

Foreign direct investment and economic growth in the new EU Member States

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According to Article 2 of Treaty establishing the European Community the Community should establish a common market to promote development of economic activities, growth and competitiveness.¹ In Article 3 of the Treaty the common market is characterized as abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital. Above-mentioned movement freedoms of production factors were determined to promote entrepreneurship throughout the Community.

Directive 88/361/EEC of 24 June 1988 for implementation of Article 67 of the Treaty determines the main sorts of capital. Those are: foreign direct investment, portfolio investments and loans. Particularly foreign direct investment flows more between Member States and amongst Member States and non-Member States. Foreign direct investment is significant for the host country because it usually includes knowledge and technology transfers.

Since joining to European Union the new Member States are part of the common market and thus foreign direct investment inflows have increased. Already according to Accession Treaty 10 acceding countries had to eliminate all restrictions imposed on free movement of capital, however joining to European Union can be associated as a “second wave” of foreign direct investment inflows. As an opportunity to receive new technologies and innovations foregoing direct investment is important for these states to enhance their competitiveness.

Foreign direct investment flows

Capital has become highly mobile across countries as a result of globalization. Under perfect capital mobility it moves from capital rich countries with low marginal product of capital to capital poor countries. The explosive growth of capital flows is one of the main characteristics of economic developments of the late twentieth century and early twenty first century.

Foreign direct investment (hereafter – FDI) is one of the most important capital flow. The most remarkable feature in FDI in recent years is the acceleration in mergers and acquisitions activity.

FDI flows are the largest capital flows to developing countries, where they represent 10% of gross fixed capital formation in 2003².

FDI contributes to smoothing economy and promoting sustained economic growth because:

1. Many transnational enterprises seek to establish both production and R&D activities in different locations all over the world, providing them with either cost effective production or an abundance of educated people and information infrastructure.
2. FDI stimulates growth of income. It can enhance growth in several ways: productivity spillovers - advanced technologies and skills. De Mellon has found that total factor productivity is positively affected by FDI³.

¹ Official Journal C 325 of 24 December 2002, p. 40

² Commission of European Communities, The EU Economy 2005 Review, Brussels, 11 November 2005, p.23

³ Theodora S.Kosma, Constantina Kottaridi, Jimmy McHugh, *On the different impact of FDI on host economies*, p.

1. FDI contributes to economic development. Increase in capital increases the output of the enterprise.
2. FDI enhances skills – usually it is possible for labour to be trained in the parent enterprise. When the investor's knowledge is absorbed by the domestic worker, they become more productive.
3. FDI contributes to increasing the export level through market access arising either from foreign' enterprises economies in scale in marketing or from their ability to gain market access abroad. Besides their contribution through joint ventures, foreign firms can serve as catalysts for other domestic exporters.
4. FDI also includes managerial expertise.

We can distinguish between so called horizontal FDI and vertical FDI. Horizontal FDI can be expressed as market-seeking investments, aimed primary at the domestic market in the host country when local production is seen as a more efficient way to penetrate this market than exports from the source country. Increased market – seeking FDI in the new Member States can be perceived as use of newly opened market opportunities. Vertical FDI is cost minimizing investment, when an enterprise chooses the location of each link of its production chain to minimize global costs and use factor cost advantages in host countries. Both horizontal and vertical FDI put capital into further production and contribute to the industrial base of host country.

Inflow of FDI influences such conditions:

1. The absolute size of foreign market;
2. Political risk – risk of a failure to pay for services, loans, dividends or prevention of capital repatriation; it does not reflect the credibility of individual business partners in the country;
3. Economic performance. It takes into account economic growth, currency stability;
4. Development of the current account of the balance of payments, public finances and unemployment rate.
5. Debt – the rating obtained reflects the assessment of the country with regard to the ratio of debt service to exports, the current account balance to GDP and the ratio of foreign debt to GDP; the rescheduling of the country's foreign debt is also taken into account.
6. Credit rating – an average of the country's rating as assessed by Moody's, Standard & Poor's and IBCA.
7. Availability of international financing – reflects the ability of the country to quickly access international capital markets.

Inward FDI stock in the new Member States at the end of 2004 reached 230 billion USD and since then FDI inflows have increased (see table1). The new Member States are attracting to foreign investors for such reasons:

1. These countries are increasingly attracting FDI in activities that require higher skills such as engineering. This quite often involves upgrading existing facilities and focusing on export-oriented manufacturing, particularly in the automotive and machinery industries. In 2001 foreign owned enterprises generated 70% of manufactured export in Czech Republic, Hungary, Poland and Slovakia¹;

¹ United Nations, World Investment Report, Transnational Corporations and the Internationalization of R&D, New York and Geneva, 2005, p.87

2. Political and economic risks are eliminated;
3. Consolidation of some industries and restructuring of certain transnational companies operations are taking in the new Member States.

Table 1. FDI net (% GDP)

State	2004			2005
	II	III	IV	I
Czech Republic	2.2	2.3	3.7	3.6
Estonia	6.2	5.1	6.0	14.0
Hungary	1.7	3.4	3.6	3.9
Latvia	2.7	3.6	4.0	4.4
Lithuania	0.9	2.4	2.3	2.2
Poland	2.2	1.8	2.2	1.8
Slovak Republic	2.9	3.3	3.1	2.4
Slovenia	N/A	-0.2	0.2	-0.2

Foreign direct investment flows in the new Member States of European Union

The process of enlargement in particular has triggered an intra-EU relocation phenomenon as European Union enterprises take advantage of the increased choice of sites for location production to be found in the new Member States while consolidating the enlarged Single Market. The importance of such intra-EU relocation is illustrated by fact that since the early 1990s FDI outflows from the EU15 to the new Member States have been four times larger than those to China despite the boom in FDI flows to developing economies. Besides for most companies the main driving force for investing in the new Member States is not lower wage costs, but rather the achievement of first mover advantages and the opportunity to get access to a growing market. These investments usually did not imply a relocation of economic activity abroad and/ or job loss domestically; they rather induce further growth.

Accession to the Union and privatization were major factors in the near past. During 1990s it was the main driver. Recently main motives of foreign investors to invest in the new Member States are economic growth (see table 2), low labor costs, low corporate tax, and size of the market, political and macroeconomic stability.

Table 2. Real GDP

State	2004			2005
	II	III	IV	I
Czech Republic	4.5	4.6	4.6	4.4
Estonia	7.3	8.3	6.6	7.2
Hungary	4.5	3.9	4.1	2.9
Latvia	7.7	9.1	8.6	7.4
Lithuania	7.3	5.8	6.7	5.7
Poland	6.1	4.9	4.0	2.1
Slovak				

Republic	5.5	5.3	5.8	5.1
Slovenia	4.9	5.0	4.3	2.6

Nonetheless, the share of the new Member States in total EU FDI activity remains rather limited in aggregate terms. In 2003 the total inward FDI stock in the 8 largest new Member States represented only 3.3% of total EU15 outward FDI stock. Survey evidence confirms the importance of the New Member states in the location strategy of European Union enterprises. Efficiency-seeking motives may be important drivers of inward FDI in manufacturing in the new Member States. For EU15 enterprises these locations offer not only lower relative factor costs and high levels of technical and educational ability but also “near-shoring” advantages due to cultural and linguistic similarities, greater ease of ensuring compliance and the geographical proximity, which might be critical for some firms, especially for those requiring frequent contacts with clients. In contrast, the FDI in the services sector, which takes up the majority of FDI in these countries, seems to be more geared to serving local markets.

Inward FDI in the new member States from the old ones compose around 80% of total inward. The most active countries are Germany and the Netherlands, together accounting more than 40% of total inward stock. France and Austria follow them and their share is 8-9% each. The varying shares of countries highlight the importance of geographical factors, although some countries may act as channels for other countries’ investment.

FDI in the new Member States is largely concentrated in Polish and Hungarian regions and also to some extent in Latvia.

Besides there is evidence that in the new Member States foreign offshoring via the setting up of local affiliates is increasingly changing the industrial structure. The stock of FDI in GDP is quite substantial, ranging from around 20% in Slovenia and Poland to almost 80% in Estonia. Moreover, in terms of value added in manufacturing, FDI amounts from 23.1% in Slovenia to as high as 64.9% in Hungary.

The service sector has received the majority of FDI inflows. Particularly financial intermediation, trade, real estate and transport have received almost 55% of the total FDI while manufacturing comprise around 40% (see Annex 1, 2, 3, 4, and 5). FDI in service sector is usually motivated by market seeking, besides services’ supply of services often request presence in the country, although FDI in export-oriented services also seems to have become important factor.

In the manufacturing sector is seen that foreign investors’ activity has been concentrated in a few industries, notably in transport equipment, electrical and eletronical equipment and food, which have received around one-half of the FDI in manufacturing. Transport equipment has gained in importance in recent years (together with metal industry), which may indicate the creation of “manufacturing export platform” in these industries. FDI in the food industry has become relatively less important, as this has mostly related to privatization and the buying of existing firms and less to relocation.

Foreign direct investment and productivity growth in the new member Sates of European Union

As the effect of structural transformation and reallocation of resources towards more productive sectors fade, it will become increasingly difficult to sustain the rapid productivity growth experience of the last decade. While the most countries still have some potential for

reaping productivity gains from resources reallocation, notably from agriculture and in some countries as Poland from traditional heavy industries, where productivity remains low, towards modern industry and services, rapid output growth rates are likely to gradually become more dependent on raising employment rates and, where low, investment rates. Higher rates of factor accumulation will be particularly important for Poland and to some degree the other new EU Member States, while in the Czech Republic the main challenge will be to enhance the productivity of investment. In Latvia, Lithuania and Estonia raising employment will be the main challenge, although Lithuania needs more investment. Among the variables representing competition and technological spillovers, trade openness appears to have been the most important. Business research and development spending has had a positive but statistically small impact on productivity growth while FDI inflows has had a positive but statistically insignificant impact. The reallocation of production factors towards industry has been associated with higher productivity growth, while the opposite is true for services.

Lower productivity of the service sector may result from relatively lower knowledge or skills intensity in this sector or weaker exposure to competitive markets. The service sector is still characterized by labor – intensive production compared with the other sectors, and this may hamper productivity growth. Accordingly openness to FDI in services is of great importance

In EU8 countries services have been the main driver of output growth in all countries, but industry has not been far behind. Slovakia, Poland and Lithuania all saw average productivity growth in excess of 3% during 1996-2004, while in Latvia and Czech Republic at the other end, average TFP growth was around 1.5%. Restructuring of remaining “strategic” or “socially important” sectors such as heavy industries, transportation, mining and agriculture will facilitate the flow of resources and towards more productive activities.

Although the majority of R&D is still done at the home, the internationalization of R&D is a slow but real process. The share of foreign enterprises in domestic industrial R&D varies widely across countries, ranging slightly more than 10% Finland to over 70% in Hungary and Ireland. These differences primarily reflect the contribution of foreign enterprises to industrial activity. For instance, in UK the share of foreign enterprises in R&D is smaller than they share in production. Besides the majority of the R&D conducted abroad takes place in other developed countries (the US and the UK are the top two destinations), a large number of the responding companies also carry out R&D in developing countries.

According to OECD the percentage of R&D carried out abroad is increased rapidly for example, between 1991 and 2001 by more than 50%. The share of foreign enterprises in total R&D expenditure by enterprises has risen most noticeably in the new Member States like Slovakia, the Czech Republic and Hungary.

As firms relocate their production and research facilities abroad as part of their internationalization strategies, an increasing share of patents is owned/ applied for by firms of a country that is not the inventor’s country of residence.

The emerging economies, including the new EU Member States, have exhibited strong productivity growth. Latvia, Estonia, Lithuania, Slovakia, Slovenia, Hungary, Poland and Czech Republic have experienced rapid total factor productivity growth over last ten years. Total factor productivity growth appears to have been particularly rapid in Slovakia and Poland. In these countries productivity was at 3% level whilst in Latvia and the Czech Republic it was less than one half of this rate (see table 3).

Table 3. Total factor productivity growth

	Czech Republic	Estonia	Hungary	Latvia	Lithuania	Poland	Slovakia
2000	4.2	3.8	2.8	0.5	17.3	5.3	2.6

2001	1.1	1.8	1.8	2.6	3.2	0.8	4.0
2002	1.2	0.0	1.5	6.2	2.0	1.4	3.5
2003	3.0	-0.3	0.1	4.2	2.4	4.1	3.6
2004	4.2	N/A*	3.2	N/A*	N/A*	4.7	5.3

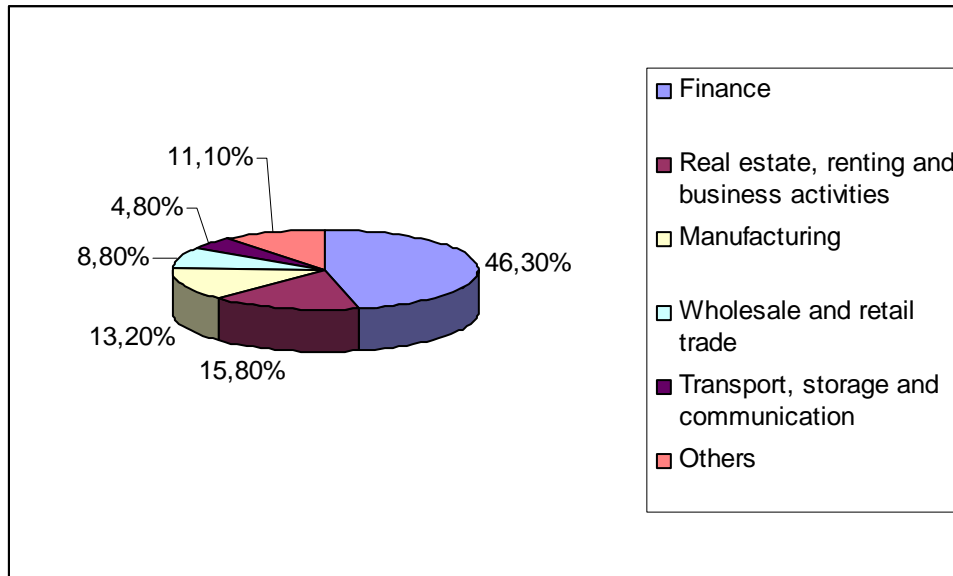
*N/A – data is not applicable

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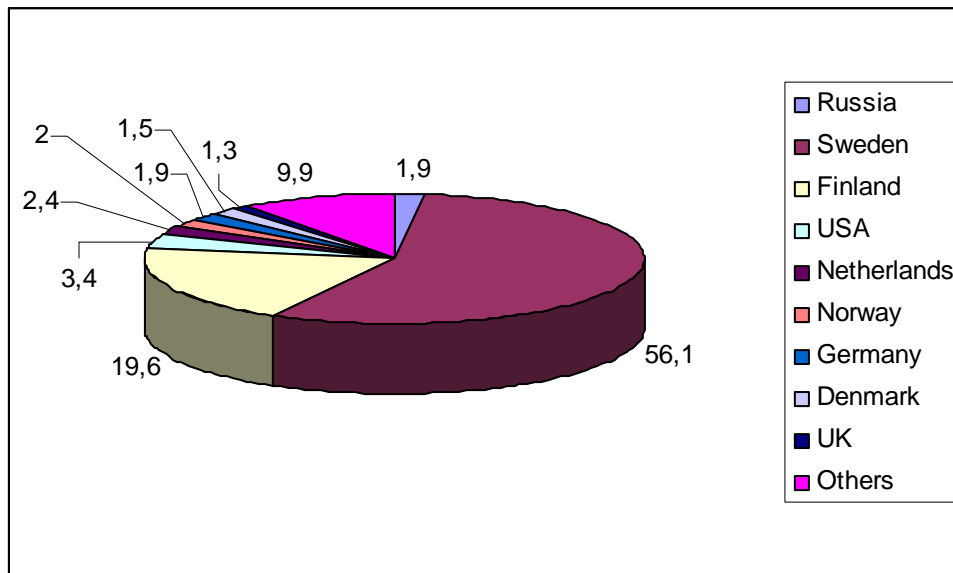
1. Commission of European Communities, The EU Economy 2005 Review, Brussels, 11 November 2005;
2. International Financial statistics, International Monetary Fund, November.
3. Official Journal C 325 of 24 December 2002, p. 40;
4. Theodora S.Kosma, Constantina Kottaridi, Jimmy McHugh, *On the different impact of FDI on host economies*;
5. United Nations, World Investment Report, Transnational Corporations and the Internationalization of R&D, New York and Geneva, 2005.

Estonia

FDI stock by activities as of 30 September 2005



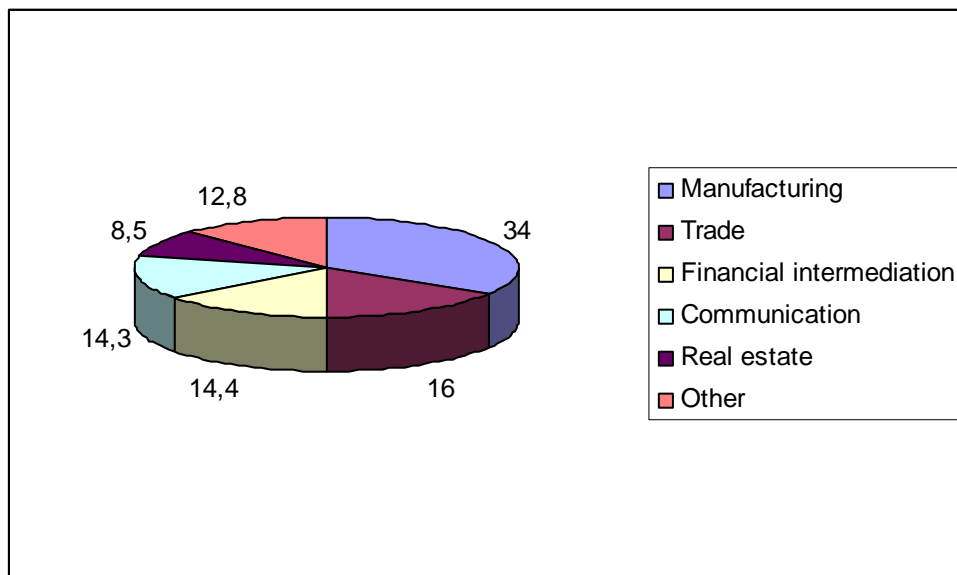
FDI stock by countries as of 30 September 2005



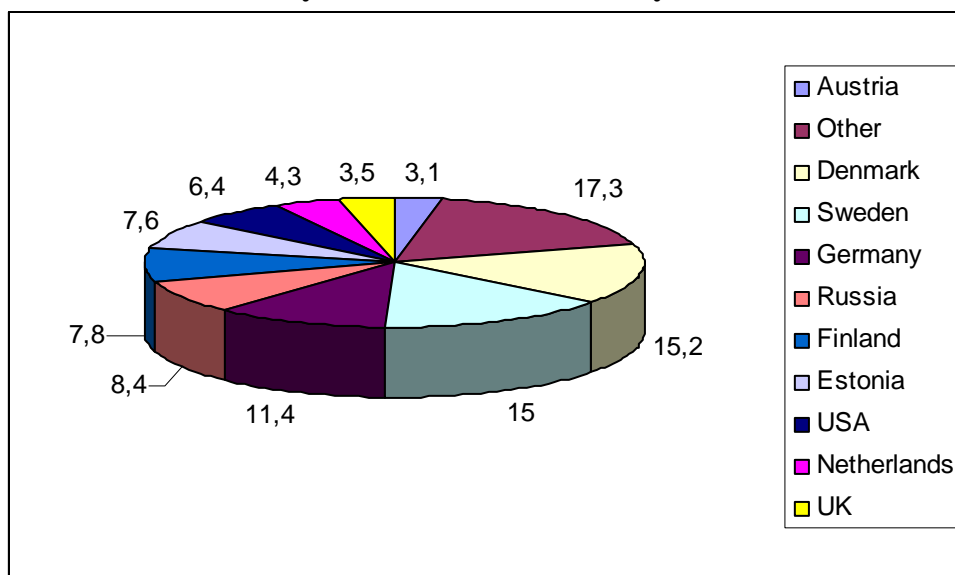
¹ <http://www.stat.ee/>

Lithuania

FDI stock by activities as of 1 January 2005



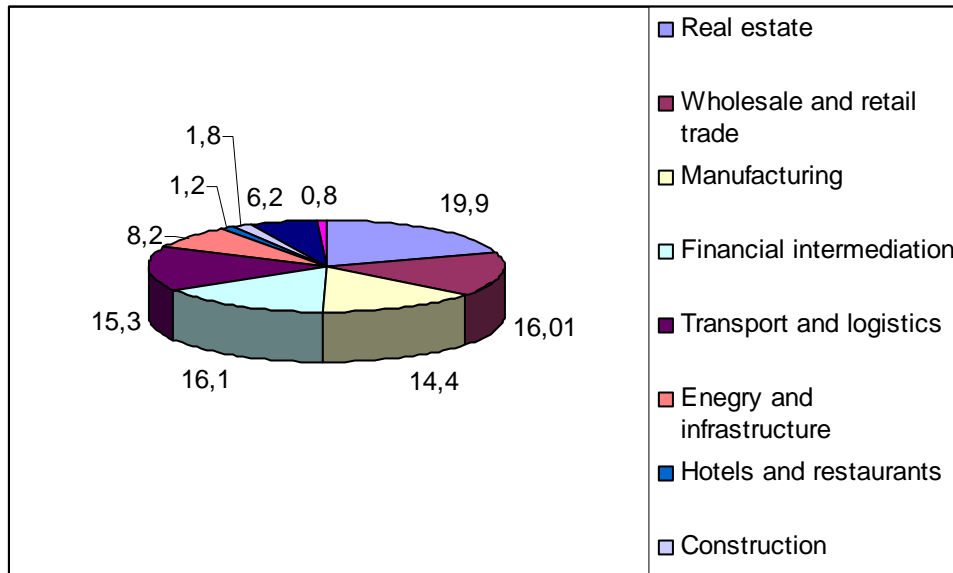
Lithuania FDI stock by countries as of 1 January 2005



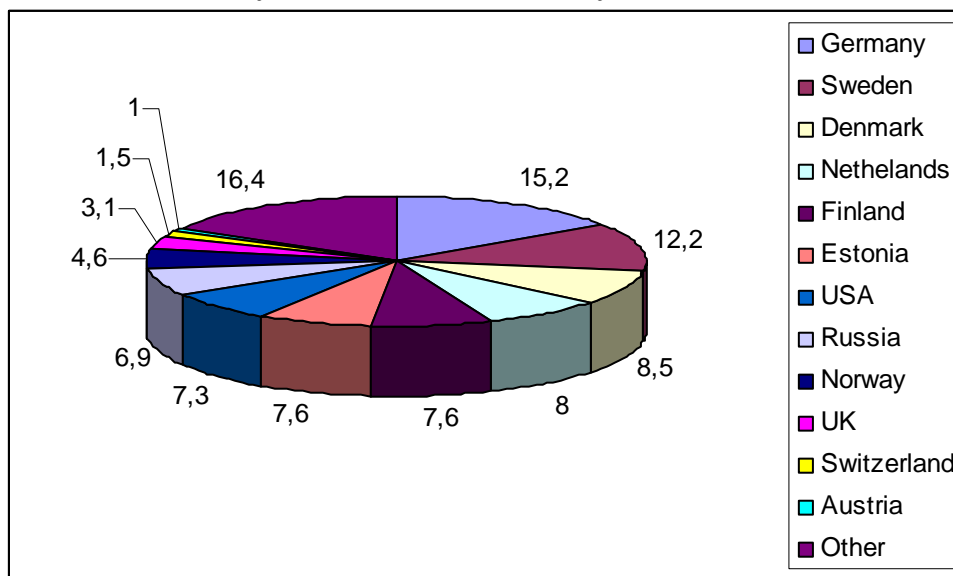
¹ <http://www.stat.gov.lt/en/>

Latvia

Latvia FDI stock by activities as of f end of year 2004



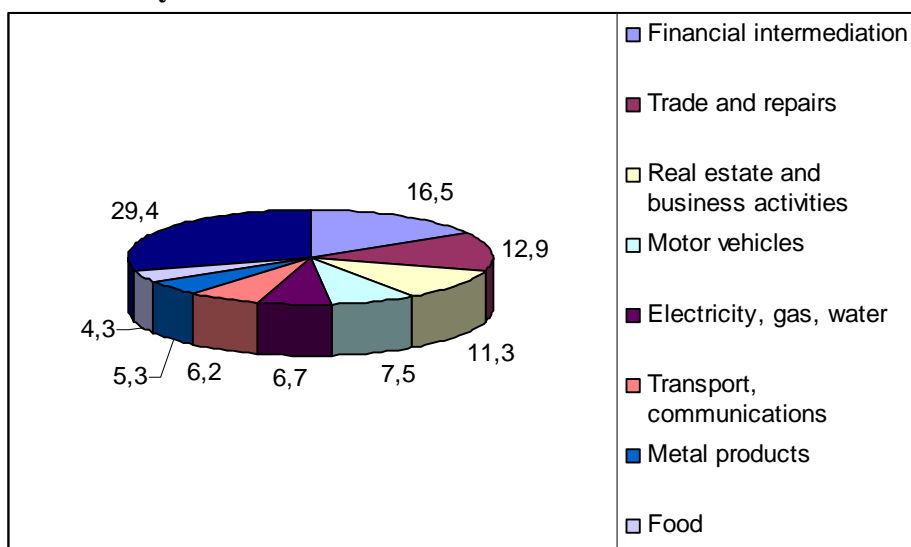
Latvia FDI stock by countries as of f end of year 2004



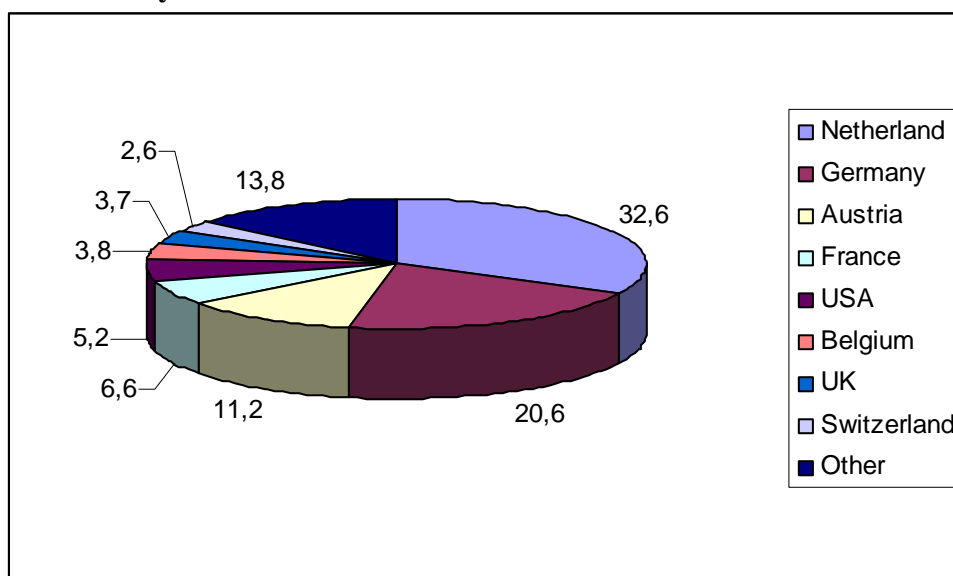
¹ <http://www.csb.lv/avidus.cfm>

Czech Republic

FDI stock by activities as of 31 december 2004



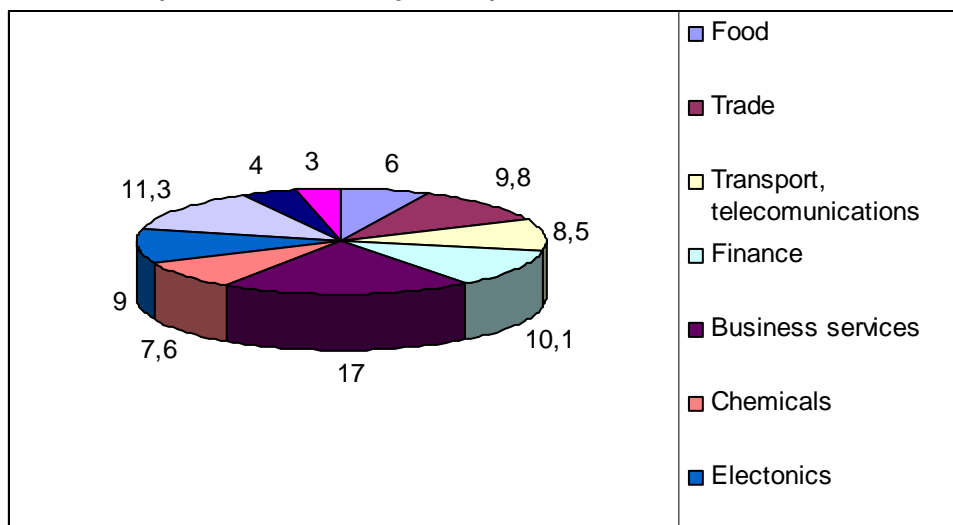
FDI stock by countries as of 31 december 2004



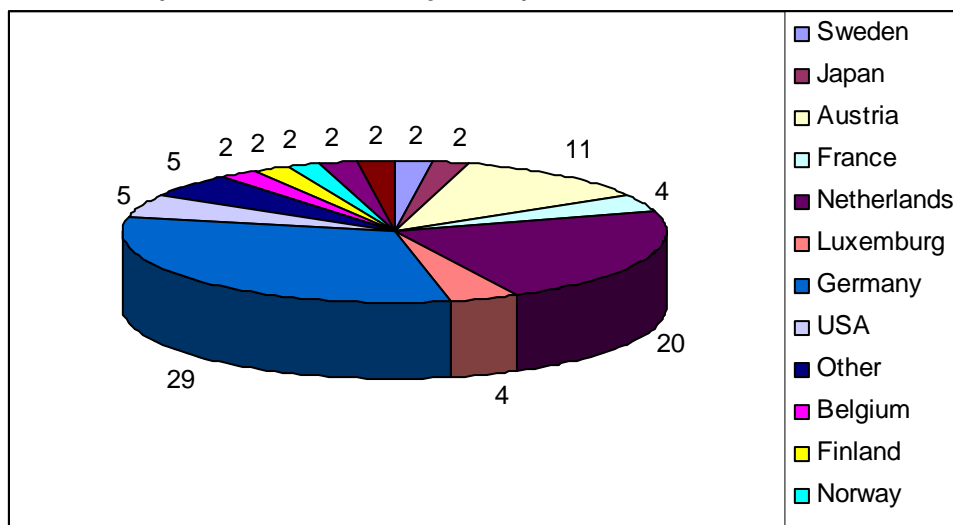
¹ <http://www.czso.cz/eng/redakce.nsf/i/home>

Hungary

FDI stock by sectors as of 24 january 2006



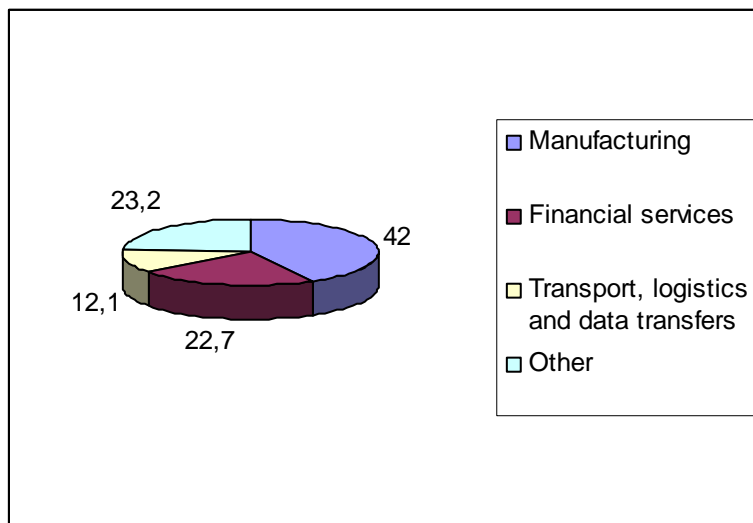
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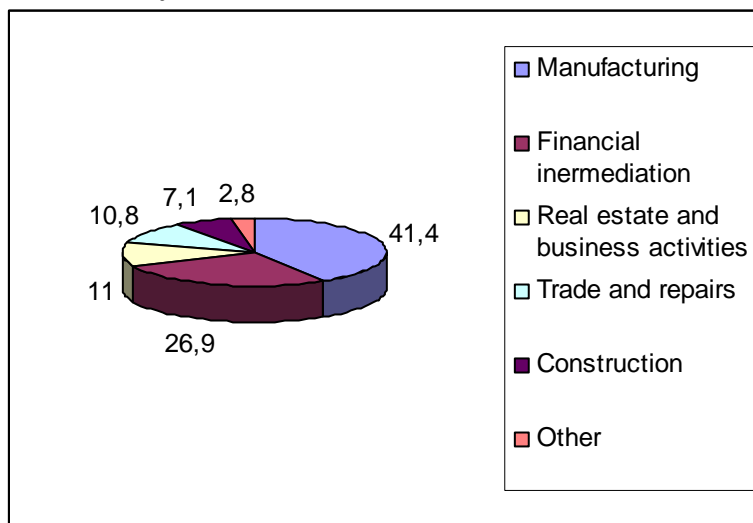
¹ http://portal.ksh.hu/portal/page?_pageid=37,115776&_dad=portal&_schema=PORTAL

Poland

FDI stock by countries as of 31 december 2004



FDI stock by activities as of 31 december 2004



¹ <http://www.stat.gov.pl/english/index.htm>