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*Transforming Competitiveness in European Transition Economies:  
The Role of Foreign Direct Investment*

by

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May 29, 2004

**Abstract**

Foreign direct investment (FDI) has become one of the main drivers of globalization and integration of the European transition economies into the world economy, especially the European Union. Its growth enhancing capacity has played a significant role in transforming their competitiveness, both locally and on international markets, and its propensity to stimulate institution buliding is changing both economic and political landscapes in the region. The economic conditionality of FDI and the EU access-driven reforms are working hand in hand in helping the goals of transition and the convergence process. The achievement of both goals is seen as the best guarantor of peace and security in the region.

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# **TRANSFORMING COMPETITIVENESS IN EUROPEAN TRANSITION ECONOMIES : THE ROLE OF FOREIGN DIRECT INVESTMENT**

## **Abstract**

*Foreign direct investment (FDI) has become one of the main drivers of globalization and integration of the European transition economies into the world economy, especially the European Union. Its growth enhancing capacity has played a significant role in transforming their competitiveness, both locally and on international markets, and its propensity to stimulate institution building is changing both economic and political landscapes in the region. The economic conditionality of FDI and the EU access-driven reforms are working hand in hand in helping the goals of transition and the convergence process. The achievement of both goals is seen as the best guarantor of peace and security in the region.*

## **1. Introduction**

Foreign direct investment (FDI) has become one of the main drivers of globalization and integration of transition countries into the world economy, especially the European Union. Alongside with trade and aid it has actively been transforming the basic economic characteristics of those economies. In addition to fostering the much needed economic restructuring, it is also contributing to the equally needed institutional and regulatory reforms, which are the long term basis for sustainability of economic reforms. Moreover, the institution building process induced by FDI also affects the nationwide political architecture in countries in which it enters, causing both economic and political change.<sup>1</sup> The result of those developments is an increased speed of economic and political transformation of the

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\* I am grateful to Barry Eichengreen, Slavo Radosevic, and Robert McGee for helpful comments on an earlier version of this paper.

<sup>1</sup> Pempel, T.J. 1999.

post-socialist economies in Central and Eastern Europe and in the Baltics, and a new wave of enlargement of the European Union.

During the past several years the debate in the transition economies shifted from stabilization and recovery to growth and convergence. The aim of this paper is to illustrate the growing importance of investment liberalization for the transition economies in Europe in achieving convergence and its sustainability through improving their competitiveness. Viewing competitiveness, as defined by OECD, as an ability to grow in an open setting, the goal is to identify some of the main channels through which FDI has been enhancing their growth and export performance. Consequently, we will be looking at connections between FDI and growth, FDI and export performance, and at the influence of FDI in ensuring the prospects for future growth in transition economies.

After a short overview of definitions and recent trends in FDI in Section 2, we will turn to the interplay between FDI and growth in transition economies, which is the subject of Section 3. In Section 4 we explore the relevance of the sectoral composition of FDI for the transition economies' export competitiveness. Section 5 focuses on the long term effects of FDI. Finally, in Section 6 we offer brief conclusions and point to the wider political implications of FDI for the region.

## **2. Definitions and Recent Trends in FDI**

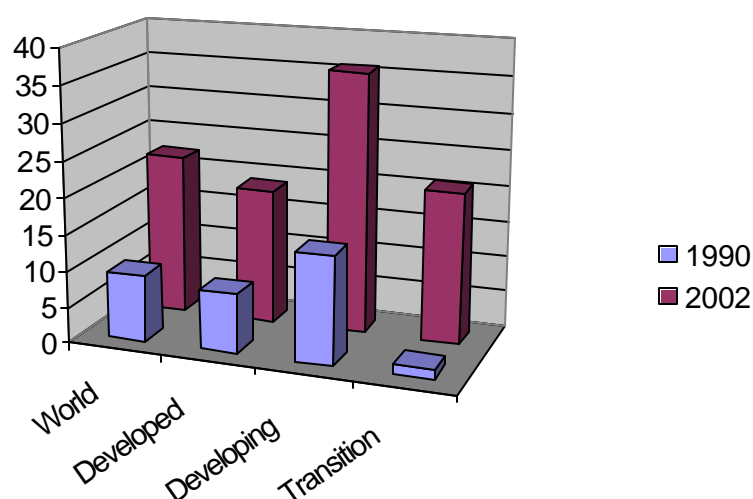
FDI represents a purchase of physical assets, such as plant or equipment, or business operations in a foreign country, to be managed by the parent corporation. It is an investment that involves a long-term relationship and reflects a lasting interest and control by a resident entity in one economy in an enterprise resident in the economy other than that of the investor. It is the ownership of 10% or more of voting stock in the local company that qualifies as FDI. Otherwise, it is regarded as foreign portfolio investment, which is an investment in foreign financial instruments such as government bonds or foreign stocks. The purpose of foreign portfolio investment is obtaining investment income or capital gains rather than entrepreneurial income, which is the case with FDI.<sup>2</sup>

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<sup>2</sup> The definitions here are based on Shim and Siegel (2001), OECD (1996), and IMF (1993).

FDI is not a new phenomenon but international production has become a particularly significant element in the world economy only in the past few decades. This is illustrated in Figure 1 by way of comparison of the inward FDI stock for different regions in 1990 and 2002. Inward FDI stock is measured as percent of GDP.

**Figure 1. Inward FDI Stock in the World Economy**  
(in percent of GDP)



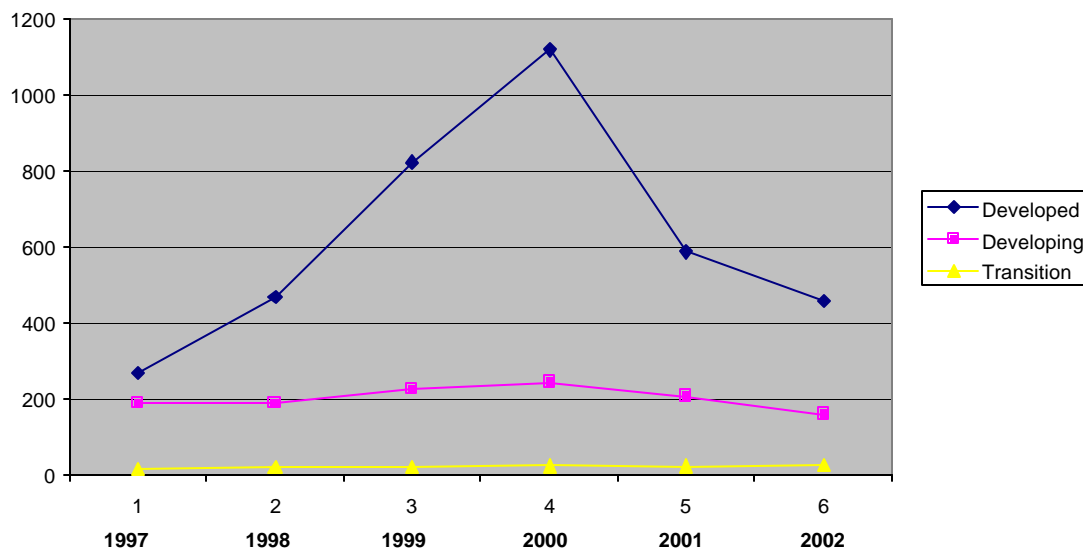
Source: *World Investment Report, 2003*.

Global FDI stock is a measure of the investment underlying international production. In 2002 inward FDI stock formed almost a quarter of the world GDP, or 22.3 percent, and the global stock of FDI was owned by some 64,000 transnational corporations (TNCs) controlling 870,000 of their foreign affiliates. Also, by 2002 TNCs employed more than 53 million people. Especially noticeable is the rising presence of inward FDI in the transition economies' production. In the period from 1990 to 2002 it rose from 1.3 to 20.8 percent of GDP.

Driven by marginal productivity and risk differentials FDI mainly flows from developed to developed countries. However, as Figure 2 shows, in the past several years trends have been modified.

**Figure 2. World FDI Inflows by Region, 1991-2002**

(billions of dollars)



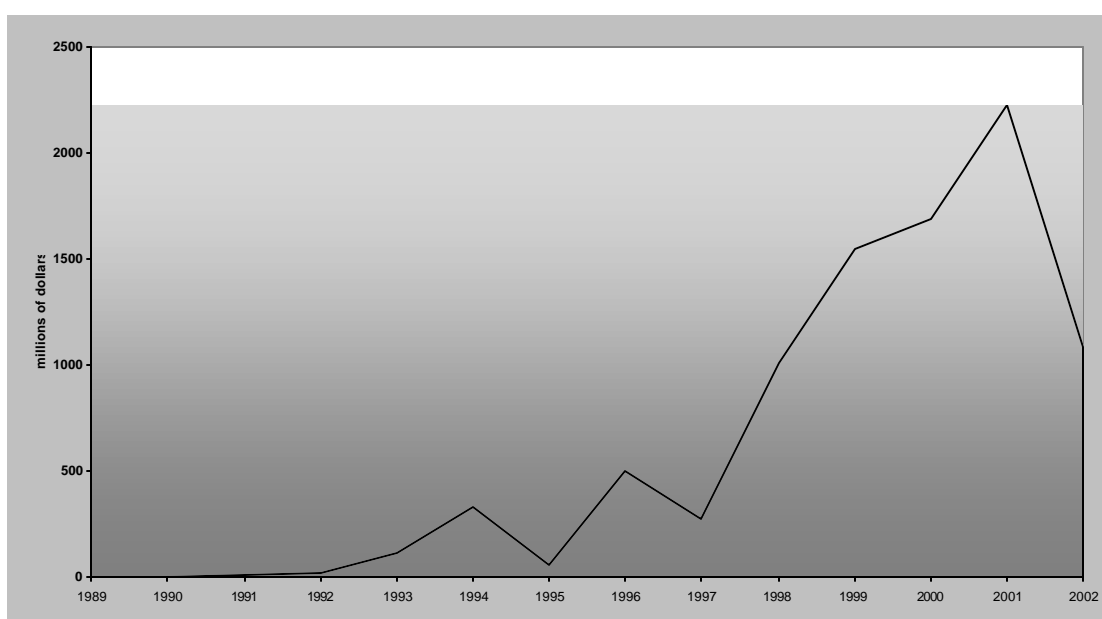
Source: *World Investment Report, 2003*.

Even though global capital flows had been on constant rise, fueled by low interest rates throughout the 1990s, in 2002 they declined to less than half of the 2000 figure. That has been explained partially by the prolonged economic recession in the world economy as well as by the loss of value of many international corporations, which resulted in a weakening of business confidence around the world. FDI flows from developed to developed countries have contracted by 59 percent in the past 3 years. The inflows into developing countries have decreased more modestly, by 34 percent, owing mostly to the booming FDI in China. However, the post-2000 global economic slowdown did not significantly affect FDI inflows into Central and Eastern Europe. New profit opportunities created by the economic and political reforms in the region caused FDI inflows into that region to increase by almost 9 percent.

The main forms in which international capital crosses borders are purchases of equity capital, reinvestment of profits, and loans to the foreign investment enterprise by the parent firm.

Equity capital normally includes greenfield investment as well as mergers and acquisitions (M&As). In fact, as a result of a large-scale wave of liberalization and de-regulation processes around the world in the past two decades, as well as the political and economic reforms in Central and Eastern Europe in the 1990s, cross-border M&A was the main mode of FDI entry. In fact, in the transforming economies privatization through FDI has been an integral part of the transition to a market economy. Cross-border M&A purchases in the transition economies are shown on Figure 3.

**Figure 3. Cross-border M&A Purchases in Central Eastern Europe and the Baltics**  
(in millions of dollars)



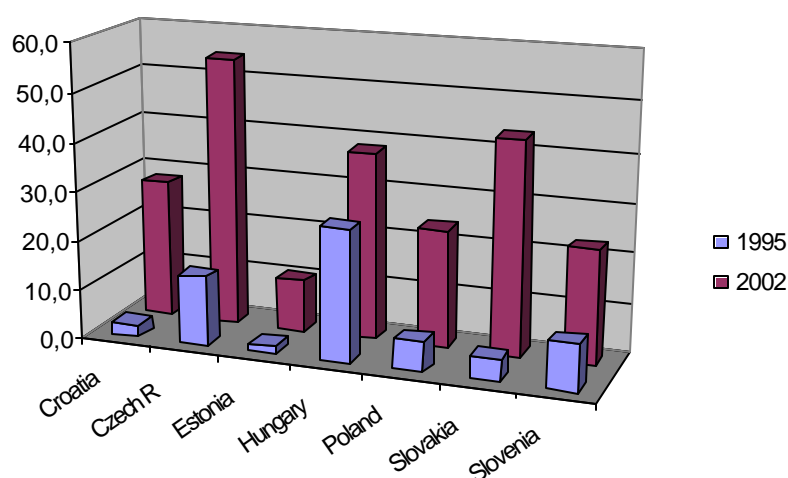
Source: *World Investment Report, 2003*.

Foreign acquisitions of domestic, mainly state owned firms in transition economies, as well as opening utilities to FDI privatization, brought foreign capital mainly into the service sectors, such as trade and financial related activities, or telecommunications and power generation and distribution. However, due to the decline of the value of stocks traded on the world's stock markets, cross-border M&As worldwide fell by 38 percent in 2002. Reflecting the winding down of privatization in some transition economies, the region recorded a significant drop in M&As as well. They declined to one half of the 2001 value. With greenfield investment on

the decline as well, what kept total FDI increasing in the transition economies was mostly the reinvested profits.

Expressed as percent of GDP, Figure 4 shows the change in the presence of inward FDI stock in selected transition economies between 1995 and 2002.

**Figure 4. Inward FDI Stock in Selected Transition Economies**  
(in percent of GDP)



Source: *World Investment Report, 2003*.

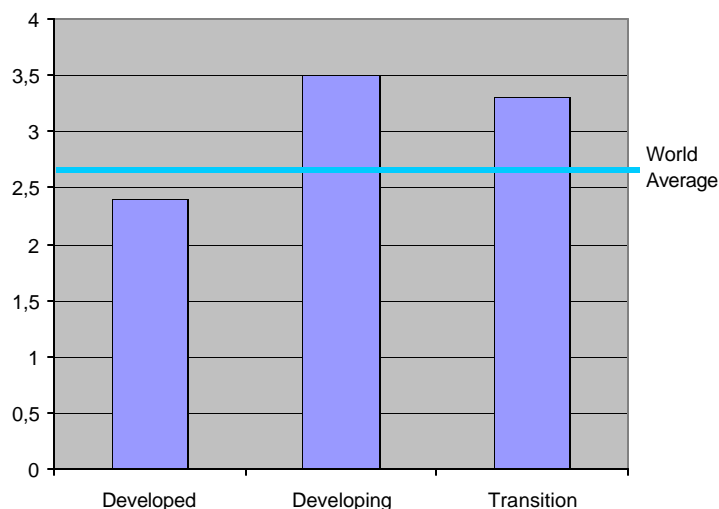
The share of FDI stock in transition economies' total output has clearly risen significantly. The change appears to be the smallest for Hungary but that is true only because Hungary started its reforms in the early 1990s and it opened up to foreign capital early on. Consequently, by 1995 the stock of FDI already built up to a significant level.

### 3. Capital Accumulation and Growth

After several transition recessions caused by restructuring, as well as by the political instability and war in the case of former Yugoslavia, output in European transition economies is rising. In fact, since 1999 total growth rates have exceeded the average world output growth rate. Figure 4 shows average world output growth rates by region.



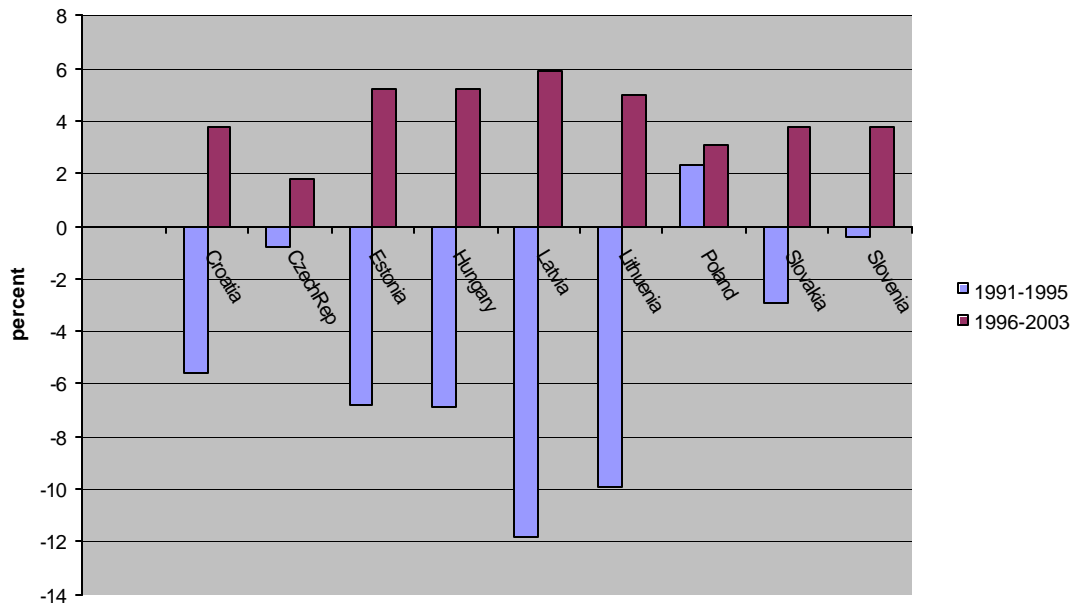
**Figure 5. Average World Output Growth Rates 1997-2002**



*Source: UNCTAD Trade and Development Report, 2003.*

As Figure 5 shows, average growth rates in transition economies exceeded the average world output growth rate by almost 1 percent. The table below shows real GDP growth rates for selected transition economies. They are the early reformers (the Czech Republic, Hungary, Poland, and Slovakia), the Baltic countries (Estonia, Lithuania, and Litva), and two of the most succesful countries from former Yugoslavia (Croatia, and Slovenia). All of them, with the exception of Croatia, became members of the European Union in 2004. The political disadvantage of having been thrust into the war, which coincided with the onset of reforms in the early 1990s, has caused Croatia to lag behind its peers in acceding to the European Union, even though its economic performance is quite comparable to theirs.

**Figure 6. Average Real GDP Growth Rates in CEEB 1991-1995 and 1996-2003**

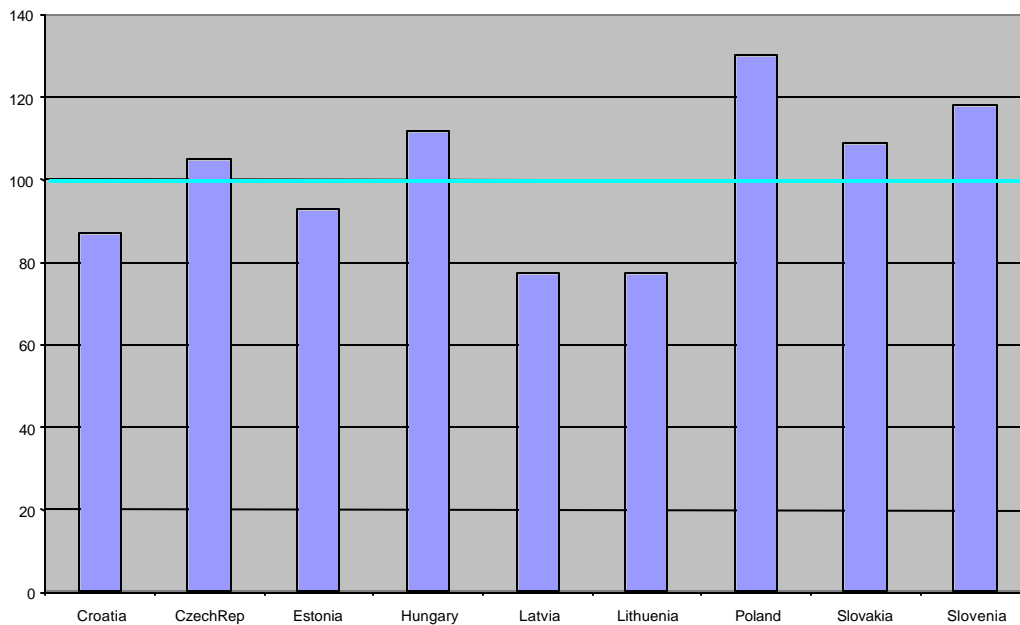


Sources: UNCTAD Handbook of Statistics, 2004.

Figure 6 compares two growth rate averages, 1991-1995 and 1996-2003. It was by 1995 that all transition economies stopped having negative growth rates, which marked the end of the first transitional recession for the region. Latvia was the last country that exhibited negative growth in 1995. After 1995 all transition countries grew at respectable rates. With a brief recession in 1998-99, when their growth was negative, both Croatia and Estonia maintained high growth rates through 2002, followed by Hungary and Slovakia. The early reformers, however, started showing a slight deceleration in their growth rates.

Depending on how low their starting base was, some countries regained and surpassed their 1989 level of GDP and some are still below it. Figure 7 shows the estimated level of real GDP for transition economies in 2002.

**Figure 7. Estimated Level of Real GDP in 2002 (1989=100)**



*Source: EBRD Transition Report 2003*

Massive reallocation of resources that is implied in economic transformation and restructuring generally also brings about certain instability in structural relationships. A frequent imbalance that appears in the growing economies is the one between gross domestic savings and investment. The disparity between those two aggregates was evident in the case of the European transition economies as well.

The investment ratio, measured as gross fixed capital formation and expressed as a percentage of GDP, was relatively high in all transition economies. Investment rates varied between 23 (Croatia) and 32 percent (Slovakia) in the 1990-2000 period. This was higher than the rates in Latin America in the observed period, where they stayed around the 19 to 20 percent level. Asia, without China, recorded investment rates of 30 percent, while China alone showed investment rates of 30 to 50 percent<sup>3</sup>. Even though European transition economies did not reach such spectacular rates of investment, their pace is considered sufficient to attain the path of convergence with their developed neighbors. The target threshold for middle-income

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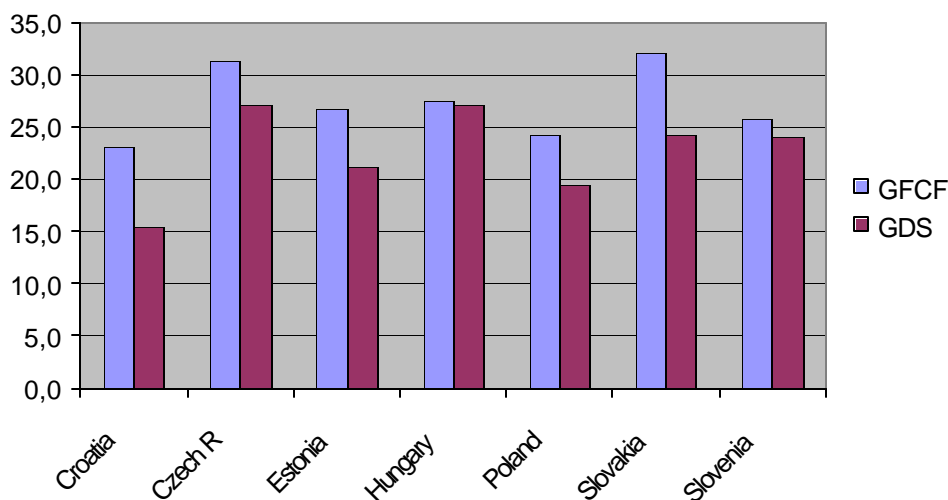
<sup>3</sup>UNCTAD, 2003.

developing countries, which would be the equivalent for the transition economies, to attain the catch-up rates of growth is estimated to be around 25 percent GDP.<sup>4</sup>

Such high investment rates, however, could not be financed entirely by the gross domestic savings as they were clearly not sufficient. The imbalance was especially pronounced in the private sector. Figure 8 presents gross fixed capital formation rates as a percent of GDP for the selected transition economies. In the same table they are contrasted with the gross savings rate expressed also as a percentage of GDP.

**Figure 8. Gross Fixed Capital Formation and Gross Domestic Savings in Selected Transition Economies<sup>5</sup> 1997-2001**

(percent of GDP)



Source: World Development Indicators, 2002.

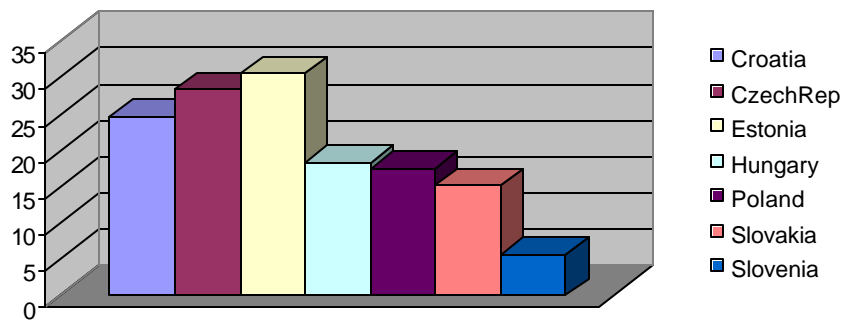
As Figure 8 illustrates, the transition economies have had generally low domestic savings rates, which were inadequate for financing the recorded rates of growth. Consequently, they relied heavily on foreign capital inflows to complement their public and private domestic investment in gross fixed capital formation. The shares of FDI in their gross fixed capital formation in the transition economies is shown in Figure 9.

<sup>4</sup>ECLAC, 2000, and UNCTAD, 2001.

<sup>5</sup>Gross fixed capital formation was calculated on the basis of real GFCF and GDP data in national currencies as on the IMF International Financial Statistics Browser and World Development Indicators Online Database.

What is of immediate importance for transition economies in relation to growth at this stage is the fact that the shares of FDI in their gross fixed capital formation are high. Figure 9 illustrates this situation for individual countries.

**Figure 9. FDI Inflows as an External Source of Finance 1997-2001**  
(percent of GFCF)

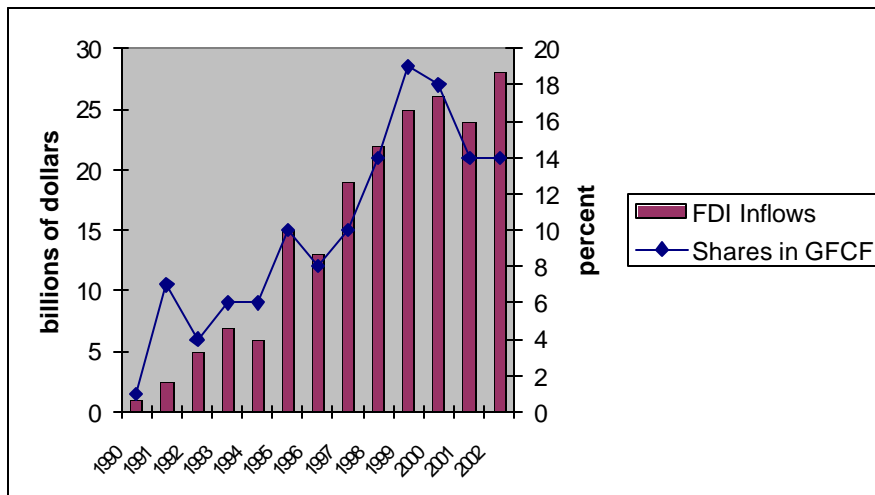


Source: UNCTAD, FDI/TNC Database, 2002.

The Czech Republic and Slovakia stand out with almost 60 percent of their gross fixed capital formation coming from FDI sources. Croatia and Estonia have a fairly similar structure with around one third of gross fixed capital formation being dependent on FDI. Slovenia started out its reform process mainly relying on domestic savings and boosting domestic productivity. It is, however, increasingly opening up and it has been taking in more FDI inflows in the past three years. Consequently, its gross fixed capital formation soon became as much as one third financed through FDI.

An overall picture comprising all transition economies in the region during the years of economic reform, 1990-2002, is shown on Figure 10.

**Figure 10. FDI Inflows and their shares in gross fixed capital formation in transition economies 1990-2002**



Source: UNCTAD World Investment Report, 2003.

It appears that FDI has risen persistently as a proportion of GDP in all transition economies. It also rose as a share of their gross fixed capital formation, even though the former does not necessarily imply the latter. The share of FDI in GFCF rose from almost zero in 1990 to as 20 percent in 1999 after which a drop to 14 percent has been recorded. For comparison, in the 1980-2000 period Latin American countries had between 10 and 5 percent GFCF financed through FDI and the trend was a downward one. East Asia, without China, showed an increase in FDI financing in the same period. It was between 10 and 15 percent while in China it was 15-20 percent, similar as in the European transition economies<sup>6</sup>.

The increase of the share of FDI in relation to the public and private domestic investment testifies to its importance as an external source of finance. Unlike short term financial flows, FDI is the source that internalizes foreign savings, that is, firms bringing in those savings actually undertake investment. Moreover, this kind of foreign capital inflow is not «footloose» so its effect will not be destabilizing for the host country. It is, therefore, a more

<sup>6</sup>UNCTAD 2003.

reliable source of financing than short term capital and it has had positive impact in closing the gap between investment and gross domestic savings in the transition economies.

Given the transition economies' distance from the world technological frontier, they are at a stage in which increases in their capital stock are more important and have more immediate impact on their economic growth than technological advances.<sup>7</sup> Catching up in this area and closing the gap between the leaders in technological development and themselves is a lengthy process the results of which take time to materialize. By complementing the scarce domestic savings as an additional source of finance, FDI is helping create conditions for the transition economies to get on the path of further technological development.

However, it is not only the volume of FDI that matters. It is also its sectoral composition. Different patterns of FDI entry by economic activity tend to produce different effects on the economic performance side of the receiving economies, and the impact on export competitiveness differs as well.

#### **4. The Implications of Sectoral Composition of FDI**

The observed annual growth rates of real GDP inevitably raise the question of their sustainability. Long term economic success depends on sustained improvements in productivity and efficiency. Consequently, only if the process of accumulation is accompanied by productivity and efficiency gains will it generate sustainable long term growth and convergence.

For an economy this assumes structural changes in output and employment as well as an overall structural upgrading, which implies shifting resources to higher value added activities. It was those processes that accounted for an important part of the rapid growth in Europe and Japan after World War Two. In the developed countries today it is the intra-industry increases in productivity that play a more significant role.<sup>8</sup> For transition economies restructuring is still a high priority in generating growth although both are important, especially since there are differences in the potential of various sectors for technical progress and productivity growth.

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<sup>7</sup>Eichengreen, 2004.

<sup>8</sup>Bailey, 2003.

The timing and extent of structural changes depend on the nature and composition of investment. FDI that enters host countries' manufacturing industries generally raises productivity in those sectors through technology transfers, by creating a network of spillover effects, including both vertical and horizontal linkages, and through a transfer organizational and management skills. By creating technological and organizational spillovers, FDI causes shifts in productivity in sectors in which it enters. If those sectors are export oriented, those advances should be noted in the country's total exports.

FDI that enters services works in a more roundabout way, the results of which are not immediately measurable in terms of productivity gains. By entering industries such as financial intermediation, especially banking, FDI shows the tendency to lower transaction costs and to increase efficiency not only in the banking system itself but also in the wider business environment, improving the general business climate. To this can be added the improvements in physical and technological infrastructure services as well as in the location-bound tourism, which can also be an important source of revenue. Advances in information and communication technologies are rapidly changing the tradability of information-related services that cut across all activities.

To examine the impact of different patterns of FDI entry on the recipient country's export competitiveness and performance, we will compare three transition countries, namely Hungary, The Czech Republic, and Croatia.

The first wave of FDI liberalization in transition economies in the early reformers brought in considerable FDI in manufacturing industries. Foreign capital was attracted to those countries by the existence of a highly skilled labor force and relatively low labor costs. The proximity of larger European markets also played a significant role. The exception in this regard in the group of countries included in this paper is Croatia which, at the time of the first privatisations, was exposed to war hostilities, and political instability is not conducive to foreign investment.<sup>9</sup> Because of this political disadvantage it has missed the first phase of FDI related positive impulses given to other Central European transition countries to restructure and jump-start their economies.

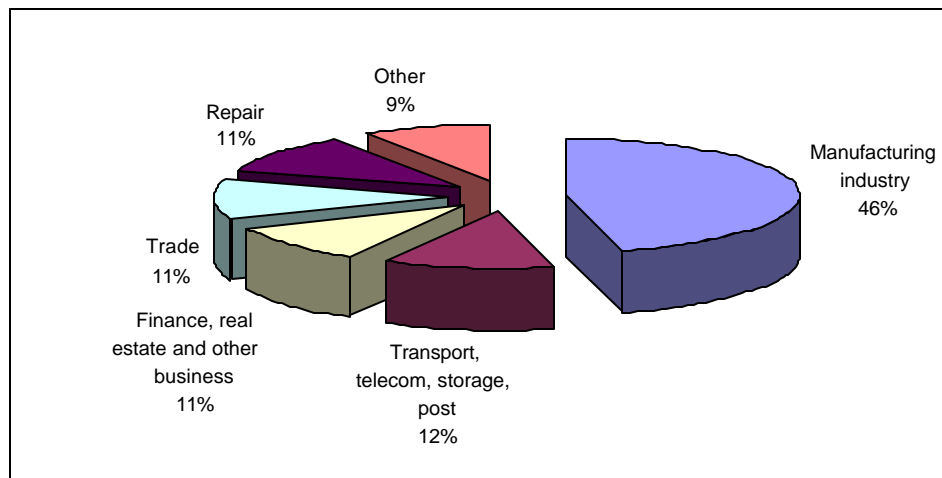
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<sup>9</sup>Brada, Kutan, and Yigit, 2003.



The largest attractor of FDI in manufacturing industries was Hungary, which resulted in a pronounced increase in overall competitiveness of the Hungarian economy, both at home and abroad. The composition of FDI into Hungary since the period 1989, when the first privatizations took place, to 2002 is shown in Figure 11.

**Figure 11. Hungary: FDI by Economic Activity (1989-2002)**



*Source: The Hungarian Investment and Trade Development Agency*

Clear dominance of manufacturing FDI brought to Hungary such names as Suzuki, Opel, Nokia, Audi, Michelin, General Electric, Electrolux, Phillips, and so on, all market leaders in their sectors. However, when total factor productivity gains are assessed, it appears that the productivity gains are recorded only in the foreign owned firms and that they produce negative spillover effects for the domestic owned firms.<sup>10</sup> Foreign owned firms also tend to have much higher levels of profitability than domestic owned ones. There is no evidence that productivity spillover included the domestically owned firms.<sup>11</sup> The reason for that is very probably the technological gap which makes domestic firms more inert than the ones receiving injections of foreign technology and management and organizational skills.

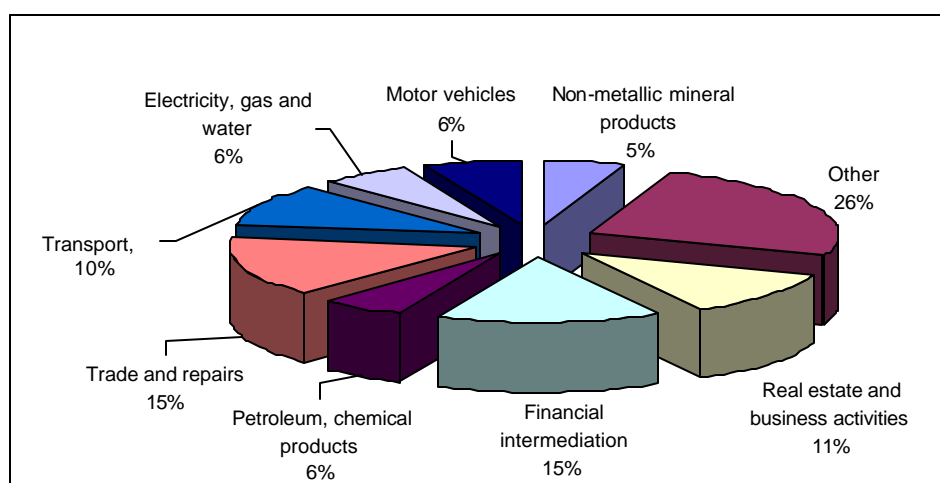
Liberalization of FDI in services also brought in a lot of FDI into trading and financial services. The mode of entry was predominantly privatization related. Opening of utilities to

<sup>10</sup> Sgard, 2001.

<sup>11</sup> This result is very similar to that obtained by Aitken and Harrison (1999) for domestic firms in Venezuela.

FDI through large scale privatization programs of state owned enterprises resulted in huge increases in FDI in telecommunications and power generation and distribution. The composition of FDI entering the Czech Republic showed a greater proportion of it going to the service sectors, even though a respectable amount entered also the manufacturing sectors, such as the production of motor vehicles, petroleum and chemical products, and non-metallic mineral products. Its composition of FDI is shown on Figure 12.

**Figure 12. The Czech Republic: FDI by Economic Activity (1993-2001)**



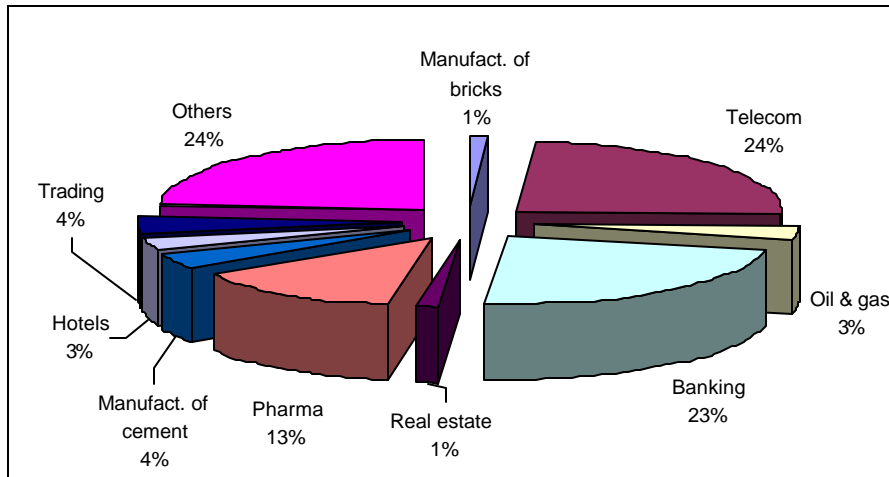
Source: *The Czech National Bank*

The Czech Republic was another early reformer but in which early privatizations were not immediately followed by a lot of foreign capital entry. The Czech Republic opened up to FDI somewhat later than Hungary and the distribution between manufacturing and services was more balanced. On the whole the productivity also improved, and again, foreign owned firms and joint ventures are those that have higher than average productivity, with a negative spillover effect on the rest of the firms.<sup>12</sup>

The sectoral composition of FDI in Croatia is shown in Figure 13.

<sup>12</sup> Djankov and Hoekman, 2000.

**Figure 13. FDI in Croatia by Activities (1993 - Q3 2003)**



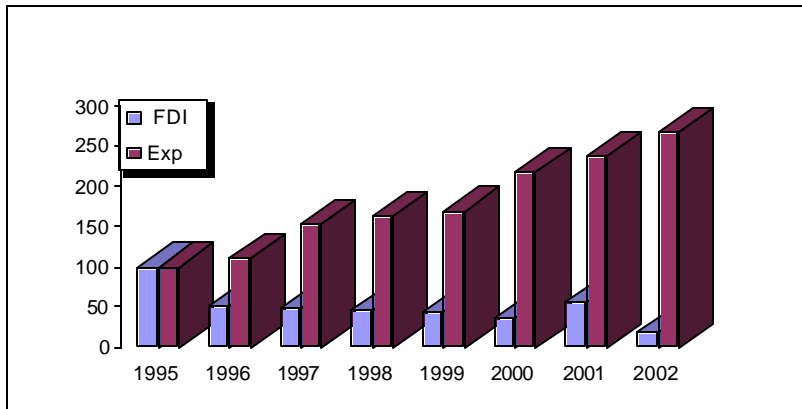
*Source: Croatian National Bank*

The only manufacturing sector that received sizeable FDI in Croatia is the pharmaceutical industry, particularly its drug producer Pliva, which is also investing abroad. Like in the other two countries, productivity improvements have been recorded in companies that have foreign ownership whereas no significant change in productivity was measured for the domestic firms.<sup>13</sup> The largest share of foreign investment in Croatia and in other transition countries, especially as of late, went into the telecommunications services and financial intermediation sector, mostly banking, which generally is not export oriented but is mostly of a local market seeking type.

It appears that countries that received more FDI in their manufacturing sectors showed greater increases in their export competitiveness than the countries in which FDI flew mostly into the service sectors. Following the overview of the three main patterns of FDI entry in selected transition economies, the next three graphs will illustrate the relationship between FDI and exports in Hungary, the Czech Republic, and Croatia.

<sup>13</sup> Sohinger, Galinec, and Skudar, 2004

**Figure 14. Hungary - FDI and Exports (1993=100)**

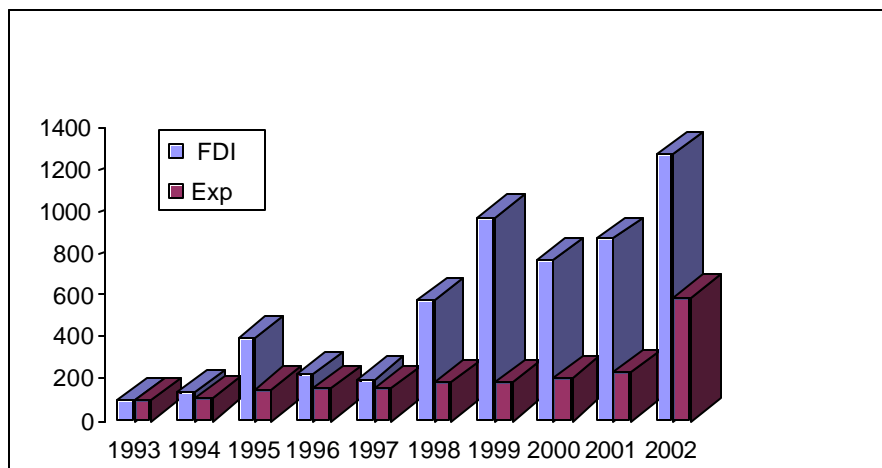


*Source: WIIW; Central bank*

Having pursued an unambiguous export oriented development strategy, Hungary attracted FDI mostly into the export oriented manufacturing sector where the abundance of high skilled low cost labor proved to be fertile ground for transnational corporations. Its exports during the past five years tripled, and the «efficiency» of FDI seems to have increased. Less and less new foreign capital was necessary to generate more exports. However, with real wages rising, this cost advantage is no longer the driving force of FDI engagement, so, together with the generally declining FDI funds, new inflows may be expected to ease in the coming years.

The structural composition of FDI in the Czech Republic was more evenly distributed between manufacturing and services, and it did not show such clear dominance of manufacturing as in the case of Hungary. The result was less explosive growth in exports relative to FDI. Still, the international position of the Czech Republic improved as did its export competitiveness. Its exports doubled since 1993 and in 2002 it was almost six times that of 1993.

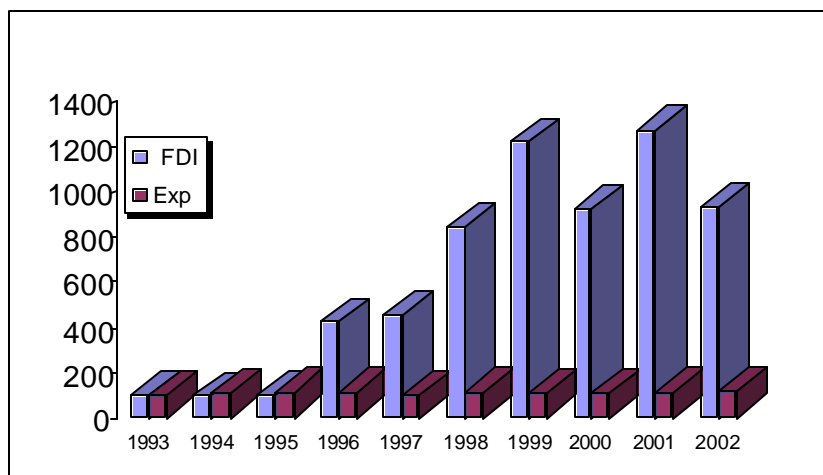
**Figure 15. The Czech Republic - FDI and Exports (1993=100)**



Source: WIIW; Central Bank

The smallest effect on export competitiveness among the selected economies has been observed in the case of Croatia. Its exports have been largely stagnant throughout the past decade. Even though FDI flowed in in large amounts, it did not seem to find the export oriented sectors.

**Figure 16. FDI and Exports in Croatia (1993=100)**



Source: Croatian National Bank

The kind of FDI that Croatia received was mainly the local market seeking type, which satisfies the growing domestic demand, such as distributors in retail trade. The latest developments in FDI inflows structure involve other services such as real estate, retail trade and more of financial intermediation, which are also not likely to change the export structure soon.

In general, if driven by local market seeking, FDI can grow only up to a certain level. Beyond that level it can continue to grow only if it is export oriented. However, having an export oriented policy does not imply the existence of political declarations but an attractive marginal productivity structure embedded in a transparent, investor-friendly environment with the necessary infrastructure and institutional and regulatory frameworks in place.

FDI role should not, however, be overstated. Slovenia was a country with least FDI inflows in the selected group, and yet its economic performance was remarkably good. Its FDI inflows have only recently started to accelerate. The development strategy Slovenia pursued was to rely on increases of domestic productivity, which proved quite effective. However, with increasing international integration, FDI inflows into Slovenia are on the rise as well.

With some exceptions, the overall picture of transition economies' export performance suggests that their international competitiveness has generally increased since they opened up to FDI. However, there appears to be great dependence on FDI sources, which becomes evident when one examines the participation of foreign investment enterprises in the total export sales of transition economies.

**Table 1. Share of Companies with FDI in Total Exports**  
(in percent)

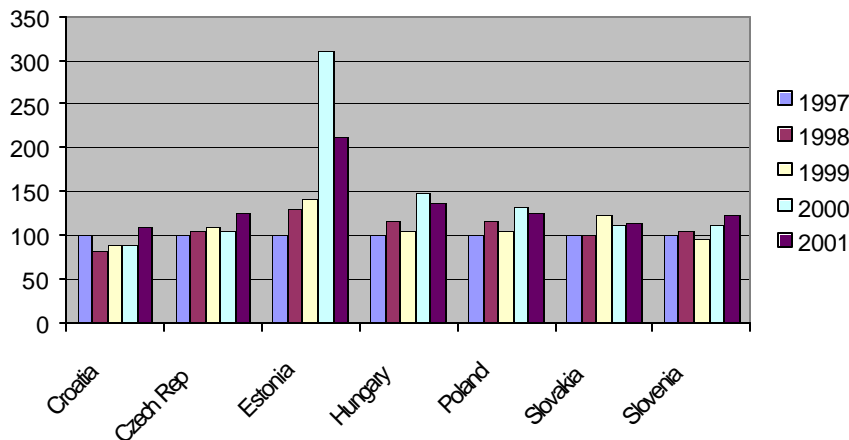
<b>Year/Country</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>
Czech Republic	47.0	60.5	n/a
Hungary	85.9	88.8	n/a
Poland	52.4	59.8	n/a
Slovenia	32.9	30.3	34.2

*Source: Hunya, 2002.*

The participation of foreign owned firms in transition economies' exports is striking, particularly in the case of Hungary, where it is almost as high as 90 percent. The question that naturally suggests itself is where the domestic firms are and why they are not showing as much international competitiveness as the foreign owned ones. It seems that productivity improvements did not spill over to the non-foreign owned sectors and that they are suffering from some sort of a «delayed spillover effect syndrome». A low starting technological base appears to be the main reason why they have so far remained untouched by the leaps of progress made in the foreign owned sectors of the economy. Consequently, the gradual closing of the technology gap is expected to increase their «willingness and ability to learn» which will affect the overall absorptive capacity of the economy. Only closing this gap between the foreign and non-foreign owned sectors will increase real competitiveness of the economy and make growth and convergence sustainable.

Another important aspect of the changing fabric of the European transition economies' competitiveness is the change in R&D intensity of their exports. High technology exports include products such as computers, pharmaceuticals, scientific instruments, electrical machinery, etc. Countries that received the most FDI in their manufacturing sectors also experienced the highest technology transfer, which is reflected in the changes of the content of their exports. These developments are shown in Figure 17.

**Figure 17. High Technology Exports as Percent of Manufactured Exports  
(index1997=100)**



*Source: World Development Indicators*

Again, differences emerge among countries having received early FDI inflows into manufacturing industries and those that have not. The early reformers, Hungary, the Czech Republic, and Poland have all increased the high tech content in their exports, even though they remain in the low value added segment of the high tech sector. The leader in transforming export competitiveness is Estonia, whose R&D intensity in exports rose by a factor of 3 and 2 in the years 2000 and 2001 respectively. This result, however, may be somewhat misleading.

Unlike the early reformers, Estonia received most of its FDI in services, yet the value added component of its export structure rose significantly. As is usually the case with small open economies, huge surges can sometimes be a result of just one firm or sector performance in a given period. In this case, high R&D intensity of exports is attributed to one firm (Elcoteq) that imported a lot of components from Finland and Sweden to process and assemble, and then export them back. So the share of the high R&D content is artificially high. In reality the value added in this sector is around 10 percent.<sup>14</sup>

The least improvement was recorded in the case of Slovenia and certainly in the case of Croatia where even a temporary erosion was recorded. The lack of manufacturing FDI there resulted in virtually no technology transfers. Relying on location specific services such as tourism, which figures prominently in Croatian exports, is not conducive to technological upgrading as a source of future growth. Some improvement in the high tech content was shown in 2001, which is encouraging. It may signal the beginning of a turnaround in the value added composition of Croatian exports

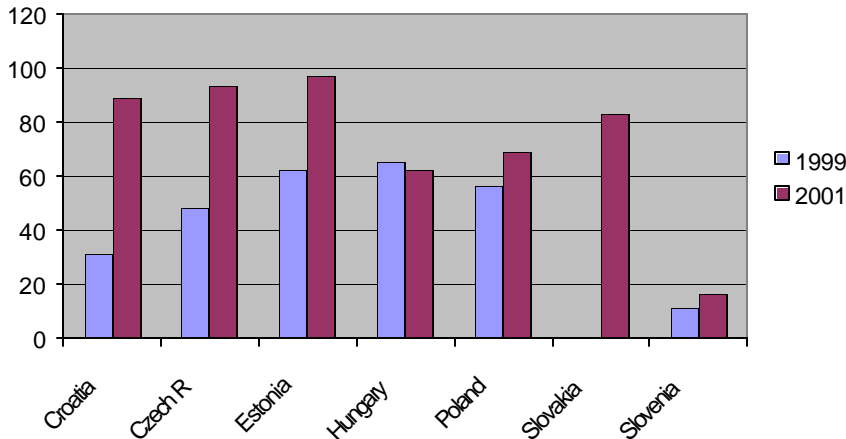
Finally, one could justifiably ask the question whether FDI in services has a positive impact on the transition economies after all, especially since so much of it entered the transition economies' trade, telecommunications, and financial sectors, particularly banking. The process of foreign bank entry in all transition economies intensified in the late 1990s and continued into the 2000s. This is partly due to the "europeanization" process, which aims to unify the European banking markets.

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<sup>14</sup> I thank Urmaz Varblane for this information.



**Figure 18. Foreign Bank Share of Total Bank Assets in Transition Countries  
(in percent)**



Source: Kraft, 2002.

With the exception of Slovenia, foreign bank shares of total assets in local banks are high in transition economies. Studies have shown that it resulted in the increase in competition, bank efficiency, and the quality of banking products and services. The consequence of large foreign bank entry has been significantly better asset quality as well as an increase in overall lending under more favourable conditions than domestic banks.<sup>15</sup> By lowering the transaction costs of doing business such developments exert a positive impact on economic activity and the possibility of growth.

Services other than banking experience similar shifts in efficiency. They, too, have an impact on competitiveness and growth because they are inputs to the production of other goods and services supplied to both domestic and international markets. Productivity effects in this case take longer to become measurable, which is why there may be a danger of understating their relevance. Moreover, if they are competitive, they can attract the highly valued export oriented FDI that is almost every transition country's dream.

<sup>15</sup> Kraft, 2002.

## **5. The Economic Conditionality of FDI**

The growth and export enhancing quality of FDI caused a shift in paradigm in the attitude of national governments in the formerly socialist European economies with regard to the foreign investment capital inflows. Attracting FDI has become a prime policy goal in transition economies. However, with privatization opportunities in CEE winding down, with their labor costs advantage waning, and with the available FDI funds decreasing worldwide, the competition for FDI funds is intensifying.

There is a variety of measures that national investment promotion agencies can put in place to attract foreign investors. They include tax incentives, such as granting tax holidays, or starting export processing zones, etc. Given that the economies granting potential concessions are small, the effectiveness of such measures in actually attracting foreign investors is rather limited. What motivates foreign investors more is the ability to include their operations in a given country into their global competitive strategy.

Consequently, in addition to improvements in locational advantages through competitiveness upgrading, what really matters are the transparency and overall institutional quality of the host economy. If an investor friendly environment is in place, both for domestic and foreign investors, FDI will flow to that economy regardless of any extra measures designed to promote FDI entry, as their potential alone can never be powerful enough. In fact, it will flow only to those places which can provide such environments. It is in this sense that we use the term economic conditionality. That is the most important long term quality of FDI as the changes of the economic system will affect growth in the long run.

An increasing awareness, which has gradually developed in the European transition economies of the importance of legal and market institutions, and which has come about as a result of the desire to attract more FDI, has speeded up the reform process. The intensity of competition for FDI funds appears to be healthy for those economies as many of the measures important for attracting them are similar to those required for a successful transition.

This process has been working hand in hand and has been reinforced by the “europeanization” process. Together with the EU-accession driven reforms, the FDI related incentives to

transform the economies have produced a sizeable number of post-socialist countries to become members of the EU. And more change is on the way, both for the new members as well as for those that are aspiring to become ones.

## **6. Conclusions**

The evidence presented in this paper shows that FDI, which flowed extensively into the European transition economies in the past decade, has affected their competitiveness, both at home and internationally. Even though transition countries differ somewhat in their individual experiences, their average performance suggests that FDI has played a significant role in helping them pull out of the transitional recession and in increasing their presence on international markets.

As an important source of external finance, FDI contributed to growth in the transition economies by increasing the physical stock of capital available for investment. Real GDP growth rates that the transition economies experienced in the past decade were above the world average, which is something they would never have achieved if they had had to rely solely on their domestic savings. Given their distance from the world technological frontier, increases in their total factor productivity, which FDI stimulated by adding to their gross fixed capital formation, played the most significant role for their growth in the past decade. At the same time, through its spillover effects and its potential for technology transfer, FDI is setting the stage for the second phase in which, not only imitation, but also innovation become the engines of growth. Relatively low level of technological development prior to FDI entry in the transition economies has prevented this from happening so far.

Another channel through which FDI has been transforming the transition economies' competitiveness has been through affecting their export performance. Such effects were especially pronounced in countries which received most of their FDI in export oriented manufacturing sectors, such as Hungary. Restructuring in production has resulted in the increase and restructuring of exports, in addition to its high technology contents, as well as in its reorientation towards the developed countries' markets, mostly the European Union. However, the ratio of foreign vs. domestic owned firms in total exports varies by individual country, but it is always high. The fact that domestic firms have not been able to successfully catch up with their foreign competitors suggests that the initially low level of technological

development of the domestic sector still causes the general absorptive capacity of the transition economies to be low.

The service sectors that received most capital inflows in the majority of countries are telecommunications and financial intermediation, mostly banking. Again, an impressive percentage of banks in transition economies have become foreign owned. The consequences of their presence have largely manifested themselves in increasing efficiency and lowering the transaction costs in the business environment. It is the characteristic of services related FDI that its effects aren't readily measurable, as is generally the case with manufacturing FDI. Rather, the efficiency gains generated by the services related FDI are more subtle and they take time to work themselves out in the system.

Because of the growth and exports enhancing effects of FDI on the receiving economy, attracting foreign capital inflows has become one of the prime policy goals in transition economies, especially given their efforts to integrate with the world economy by joining the European Union. However, the FDI funds seem to be declining worldwide, and they are likely to subside in the transition economies as well. To be attractive to foreign investors, transition countries must put in extra effort to create transparent, investor-friendly environments in their economic, legal, and political systems, the process which, in the final analysis, promotes the very goals of economic reforms. In fact, FDI inspired institution building is part of the more complex and lengthy, second phase of economic reforms, following the macroeconomic stabilization and market liberalization of the early years of transition.

Thus, the presence of FDI helps to create a powerful set of economic and political incentives that affect the prosperity of the European transition economies, and that will eventually determine the quality of their integration with the rest of the world. From a wider political perspective, having the transition economies well integrated into the European space remains an essential component of general European stability. It is in that context that the FDI and the EU accession-driven reforms, working essentially together in transforming the post-socialist economies in Europe, have a broader meaning. In addition to the economic benefits to the transition economies and wider, realizing the goals of transition and achieving convergence will also act as the best guarantor of peace and security in the region.

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