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Foreign Direct Investment in the New Central and Eastern European EU Member States

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ABSTRACT

The aim of this paper is to provide some assessment of the Foreign Direct Investment (FDI) prospects of the eight transition countries acceded to the EU on May 1st, 2004, namely Poland, Hungary, the Czech Republic, Slovakia and Slovenia and the three Baltic states i.e., Latvia, Lithuania and Estonia. In particular, it would attempt to assess the main FDI determinants for these countries after accession. Regional trade integration, labor cost, country risk, domestic market, and privatization policies appear to be significant factors mobilizing inward FDI to the EU New Member States.

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Key words: *Regional integration, FDI, EU enlargement.*

1. INTRODUCTION

The aim of the paper is to assess the Foreign Direct Investment (FDI) prospects of the eight transition countries, namely Poland, Hungary, the Czech Republic, Slovakia, Slovenia, Latvia, Lithuania, and Estonia, which acceded to the European Union (EU) on May 1st, 2004, (EU-8 countries). In particular it would attempt to assess the main determinants of the FDI flowing into these countries after accession.

There is an extensive literature on what motivates firms to internationalize their production activities. Theories are rooted in international trade and market imperfections theory (Hymer, 1976; Kindleberger, 1969; Vernon, 1966), theory of firms and internalization of markets (Buckley and Casson, 1976; Coase, 1937), and the eclectic paradigm and the Industry Development Path (IDP), (Dunning, 1977, 1993; Dunning and Narula, 1996).

FDI motives may be classified in two broad categories: market seeking, and production factor cost seeking.[1] Market size is considered a significant FDI determinant as large markets offer opportunities of capturing economies of scale, of seeking economic rents through internalizing the further use of already existing firm specific assets, *e.g*., capabilities of product differentiation and marketing, of gaining access to domestic markets and establish market shares either in a game of international oligopoly competition, or by preempting the market, or even by serving a market on equal competitive terms with local producers, *e.g*., avoiding transportation and/or trade restriction costs, closing the psychic distance between the home and host market, etc.

A number of studies on FDI in Central and Eastern Europe (CEE) point out that market seeking motives are the dominant reasons for entering these markets.[2] In particular, strong margins and growth opportunities offered by the novelty appeal of western goods and services, especially in the early 1990s; exploitation of the first entry advantage in markets with little or no competition; and capturing the local market and gaining market share are reported as the main drivers of foreign firms entry in CEE.

Low cost production, especially labor and capital cost is part of a global sourcing strategy for improving competitiveness aiming at assisting exports and increasing profits. Labor in CEE is considered of high skill and training levels compared to other developing countries with large wage differentials *vis-à-vis* the EU-15. Low labor cost has been verified as a significant motive for FDI entering the CEE.[3]

Given that CEE countries are on a path of transition from centrally planned to a free market economic regime along a political transformation from one party autocratic regimes to pluralistic Western type democracies there is some uncertainty as whether or not this process is irrevocable. This uncertainty reduces as both the form of government and political stability consolidates and both economic and political liberalization assume a stable pace. In addition as the economy overcomes the output transition shock, macroeconomic imbalances are reduced, and economic growth becomes positive and sustainable the business environment increases its investment friendliness by diminishing economic risks as they are portrayed in fiscal crises, sharp currency devaluations, inability to serve foreign debt, etc. Country risks as they are measured by interest rates, state budget balance, inflation, corruption, *etc*., are identified as having some effect on inward FDI to CEE by empirical studies (Holland and Pain, 1998; Bevan and Estrin, 2000).

2. THE MODEL

The model function is as it follows:

$$FDI = F(YN, PR, IN, LI, WR, XR, MR, IR)$$

Where:

FDI = inward FDI to country *i*

YN = GDP per capita of country *i*

PR = Privatization revenues of country *i*

IN = EBRD index of infrastructure reform for country *i*

LI = EBRD index of price, foreign exchange and trade liberalization

WR = relative labor cost = W_i over WEU-15

W_i = wages in country *i*

$W_{EU\text{-}15}$ = EU average real wage

XR = ratio of exports to EU over total exports of country *i*. That variable represents trade integration in the EU.

MR = ratio of imports coming from EU over total imports of country *i*.

IR = Ratio of lending rate in country *i* over SDR interest rate. Relative interest rate approximates country risk.

Country *i* belongs to the newly acceded to the EU transition countries, *i.e*., EU-8.

The log linear form of the equation is estimated using GSL econometric technique (with cross section weights) over a set of panel annual data comprised by all eight EU new member states (EU-8) for the period 1992-2005. The equation has a log linear form because under this specification elasticities given by the estimated coefficients are constant.

The FDI, GDP per capita, privatization revenues, infrastructure index, liberalization index and interest rates for the EU-8 countries have been sourced from EBRD Annual Transition Reports, while labor cost and SDR interest rate, from IMF, *International Financial Statistics*; and the *Eurostat*. The source of exports and imports is IMF, *Direction of Trade Statistics.*

3. RESULTS

The results are presented in Table 1. GDP per capita, privatization revenues; relative labor cost and country risk are the statistically significant variables and they all have the expected sign. Exports appear to be a significant and positively related factor with inward FDI. The negative sign of the imports variable indicates that FDI is import substituting.

Table 1
FDI Estimates for the Period 1992-2005

	GLS estimates	
Constant	–2.26	(0.78)
YN	0.56	(1.74*)
PR	0.36	(2.68**)
IN	–0.13	(0.12)
LI	2.26	(1.16)
WR	–3.31	(4.43**)
XR	0.37	(1.77*)
MR	–0.81	(2.67**)
IR	–0.50	(1.73*)
R^2	0.84	
F stat.	10.52	**
DW	2.09	

* Means significance at 10% level.
** Means significance at 5% level.
The values in parenthesis are τ-statistics

The econometric investigation shows that factors pulling FDI to the accession countries are: (a) Their domestic market with both privatization of state owned firms and import substitution present attractive options for market entry and (b) A pool of well-educated low cost labor form the basis for factor cost sourcing and then exports, especially to the EU-15 countries. Also as political and economic stability improves and a business friendly environment is consolidated, country risk is reduced and FDI activity is facilitated. FDI is rather more elastic with respect wage differentials between the EU-8 and the EU-15 than the other statistically significant

variables. The elasticity of the latter is below unit for all cases vis-à-vis elasticity above unit in the case of the relative labor cost. The implication is that future increases of the labor cost in the EU-8 towards convergence with the EU-15 would diminish the motivation of foreign firms to invest in the EU-8 to a greater extent than any favorable effect stemming from advances in the domestic market, e.g. increases of the per capita income. On the basis of the above-described scenario future prospects of FDI inflows to the EU-8 may be assessed as it follows:

(a) Diminishing role of the privatization, especially the large scale one related acquisitions, since the process is almost complete.

(b) The domestic market of the EU-8 would continue to offer opportunities for entry due to growth of per capita incomes as a result of economic growth and convergence towards the EU-15 average, but mainly, due to a number of undeveloped markets and significant gaps vis-à-vis the more mature markets in the Eu-15. Closing these gaps could spur consumer demand, create new market segments, and demand for new products and services. Potential growth rates are relatively higher in sectors facing wider gaps than the average, *e.g*., banking and financial services, corporate services, *etc*.

(c) The EU-8 integration with the single market involving the complete liberalization of flows of products and services within the enlarged EU would encourage the establishment of regional production and marketing networks that take advantages of regional differences in comparative advantages. The EU-8 countries are endowed with a well- educated labor force the cost of which would continue to be well below the EU-15 average. Currently, the hourly labor cost in the EU-8 is below some 20% of its corresponding average in the EU-15. In addition, the EU-8 offers and tries to improve a business friendly environment through cutting red tape and taxes, and providing investment incentives. That would stimulate the location or even the re-location of labor intensive value added activities ranging from manufacturing to service operations, *e.g*., call centers, software development etc. to the EU-8 at the expense of the EU-15 states. There is a possibility of establishing clusters of suppliers around a primary manufacturing activity. A good case in point is the already emerging motor vehicle cluster the foundation of which was laid by the acquisition of Skoda by Volkswagen in the Czech Republic in 1994. Rationalized FDI in the EU-8 would be related to exports activity.

However, labor cost in alternative locations is lower than in the EU-8 states, e.g. average monthly wages in Southeastern transition Europe is half the level in the Czech Republic, Poland and Hungary. Southeastern European transition countries enjoy preferential access to the EU market. Bulgaria, Romania and Croatia are accession countries; they are on a road of intra-regional trade liberalization, ongoing privatization and enterprise restructuring, and offer incentives to FDI. For these reasons they are attractive alternative locations for FDI. In addition, there are emerging FDI locations in certain Commonwealth Independent States (CIS) countries, Russia and Ukraine in particular while Asia offers low labor cost and outsourcing opportunities. Already, FDI flows to Southeastern transition Europe are increasing, while these to the EU-8 are declining. Hungary has suffered some relocation of labor-intensive production to Romania,

Ukraine and China while the Czech Republic suffered some disinvestments in the telecommunications sector.[4]

4. CONCLUSION

The econometric analysis has given results in line with the results of other empirical investigations about FDI motives in transition countries. In particular, entry to domestic markets through imports substitution and privatization related acquisitions is the primary motive while exporting to the EU-15 using the EU-8 as a low cost location follows suit. There is a mixed picture about FDI prospects in the EU-8 countries. Any upturn in FDI inflows would accrue first from the integration process with the single market leading to the building of production clusters on the basis of low cost well-trained labor; and, second, from the development of the domestic markets. Privatization related FDI would cease due to the end of the privatization process while emerging low cost locations in Southeastern Europe and the CIS along wage increases in the newly acceded transition countries themselves would challenge strongly the FDI attractiveness of the latter.

Notes

1. See Root, 1994.
2. See indicatively: OECD, 1994; EBRD, 1994; Paliwoda, 1995; Lankers and Venables, 1996; Meyer, 1998; Bevan and Estrin, 2000.
3. See for instance Holland and Pain, 1998; Bevan and Estrin, 2000; Weise *et al*., 2001.
4. See Kyrkilis, 2004.

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