The Impact of Global Recession on FDI – Poland's Case Study

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Abstract

Increased market apprehension caused by the recent global recession has resulted in a substantially decreased foreign direct investment (FDI) in many countries. Poland, by contrast, has enjoyed stable FDI levels that, after a relatively brief pause and certain structural adjustments, have continued to fuel that country's economic growth. In this paper we quantify recent FDI levels in Poland and identify the housing and financial sectors, foreign banks, outsourcing, and offshoring as key contributors to that observed outcome. We conclude that the contraction of FDI in Poland was short-lived and did not substantially diminish Poland's mid-term economic growth.

Key words: Foreign Direct Investment, Effects of global recession on Poland

1. Introduction

The recent global recession and resulting rapid contraction of the availability of international capital have had a major negative impact on the FDI flows to many economies. While generally the impact of FDI on a host economy can be controversial, its rapid decline is always negative. Typically, the positive impact of FDI stems from filling domestic savings gaps, transferring technologies, upgrading domestic labor market and increasing exports; its negative effects are linked to the results of possible sharp contraction of its flows.[1] The major question discussed in this paper deals with the effects of the recent global recession and financial crisis on Poland's inflow of FDI. In most countries, global recession led to an increased market apprehension and reduction of FDI. In Poland's case, this reduction was short-lived and after some structural adjustment, FDI continued flowing, positively affecting Poland's growth.

In the first part of the paper, we consider the major factors attracting high and rising capital flows to Poland in the last decade prior to the recession, examining FDI by industry and country of origin. In the second part, we present changes in those flows following the global recession and financial crisis, finding that the initial reduction of FDI in 2008 has been reversed by 2010, though the recent FDI is often directed towards new and different projects. After analyzing the key reasons for a limited contraction of FDI in Poland, in the last section we describe its new post-crisis patterns. We conclude that crisis induced contraction of FDI in Poland was short-lived, and led to some restructuring of projects involved but overall had no major impact on the economy.

2. Literature Review

The rapid increase in international FDI flows has been followed with the similar rise in academic research on its causes and effects. Historically, most research on FDI attempted to quantify the importance of various factors driving foreign investment. Classical models determining FDI rely on location approach (Dunning 1981), often focusing on factor endowments (Helpman, 1984), openness to trade (Hejazi 1999), comparative advantages and institutional factors (Bush et al., 2003). However, the literature is not unanimous on the relative importance of each of those factors, as some studies find market size and economic growth to be the key determinants (Pye 1998 and Altizinger 1999) while others question their relevance (Holland and Pain 1998), prioritizing labor competitiveness and/or business climate.

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When the role of factors attracting FDI is examined for Poland in the last decade, the literature stresses such key drivers as market size and macroeconomic growth, competitive labor costs and productivity, trade openness, currency stability, access to the third markets, subsidies and tax incentives. Specifically, the size of Poland's domestic market, the largest of central European economy undergoing transition, and its economic growth have been highly relevant in attracting FDI (Savary 1997 and Resmini 2001). However, some research (Lankes and Venables 1997) found labor, particularly competitive wages to be the primary reason for such inflows. Following Poland's accession into the EU in 2004, several additional factors gained importance in FDI decisions - Poland's trade openness, access to the third markets, taxes and subsidies available through the EU funds (Merlevede and Schoors 2004). Additionally, following the Polish currency peg introduced in 2004, which facilitated its relative stability, limited currency risk added to the attractiveness of that market.

While there is an extensive literature on the factors facilitating FDI flows, the literature on FDI responses to the recent recession and financial crisis is still scarce. In this study we examine the response of Poland's FDI to the 2008 global recession and factors explaining this response.

3. Importance of FDI for Poland

Among the emerging market economies of Central Europe, Poland has attracted the largest inflow of FDI in last decade, peaking at over 15 billion dollars in 2006. Poland was also home to the highest number of FDI funded projects (see Chart 1). In fact, in the period 2001-2007 the average growth rate of Poland's FDI exceeded its macroeconomic growth rate, accounting for over 5 percent of annual GDP, as accumulated FDI stock reached almost 25 percent of GDP by 2006 and 50 percent in 2010, and substantially supplementing local sources of capital (Poland 2011). FDI also played a critical role in Poland's foreign trade as it generated more than half of that country's turnover in 2005-2010 (see Table 1).

Historically, the dominant sectors attracting FDI to Poland included manufacturing, primarily automotive, food processing, electronics and telecommunications sectors, immediately followed by the financial services industry and most recently, by real estate and retailing. As of 2008, FDI in manufacturing represented about 37% of the country's total stock (Torrisi, R. 2009**)** and some of the major companies participating in the process included Dell, which moved large part of its operations from Ireland, included GE, GM and Microsoft.

Over the last decade, the ranking of countries involved in Poland's FDI shifted only slightly, as the top sources of funding continued to be Luxemburg, Germany, France and Netherlands. In 2010 alone, companies from Luxembourg invested over $ 2.5 billion, the largest of them being ArcelorMittal (steel company), which created over 10 thousand jobs. Other firms originating from Luxemburg include Goodyear Luxemburg, Avon Luxembourg Holdings, Best Eastern Plaza Hotels International, and Empik Centrum Investments. One reason why Luxemburg dominates the chart stems from its' liberal tax policies, which encourage many foreign and Polish firms to take advantage of that market entry. It is not possible to quantify the number of Luxemburg investors with Polish links or heritage but they are believed to be substantial in numbers (Wilkowicz, 2011). Thus, some of Luxemburg FDI flowing to Poland often originated in Poland but companies are registered for tax purposes in Luxemburg.[2]

The consistently high positions of Germany, France and other EU members are rooted in more traditional reasons related to the attractiveness of Poland's market. These reasons include primarily the size of Polish market, its growth, and competitive labor force.

Among the factors driving FDI to Poland, its labor competitiveness has gained the major role over time as relative ratios of costs of labor to productivity remained low. Even during economic boom following Poland's accession to the EU in the period 2004-2008, the average cost per worker increased only by 15 percent (Sedlak&Sedlak 2010), of which direct pay accounted for over 75 percent of those costs. The equivalent numbers for the Czech Republic and Hungary were 40 percent and 33 percent and over 90 percent. By 2008, Poland's average hourly cost of labor was 1,104 Euro, as opposed to, for example, 4,900 euro in Luxemburg. The only countries with lower absolute costs were Slovakia, Latvia, Lithuania, Romania and Bulgaria, all smaller in size, and experiencing lower economic growth. Poland's labor competitiveness is also evidenced by its slow growth in a nominal unit of labor cost index, which was 15 percent between 2000 and 2010, as opposed to the Czech Republic 33.9 percent, Bulgaria 72.9 percent, or Hungary 57.8 percent (Eurostat Labor 2011).

Some of the reasons for Poland's labor competitiveness stem from its productivity. Using average educational attainments as a proxy, Poland's workers have one of the highest average number of school years - 18.1 (Eurostat 2011a) with numbers only higher for Finland, Island, Norway, Denmark, and Belgium, all with significantly higher wages. Educational attainment of labor in Poland is also evidenced by its fourth largest number of students enrolled in tertiary education behind Germany, Great Britain, and France, all with much higher overall population (Eurostat 2011b).

In addition to its size, macroeconomic growth and competitive labor force, following rapid legal transition in the early 1990s, Poland also provided a relatively stable fiscal climate for FDI, introducing relatively a few changes in tax code in the last 15 years. Some of the most attractive features of Poland's legal environment include its lowest indirect taxes on products within the EU 27, including import duties, low employers social contributions, and both low income and corporate taxes. In these last two areas Poland ranks 4th and 6th in among 27 EU countries.

4. FDI responses to the 2008 recession and financial crisis

4.1. Stability of financial sector and housing market

Following the 2008 global recession and financial crisis, the flow of FDI declined worldwide. While initial contraction of FDI often did not distinguish among emerging markets, by early 2009 Poland became one of few economies where outflows diminished, remaining roughly at $11 billion through 2010 (Ernst & Young's 2011). In fact, by 2010 Poland's new FDI inflow constituted more than half of the total of ten neighboring countries and Poland climbed to the 11th position in the ranking of thirty most attractive FDI locations worldwide (see Table 2).

There are several reasons for this limited contraction of Poland's FDI in the midst of global recession. Unlike the rest of the EU, Poland's economy continuously grew despite the global downturn; in 2009 at 4.7 percent (the highest rate in Europe), 2010 at 3.9 percent and 2011 at 4.3 percent. That growth was facilitated by several macroeconomic structural and policy factors, most of which are beyond the scope of this paper. However, two key factors contributing to macroeconomic growth and critical for FDI inflows involved relative stability of Poland's financial sector and housing market. These are the same sectors that attracted new FDI to Poland and were also the hardest hit in other countries.

The relative resilience of Poland's financial sector to global recession has several explanations. First, Poland's conservative banking strategies precluded banks from purchasing speculative instruments; second foreign mother banks decisive assistance from at the onset of the crisis and third, the absence of the housing bubble. Prior to the financial crisis, in 2007 the Polish banking system was dominated by foreign commercial banks, primarily originating from the EU countries. Relatively to other transition economies Poland began privatization of its banks relatively late and foreign banks operating in Poland performed traditional roles of commercial, not investment banks. Consequently Poland was not exposed to the toxic assets causing major financial problems in other countries.

Foreign mother banks also shielded Poland's financial system. Those mother banks rushed to the rescue when needed; increasing the inflow of liquidity by 60 percent in the period June 2008-2009 (28 percent if adjusted for the exchange rate fluctuation). Since Poland's financial investments were traditionally viewed as strategic by mother banks, they continued to share know-how, improve infrastructure, and only gradually introduce new financial products. Based on studies of Russian banking sector response to the crisis, literature indicates (Fungacova 2011) that typically foreign-owned banks reduce their credit supply more than domestic private and state controlled banks, supporting the hypothesis that foreign banks have a "lack of loyalty" to domestic actors during a crisis, as well as the view that an objective function of state-controlled banks leads them to support the economy during economic downturns. This hypothesis was not verified by Poland's experience.

The relative financial stability has not extended to the rest of the region. While the percentage of non-performing loans in Poland remained roughly stable between the summers of 2008 and 2009, accounting for only 4.5 percent of all loans in July 2009 (Cienski 2009), the number of non-performing loans regionally, on average, more than doubled. In Estonia, the growth rate of non-performing loans was 2.6 times, and in Latvia, the number of non-performing loans more than tripled (EBRD 2009).[3] Poland's loan-to-deposit ratio of 120% in March 2009 was considered relatively safe compared with many other developed economies, and its loan/asset ratio of 56.0% matched the median number in that period for Western European countries (Banker 2009).

At the same time, total deposits in Poland grew even in the midst of the crisis, averaging 18.6 percent between June 2008 and 2009. At the same time, the banking capital adequacy ratio dropped only slightly from 11.5 to 11.1 percent by July 2009 (Urzad Komisjii 2009), allowing bank profitably to remain positive, averaging 8.4 percent in 2008 and 2.7 percent in the first quarter of 2009 (GUS 2009c).

While mother banks often shielded their banks in Poland from major effects of the crisis, they did not entirely eliminate its impact. The key negative impact of recession was felt by the in terms of risk management, particularly in terms of banking policy towards credit for corporate clients. Foreign banks limited their credits for Polish firms more than Polish banks; for example, in the 2008-2009 period, the decline in credit available was from 2.4 to 1.2 percent in Polish banks and from 1.9 to -0.2 percent in banks with foreign capital. At the same time, there was basically no difference in credit response towards households between banks with foreign and Polish capital.

The second critical reason for Poland's relative macroeconomic stability and continuous inflow of FDI was its housing market. Historically, throughout the 1990s Poland experienced relatively slow growth of the mortgage market, in the face of persistent and sustained demand for housing. By 2008, mortgages constituted only 10 percent of Poland's GDP, as compared to 18 percent in the Czech Republic, 20 percent in Hungary, and 70 percent in the United States (Global Property Guide 2009). This limited use of mortgages also contributed to the relatively low share of consumer debt and subprime lending was virtually nonexistent.

The positive macroeconomic impact of particular bank practices is well-illustrated by the mortgage policies of UniCredit. UniCredit, which owns Poland's two largest banks, issued mortgages exclusively in Polish currency. This buffered 30 percent of all Polish mortgages from short-term currency depreciation and, in so doing, helped diminish the level of domestic panic and the magnitude of capital outflows by investors from Poland. It also contributed to stabilizing real property values by allowing more Polish borrowers to remain timely on their loan payments, and incentivizing them to do so.

Moreover, the same slow development of the mortgage market also characterized Poland's poorly developed foreclosure and bankruptcy procedures, which further shielded real estate values. Consequently, in the first quarter of 2009, the average decline in real estate prices ranged from between just 3 percent in Warsaw (the most expensive and fastest growing housing market in Poland) to approximately 9 percent in Krakow (Open Finance 2009). By contrast, the average decline in real estate prices exceeded 15 percent in the Czech Republic and almost 30 percent in Hungary (Global Property Guide 2009). It would be therefore safe to say that Poland avoided the bursting of real estate bubble felt by many in the region.

This confluence of factors helped persuade foreign investors, who initially failed to differentiate between East European markets, to reconsider Poland, which in turn positively affected the value of Polish currency. In fact, between February and September 2009, the zloty appreciated 19 percent and exceeded its pre-crisis dollar value (NBP 2009). The zloty appreciation rendered Swiss franc denominated mortgages more affordable, as persistent housing shortages made the subsequent correction in asset prices and tightening in credit conditions less deflationary to the Polish economy than elsewhere in the region.

4.2. Rising role of offshoring and outsourcing

One of the additional factors contributing to the resilience of Poland's FDI to the global recession was its continuous attractiveness to offshoring and outsourcing. When companies decide to offshore their business operations to low-cost countries, typically they have two choices. One is to open a company-owned shared services centre, and the other is to outsource operations to a third-party provider. In the last decade Poland became a major third party service provider for a great number of multinationals, including some of the largest, such as Royal Dutch Shell, Tchibo, Electrolux, and Philip Morris International. Poland's ability to attract FDI through this market entry mode is often compared to that of India, which has a population almost 28 times that of Poland but the suitable pool of engineers in India is only three times larger than that of Poland. However, the EU membership and consequent adoption of the EU data protection laws makes Poland often more competitive, particularly for HR offshoring.

Additional factor attracting offshoring capital stems from Poland's urbanization. In addition to its capital Warsaw, Poland has several large regional cities with population greater than 500,000.

Foreign investors seeking offshoring location typically prefer large non-capital cities, with developed infrastructure but lower costs of operations. The most successful cities are Krakow, Lodz, Wroclaw, Gdansk, and Poznan as compared to Hungary and the Czech Republic with only one or two cities large enough to be BPO hubs. Poland's large cities tend to specialize and benefit from economies of scale: Warsaw, Lodz, and Poznan are big on finance and accounting, while Krakow, Gdansk, and Katowice focus on IT, and Wroclaw leads in research and development.

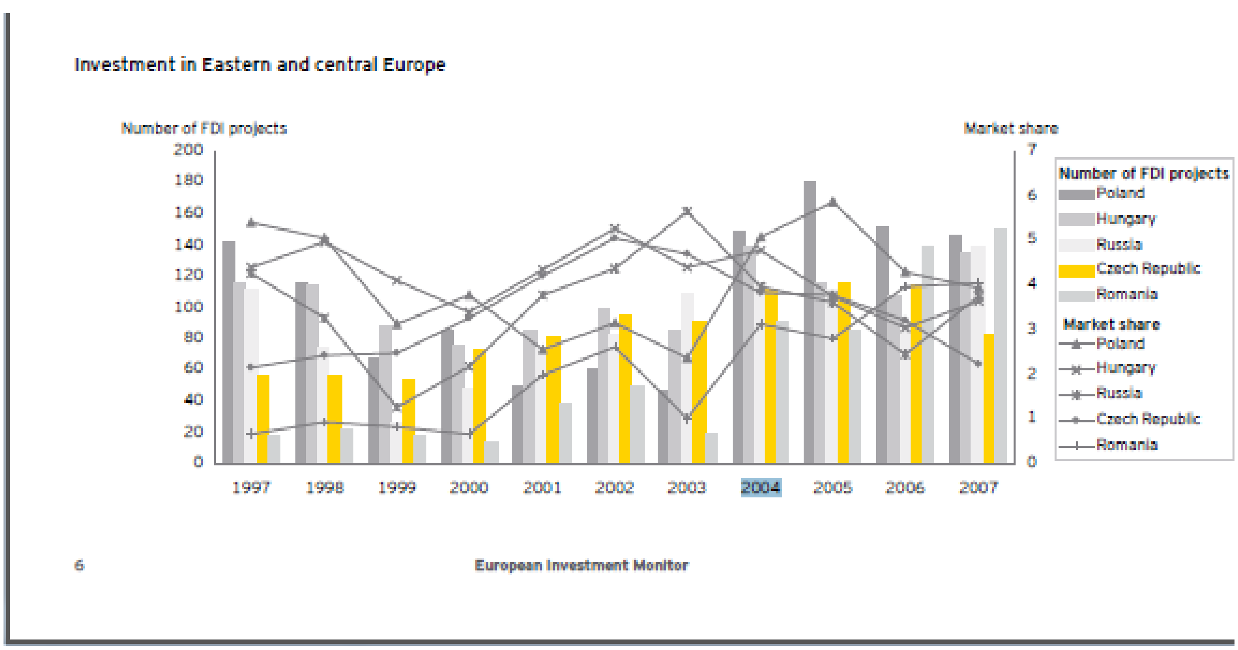
The FDI flow to Poland's financial services, IT, and HR continued despite the global recession. Between years 2005-2010, the number of new FDI funded business centers in Poland increased from 123 to 300 (Ernst&Young, 2011). In 2009/2010 alone, the growth rate of new jobs stemming from offshoring was 70 percent as compared to the average of 21 percent for Central and Eastern Europe (Ernst&Young, 2011). By 2010, offshoring related jobs accounted for second highest number of Poland's FDI related jobs, after the auto industry,[4] the process which must have further diminished the impact of the global recession on Poland's economy.

5. Conclusions

The recent global recession and rapid contraction of international savings have had a major negative impact on FDI flows to many developing economies. While in most countries the global recession led to an increased market apprehension and reduction of FDI, in Poland this reduction was short-lived and after some structural adjustment, FDI stabilized and even increased in some areas.

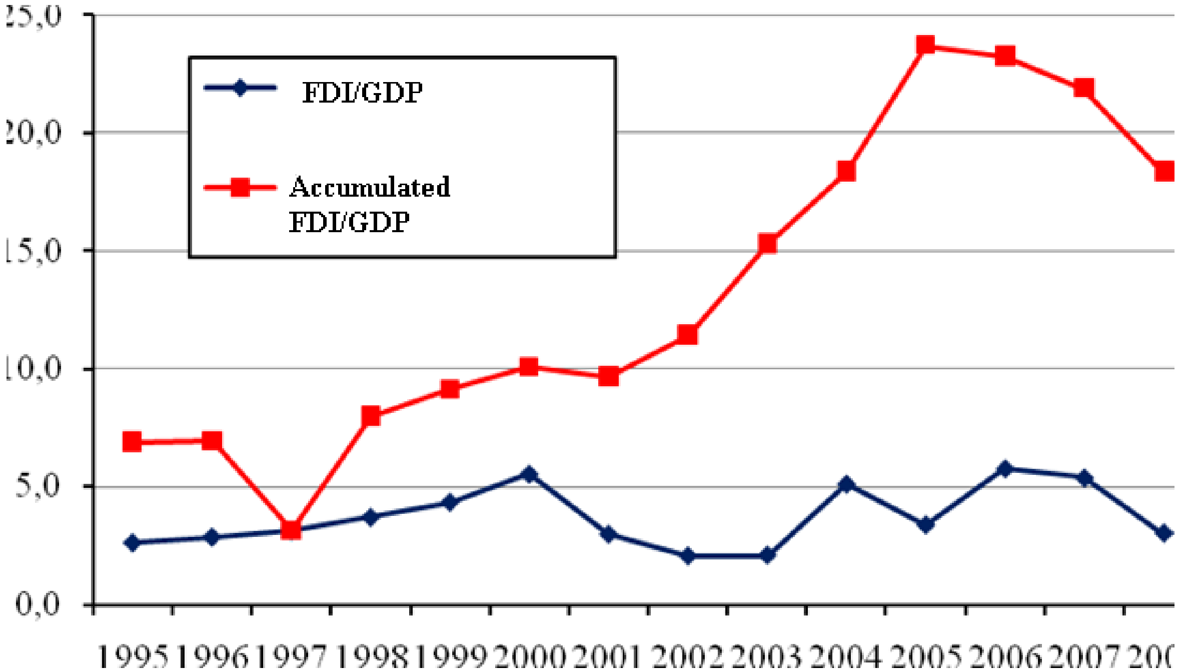
In addition to factors that originally attracted FDI to Poland, three key reasons are considered most important in explaining FDI resilience to the global recession and financial crisis: the relative stability of Poland's financial and housing sectors as well as Poland's rising attractiveness for offshoring. The reasons for the relative stability of financial and housing sectors, particularly hard-hit elsewhere are related to the role of foreign banks in Poland and slow development of the mortgage market. The rising inflow of capital though offshoring, which was also helpful in offsetting some outflow of other forms of FDI is related to its changing composition. By mid-2000s, the composition of offshoring capital shifted from supporting low technology manufacturing in favor of medium and high technology sectors, banking, real estate, and IT sectors. Consequently, the impact of global recession and financial crisis on Poland's FDI was limited and after its short contraction FDI continuous to have a strong positive effect on Poland's growth despite global economic downturn.

Chart 1. Market Share of FDI for selected countries in transition



Source: http://stats.oecd.org

Table 1. Relation between FDI/ GDP and accumulated stock of FDI/GDP, in percent



Source: Grażyna Ancyparowicz, 2009, p. 22

Table 2: Inflow of FDI in 2010 in EU 10 countries in billions of US dollars

Country	BUL	CZ Rep	EST	HUG	LATV	LITH	**POL**	ROM	SLOVA	SLOVE
FDI inflow	4.5	2.7	1.7	-5.6	0.07	0.3	**11.4**	6.3	-.05	-.067

Source: Poland's Competitiveness, 2011, p.103

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Endnotes

[1]The other possible negative impact of FDI stems from providing wrong kind of resources and distorting domestic factor endowments. Given the positive role of FDI for Poland that possibility is not covered here.

[2] High share of FDI from is also explained by that country's tax policies

[3] Unfortunately, it is still too early to fully assess the causes of these diverse growth rates. They may reflect procrastination strategy among banks to roll-over dubious loans, or an upgrading of risk-management systems by foreign parent banks.

[4] It should be noted that there is some overlap in previously reported statistics on the number of new jobs originating though FDI in the financial sector and jobs listed as part of offshoring.