poland for a greenfield site and received more than one hundred replies. The initial choice was Łódź, a textile center west of Warsaw. Consecutively, a group of politicians and municipal officials from Plotsk came up with a more attractive deal on an empty 10.000 square meters warehouse complex which was converted into a modern factory in four months time by local constructors. When Levi's accepted the offer by Plotsk, Łódź hit back with a salvo of angry propaganda that grew into a war of words. Plotsk authorities, on their side, were extremely helpful in cutting through red tape locally and in Warsaw.

According to Levi's Poland, a greenfield manufacturing base, which made it possible to stay clear of the privatization and industry ministries, was the only option to be considered. The greenfield site replicated a Western European or US factory without outdated equipment or methodology. According to Levi's, this is the best way to achieve the efficiency and quality demanded for a brand product. The company is very happy with the attractive package from the local authorities, because for many investors - even established ones looking for new sites - buying land and getting permissions is made incredibly difficult by local authorities<sup>37</sup>.

It was no problem for Levi's to recruit the two hundred and thirty, mostly female, employees in a city of high unemployment. Each received up to six months on-the-job training from locally hired supervisors, who had been trained for several weeks at a Levi's plant in Hungary.

Levi's pays wages that are slightly higher than the average plus bonuses for a forty-hour week. But wages account for only about 15% of total costs at the plant, which is as highly automated as any in the world. Absenteeism is negligible and reject rates are near Western levels where wages are much higher.

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<sup>36</sup> Tiisanen, T. & Berry, R. Fifty ways of doing business in transitional economies, Helsinki University of Technology, Lifelong Learning Series 2/1995.

<sup>37</sup> Business Central Europe, April 1994.

Production in Plotsk started with 1,5 million pairs of jeans annually and this was expanding to 2-3 million by the mid-1990s. About half of the production is exported to Western Europe. Levi's recognizes that, at a retail price of USD 50 for a pair of 501s, the Polish market cannot absorb all the local production. Cheaper alternatives rapidly entered the Polish market. Levi's recognized that, e.g. B Strauss 501, Levi Strauss and Live Strauss jeans had flooded the market.

In 1993, the Warsaw district court granted permission to seize jeans illegally bearing the Levi's trademarks at MarcPol Warehouses <sup>38</sup>. This case is regarded as an important precedence in a country in which intellectual property rights and trademark protection are provided in principal but in which the legal enforcement in this sphere is an obvious problem.

Alongside the unfair competition of local entrepreneurs, Levi's has also been facing the problem of supplies. Local textile mills are not able to deliver cloth, which is good enough for Levi's products. Therefore, cloth is completely imported from the US. Levi's complains bitterly of long delays and inefficiency at the Polish customs, which means that the plant has to carry twice the normal stock levels.

In its global marketing strategy, Levi's traditionally uses franchised retail outlets. Levi's Poland very soon realized that few Poles can afford the USD 200.000 needed to set up a franchised store and set up a network of twenty-six retail shops on its own. However, in 1994, the first agreement with a franchisee was signed.

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In the beginning of the 1990s, a great shock hit the Polish leather industry. Trade with the Soviet Union collapsed and the local market was flooded with imported goods. As shoe stocks in state-owned companies accumulated, so did their debts. Many Polish shoe manufacturers could not adapt to the free market economy and went bankrupt.

Some of them have been successfully privatized. Syrena was one of the best-known brands in communist Poland. In 1993, it was closed down but it revived in 1996 by four private shoe companies. The new Syrena concluded a co-operation agreement with an Italian company and, using Italian designs, prepared a summer collection of sandals that sold like hot cakes.

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<sup>38</sup> Business Central Europe, October 1993.

Bata (Canada) is one of the best-known players in the global shoe business. It opened its first retail outlet in Warsaw in 1993. In 1996, Bata already had four retail units in Poland. According to Bata Poland, their stores cater to the needs of a wealthier group of customers who focus on the quality and design without paying much attention to the price<sup>39</sup>.

Bata's story is one of the most interesting cases in the context of Eastern European economic history. Back in 1894, Tomas Bata invested a small sum inherited from his mother in a two-room workshop in the Moravian town of Zlin (Czech Republic) and began making shoes. By the time Tomas Jr. inherited the business in 1932, Bata factories were producing 36 million pairs of shoes a year. By 1938, Bata had become one of the world's first true multinationals with manufacturing and retailing units in 40 countries. But with Hitler on the verge of invading Czechoslovakia, 24-year-old Tomas Bata junior traveled to Canada to establish a shoe factory as a precaution to safeguard the family business.

After the war, in October 1945, the Bata shoe company was nationalized without compensation and, following the communist coup of 1948, renamed Svit. Zlin was renamed Gottwaldow, after Czechoslovakia's first and very unloved communist boss.

In the post-war period, Bata expanded its operations continuously. In the early 1990s, Bata's global operations employed 70.000 people in 65 countries with annual sales of 300 million pairs of shoes<sup>40</sup>.

When Tomas Bata Jr. visited Prague for the first time after the velvet revolution in 1991, he bought 29 state-owned shoe shops, plus a small factory, for USD 10 million. Since then, the retail chain has grown to some 50 shops with a 10 % market share in the Czech Republic<sup>41</sup>. So, instead of buying back family property, Bata focused on penetrating the retail market with a small-size manufacturing operation. In shoe-making, Bata sub-contracts parts of the production process, such as the stitching of uppers, to the Svit combine and also buys component parts from Svit's workshops. In the mid-1990s, Bata's factory found it more reliable and cost effective to import soles from Italy than to buy them on the Czech markets.

The clothing and footwear business in post-communist Poland includes several lessons:

- Levi Strauss already was a very well-known trade mark in the communist time. In many communist countries, Levi's were sold in local hard currency shops;

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<sup>39</sup> The Warsaw Voice, October 6, 1996.

<sup>40</sup> Business Central Europe, October 1993.

<sup>41</sup> Central European Business Weekly, November 1995.

- Therefore, it was understandable that Levi's started planning operations in Poland in the early stage of systemic change (in Hungary even before that);
- Direct export from Western factories was obviously an option that was rejected. With this method, it would have only been possible to reach a small niche at high prices;
- A clear decision favoring the greenfield option was made. Administrative hassle and dubious price evaluation involved in acquisitions was thus avoided. Obviously, with the greenfield option, the problem of retraining and/or firing old workers was also avoided;
- Levi's has used the existing competition between local authorities in attracting foreign investors in a clever way;
- Clearly, it is not important for a factory relying entirely on imported materials to be in the textile center of the country (Łódź);
- The branded goods are very expensive for a local market with low disposable income. However, the Polish market is fairly large and there is quite a high demand for Western quality goods. If Levi's Poland produces some 2-3 million pairs of jeans a year and sells around 50% of this output locally, the Polish market absorbs 1-1,5 million items annually;
- It is important in this case that the producer is tightly controlling its retail network. In Levi's case, the customer knows that the "real McCoy" is available at certain outlets only;
- It is encouraging that Levi's won its legal case against counterfeiting. However, it is highly likely that continuous vigilance against copycat products will be needed in a country where there is a certain ambivalence towards intellectual property rights;
- Even though Levi's Poland points out that in its modern production facility labor costs play a minor role only, it is clear that cost savings have played a role in the investment decision: half of the production is exported to Western Europe where labor costs are essentially higher;
- It was expected in Prague in the early 1990s that Tomas Bata would acquire Svit's extensive (and obviously unprofitable) operations out of emotional reasons;

- However, Tomas Bata did not allow his heart to rule his head: he concentrated his efforts on retail operations in Prague;
- Bata's manufacturing business in the Czech Republic is of marginal importance only;
- In Poland, Bata has not entered manufacturing field at all;
- Bata's focus on both TEs mentioned (Poland and the Czech Republic) is on retailing, in which the brand-name is already well-known out of historical reasons;
- There is a clear dual market in the TE footwear business: prestigious and stylish products are in reasonable demand even if prices are high in the eyes of an average person. At the same time, there is a fierce price competition in the low market segment;
- It can be assumed that, in Poland (as well as in other TEs), local producers cannot compete with cheap imports in the low market segment and not in quality with prestigious (brand name) imports;
- Thus, Polish shoe-makers must look for co-operation deals with Western companies (which can provide, e.g., design);
- Bata is one of the most internationalized companies in the leatherwear business. Thus, it has obviously been able to minimize its labor costs by selecting absolute wage advantages among those 65 countries in which it has a presence;
- Shoe retailing is one of the branches in TEs in which early entry is important. Famous German brands like Salamander, Bama, etc. are already visible in TEs;
- Thus, competition in the upmarket segment is emerging.

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It is a well-known fact that retailing companies are latecomers in the internationalization process. In rich part of the world, a consolidation process has taken place. The size of average retail shops (especially in grocery sphere) has continuously grown when new super- and then

hypermarkets have appeared. The biggest grocery-store chain in the world, Wal-Mart, is the biggest company in the world measured by yearly sales.

The concentration or consolidation process in mature market economies has got certain limits. Overall, sales are growing only very slowly, or not at all. Out-of-town markets in various metropolitan areas cannot expand endlessly because of limits in suitable real estate. At the same time, competition has become more and more intensive, while one of the most important means of competition is the price or the average monetary value of a consumer basket.

In this intensified competition, in which consumers demand good value for money, the habit of using own (or private) labels has started spreading. Successful grocery chains have introduced value-lines, or own-label goods, which are more or less equivalent of branded goods, but cheaper. Contract manufacturing used by retailers has increased rapidly in recent years in food and non-food spheres. Mighty retailers are pressurizing manufacturers more and more in the global economy.

A high level of market saturation in the USA and in the EU is one of the reasons behind the global drive of retailers. TE-region is an interesting ingredient in this game: post-communist countries offer a “virgin land” environment for modern big-size and cheap-price markets. Therefore, it is only natural that a remarkable invasion of Western grocery store chains has taken place in TEs.

Tesco is a British chain, which in the turn of the century was one of the most international retail giants measured by presence in different countries. Tesco runs over 900 stores in ten countries and has a 16% market share in British highly competitive market. Tesco is said to deliberately keeping its margins flat, ploughing back into lower prices the gains it reaps from economies of scale. That brings more sales, and thus more economies of scale. This same strategy is used by its American rival, Wal-Mart, which in the end of the 1990s acquired Asda, one of Tesco’s British rivals <sup>42</sup>.

Tesco is an international player with substance and with a definite regional strategy in TE-region with Hungary, Poland, the Czech Republic and Slovakia as target countries. Acquisition spree of Tesco in TE-region started in Hungary, where it took over Global TH, a formerly state-owned chain in 1995. With this deal, Tesco acquired 43 local supermarkets. Even before this deal, Tesco had opened its first purpose-built supermarket of 12.000 sq. m.

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<sup>42</sup> The Economist, August 11, 2001.

Also in 1995, Tesco acquired four-fifths of the shares in Sovia SA, a Polish private supermarket chain with 36 outlets in 20 locations in southern Poland. After that ambitious long-term expansion, plans were made to expand Tesco system to cover all Poland.

One of the first Western retailing companies entering TE-region was Kmart (US) which acquired 13 stores in the former Czechoslovakia in 1992 via the privatization process. However, Kmart faced difficulties on its home market (US) in the middle of 1990s and sold its outlets in Central Eastern Europe to Tesco. In this deal, Tesco received six outlets in the Czech Republic and seven in Slovakia. This takeover brought to the British company 13 profitable stores with prime city-center properties in two different TEs.

Tesco has invested heavily in four TEs with an overall population of some 65 million people. The British company is convinced that on the long run there will be considerable logistics and buying synergies. Early entry with considerable size is regarded as essential success factors.

Even if there has been a strong invasion of Western retailers in the Polish market in the 1990s, the scene in the turn of the century was still rather fragmented: there were some 200.000 food stores in the country, the big bulk of which were local shops and street kiosks. Approximately 5-6% of the grocery turnover was in the hands of Western hypermarkets.

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The Polish banking sector has experienced a really fundamental institutional restructuring in the transition period, during which strategic investors from the West have been eager to get involved. However, the biggest Polish bank (the first one on the list below) is still state-owned. This important sector can be described as follows <sup>43</sup>.

#### PKO BP

PKO Bank Polski is the largest bank in Poland, boasting nearly 85 years of experience and 30% of Poles' overall savings. The scale of its operations is reflected by its assets: zł 91 billion. The bank has 1.251 branches and runs the Inteligo online bank, which provides round-the clock-access to accounts. BKO Bank Polski covers all types of banking services on the Polish banking, money and capital markets, addressed to individuals and corporate clients, as

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<sup>43</sup> Details taken from Warsaw Voice, monthly supplement, no 37, November 2003.



well as clients in the small and medium-sized business sector, public institutions, budget-financed entities, communes and local government bodies.

PKO Bank Polski has almost 6.000 units (divisions, branches and agencies) and over 3.560 School Saving Funds (SKO). With Poland's largest network of bank outlets, PKO has earned a leading position among card issuers: it holds 29% of the national market. At the end of December 2002, the bank was serving over 4,26 million debit and credit cards, its clients having completed over 139 million operations. The bank's work force amounts to nearly 40.000.

PKO Bank Polski has a rapidly developing network of ATM's. Currently, over 1.700 ATMs work online, including over 770 with a deposit function. PKO Bank Polski operates with some 700 Banks the world over, to which it can directly address information and instructions when serving money transfers and commercial operations through SWIFT.

#### Bank Pekao SA

Bank Polska Kasa Opieki SA began operating October 29, 1929. Today it holds 20% of the Polish banking sector's overall assets; it is the second largest company listed on the Warsaw Stock Exchange and the largest private bank in Central and Eastern Europe.

Bank Pekao SA holds second place in the credit and deposit market; it has the second largest network of branches, over 800 throughout the country, and a rapidly developing network of electronic distribution channels: teleserwis, Poland's second largest ATM network; office banking; Poland's first online division; and it holds a 24-% share of the card market. Bank Pekao SA also operates Poland's largest brokerage. Pekao SA's services are aimed at several groups of clients, supplemented by products of the Pekao SA capital group, which covers several highly specialized financial institutions.

#### BPH PBK SA

Bank Przemyslowo-Handlowy PBK SA, a subsidiary of Bank Austria Creditanstalt, is the third largest bank in Poland. It is also third among Polish listed banks in terms of capitalization. BPH PBK's share in basic market products is 10%, and its share in housing loans for individuals exceeds 15%. Currently, the bank is among the leaders in this market segment in Poland. BPH PBK provides services to over 2,7 million clients, with a network of nearly 500 branches throughout the country.

The bank offers modern products alongside credit, deposit and settlement services. Services to clients are provided by the bank's branches and through rapidly developing alternative distribution channels such as the Internet, SMS, WAP and its call center. The bank's strategy focuses on retail banking, amounting to services for middle-class clients and corporate banking, especially in the sector of small- and medium-sized businesses and large corporations, including international ones. In 2003, BPH PBK was recognized as the Best Bank in Poland by Euromoney financial magazine.

#### CitiBank Handlowy SA

CitiBank Handlowy SA provides services to over 18.000 corporate and 700.000 individual clients through its network of 160 branches in Poland. Bank Handlowy w Warszawie SA was founded in 1870; it is the oldest commercial bank in Poland and among the oldest in Europe. The year 1989, which proved to be a turning point for the Polish economy, opened a new chapter in the bank's history. The bank lost its monopoly on foreign settlements but won larger freedom of operation in all bank services. Swift development of its branch network and new financial services resulted in a market growth in the bank's operations both at home and abroad.

In 1997, after an almost 60-year hiatus, Bank Handlowy returned to the Warsaw Stock Exchange. In 2000 a radical change in Bank Handlowy's shareholder structure took place as the bank became part of the global Citigroup network: the world's largest financial institution purchased a controlling stake in Bank Handlowy, and the Banking Supervision Commission gave its consent to the companies within Citigroup exceeding 75% of the bank's share capital, which opened up the way to the merger between Bank Handlowy and Citibank (Poland) SA. The formal merger took place March 1, 2001.

Citigroup is the largest global company providing financial services. It serves some 200 million individual, corporate, governmental and institutional clients in over 100 countries.

#### ING Bank Slaski

ING Bank Slaski was founded in 1989 after nine regional commercial banks were spun off from the National Bank of Poland (NBP); at that time its name was Bank Slaski w Katowicach.

In 2002, as a result of a series of stock market transactions, ING Bank N.V. became its strategic investor with an 87,77-% stake. In September 2001, in accordance with the global

strategy of the ING group, the bank, jointly with other ING companies in Poland, introduced a common ING brand and adopted the name ING Bank Slaski.

ING Bank Slaski is one of the leading retail banks in Poland. In March this year the number of personal deposits served by the bank exceeded 1 million. ING Bank Slaski covers a network of over 330 branches throughout Poland, over 550 ATM's, and the INGBankOnLine banking system. Its services cover personal accounts, deposit and credit products and cards.

ING BSK is among the leaders in the card market. It was one of the first banks to introduce the VISA Electron card, and the first bank in Central and Eastern Europe to introduce the VISA Electron Credit card. Moreover, it is the only bank in Poland to offer clients two debit cards for one account: VISA Electron and Maestro.

The core of the bank's business is services for corporate clients. The bank runs over 160.000 corporate client accounts for small, medium-sized and large companies.

#### BRE Bank SA

BRE Bank is regarded as one of the leading financial institutions in Poland in terms of capital, scope of operations, development, variety of services, and banking technologies. BRE Bank specializes in export and foreign trade transactions. It facilitates settlements in foreign trade and protects its clients from the risk of importer insolvency.

BRE Bank plans to achieve an equally high position in the market of services for retail clients; since November 2000, these clients have had access to attractive bank products through mBank, the unquestioned leader in online retail banking in Poland. More than 25% of e-mail banking in Poland is through mBank.

#### Bank Zachodni WBK

Bank Zachodni WBK is a universal bank providing services to both individual and corporate clients. It is one of the five largest banks in Poland, with a controlling stake of 70,5% held by the Allied Irish Bank. Bank Zachodni WBK emerged as a result of a merger between Zachodni and Wielkopolski Bank Kredytowy in June 2001, and is among the largest companies listed on the Warsaw Stock Exchange. Bank Zachodni WBK's equity exceeds z1 2 billion, while its assets amount to z1 25 billion.

Bank Zachodni WBK has a network of 427 branches, 573 ATM's and nearly 7.000 POS terminals. Thanks to modern technology and expanding services, the number of clients using

the bank's services over the Internet, telephone and mobiles has grown to 380.000. Bank Zachodni WBK is one of the largest banks in Poland in terms of card issue; nearly 1,3 million cards are now in use.

#### Kredyt Bank SA

Kredyt Bank was founded in 1990 as one of the first private banks in Poland. Since the very beginning it has actively participated in consolidating the Polish banking sector. In 1993 it purchased shares in Bank Ziemski w Warszawie and then took over that bank. A similar deal was concluded a year later with shareholders of Wroclaw Bank. In 1995 PBH Gecobank was incorporated and in 1996 Kredyt Bank purchased stock in BDP Glob bank. The shares of Kredyt Bank were first traded on the Warsaw Stock Exchange in 1994.

The year 1997 marked a turning point in the bank's efforts to win a strong position in the market. It was then that an agreement was signed with the National Bank of Poland on the purchase of shares in Polski Bank Inwestycyjny and Prosper Bank; in 1998 this was followed by Agrobank.

Its shareholders are now mainly renowned foreign and domestic institutions. The largest stake is held by the Belgian KBC Bank N.V. based in Brussels, which owns 76,46% of Kredyt Bank's share capital. Another 5,2% is held by the Italian Sanpaolo IMI S.p.A.

#### Bank Millennium

Bank Millennium emerged in January 2001 when BIG Bank Gdanski merged with BIG Bank SA. Restructuring of the bank began, designed to adjust it to client needs. This long-term process was based on the assumption that the bank's operations should be centered using a modern, uniform information technology system, along with the standardization of services addressed to individual groups of clients using specialized business lines.

Specialized business lines emerged: Millennium, serving individual clients; Millennium Business, serving small companies; Millennium Prestige, serving individual clients of high financial status; Corporate Banking, serving large and medium-sized companies; and Central Unit, serving strategic clients and large companies.

#### BGZ SA

Bank Gospodarki Zywnosciowej SA is a commercial bank specialized in financing agriculture, the food business and regional infrastructure. It is BGZ's objective to take part in the implementation of structural programs funded partly by the European Union and

addressed to agricultural companies, food industry companies and companies forming regional infrastructure.

The State Treasury is the dominant owner of BGZ, with a 69,45-% stake. The rest of the stock belongs to the cooperative banking sector. According to the present strategy of BGZ, the shares of BGZ SA are to be floated to the public in 2003.

BGZ has a network of 360 branches and 330 ATMs throughout the country. Clients have access to the full range of the bank's services, addressed both to companies and individual clients. BGZ's clients can also contact the bank through channels based on modern tele-information technology: e-Integrum electronic banking system; TeleIntegrum phone services; and Home Banking.

## 6. Conclusions

Poland is far the largest TE in Central Eastern Europe. This new EU-member has a very peculiar economic structure. With a large number of small farms, Poland will receive extensive subsidies from Brussels. It is interesting to see how Polish rural economy will be able to absorb the forthcoming extra money.

It is not an overstatement to maintain that Poland experienced an economic miracle in the 1990s with a strong investment boom and successful restructuring of export. Poland was not able to catch up with Western Europe in living standard, but the gap in welfare has declined.

Strong economic growth could not solve the problem of unemployment. In actual fact, unemployment rate increased clearly amid the boom period. Productivity increased rapidly in manufacturing, but so did unit labour costs. Therefore, about one fifth of the labour force was out of work in the early 21<sup>st</sup> century.

Competition has obviously strengthened in the Polish transition because inflation has abated very clearly in the first years of the new century. Current account deficits have not been excessive. However, balancing the books in the public sector seems to be a headache. Special attention must be paid to this problem because the membership of EMU becomes an up-to-date topic.

Poland has not been especially successful in attracting FDIs in TE comparison. However, capital inflow in FDI-form has not been negligible. FDIs have revolutionised telecom, retail trade and financial service sections. Foreign capital has also contributed essentially to restructure manufacturing industry.

It can be assumed that a certain level of saturation has been reached in FDI activity. In TE-comparison, Poland has become a relatively high unit labour cost location. Thus, labour intensive branches will not be likely to attract extensive FDI-flows in the near future. Rapid decrease of unemployment is thus unlikely. It will not be easy to find mitigation to the labour market problem by exporting workers because demand for blue-collar workers in Western Europe is limited.

Exchange rate between zloty and euro gives presently pretty good price competitiveness to Polish exportables. Thus, no serious CA problems in Poland can be expected in the near future.

Overall, Polish transition has been highly successful process. Living standard has increased rather rapidly without causing serious imbalances in the economy. However, Poland is facing some serious problems in restructuring in her rural society. Obviously, it takes time to overcome all structural problems of the Polish economy. Hopefully, the EU-membership will have a positive impact on the restructuring process.

All new EU-members have to learn how to make the best use of facilities now available to them for promoting investment, such as EU regional development funds which are more limited than those for the 15 former EU-countries. The new EU-members have to develop the institutional framework to administer and properly channel the variety of funds available from the EU.

Obviously, all new EU member countries must try to combine their advanced education with competitive production costs. The legal regime of the EU provides the necessary framework for the free movement of production factors within the region, in offering national treatment and in aiming for competitive equality within the union. Obviously, in this new integrating Europe, skill-intensive assets in every simple member-country, including Poland, will be the most important success factor.



## **Poland, the Largest New EU Country**

This book analyses the economic development of Poland, the largest country in Central Eastern Europe. In the post-communist period, Poland has experienced an economic miracle, which has enabled the country to enter the EU. In the Polish economic boom in the 1990s foreign investors have played a very important role.

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The Northern Dimension Research Centre (NORDI) is a research institute run by LUT. NORDI was established in the spring of 2003 in order to co-ordinate research into Russia. The most outstanding characteristic of NORDI's research activities is the way in which it integrates technology and economics. NORDI's core research areas are:

- Russian business and economy
- Energy and environment
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- The ICT sector
- Logistics and transport infrastructure