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**Research Report**

## FDI has benefitted the EU members from Central and Eastern Europe and can continue to do so

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## **Columbia FDI Perspectives**

Perspectives on topical foreign direct investment issues

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### **FDI has benefitted the EU members from Central and Eastern Europe and can continue to do so\***

by

Zbigniew Zimny\*\*

Since opening to FDI in the early 1990s, the eleven European Union members from Central and Eastern Europe (EU-11) have attracted sizeable FDI flows. From a zero level, MNEs now play important roles in these economies. While this may be seen as excessive dependence and disconcerting to some, FDI has had a significant net positive impact and is indispensable for continued economic progress for years to come. This message and resulting policy conclusions differ from those presented in Laza Kekic's *Perspective*.<sup>1</sup>

The list of benefits (and costs) that need to be considered to assess FDI's impact on host countries can be long, as firms—domestic and foreign—affect most aspects of economic life. Yet, some benefits are more important than others: if they are critical for economic development, can be obtained mainly from MNEs, are on a scale making a difference, and come at a relatively modest cost to the economy. They include productivity, exports and upgrading of economic activities through a shift from traditional, less productive, to modern, more productive activities.

On these metrics, FDI has greatly benefitted the EU-11 countries. In 2016, foreign affiliates contributed on average:<sup>2</sup>

- 40% to the value added of EU-11 business economies; in Hungary, Slovakia, Romania, and Czechia, the share was much higher.
- 54% to the manufacturing value added, including more than 70% in Slovakia and 60% in Hungary, Czechia and Romania.
- Nearly 60% to exports, including most of the exports of Hungary and Slovenia (around 80%) and of Romania (nearly 70%). Their share of manufacturing exports was higher in all countries. Overall, the EU-11 countries avoided de-industrialization owing to FDI.

Foreign affiliates in all EU-11 countries exhibited 80% higher labor productivity and offered 55% higher wages than domestic firms in 2016. They were more productive across industries, reflecting the transfer of superior technology and managerial and organizational practice from parent

companies. The productivity advantage means that, if a foreign affiliate and a domestic firm both invest a dollar, the GDP growth resulting from foreign investment is 80% higher, and the subsequent gains are shared with their workers to a greater extent.

The indirect impact of FDI on the productivity of domestic firms is less straightforward. However, with the emergence and maturing of private domestic enterprises since the late 1990s, research started showing net positive productivity spillovers, especially through backward linkages, in several EU-11 countries.<sup>3</sup> There has also been an upgrading of manufacturing and exports by foreign affiliates toward high- and (mainly) mid-technology industries. The rapid expansion of foreign business centers in the past decade exemplifies both FDI and services sector upgrading. The centers employ overwhelmingly tertiary graduates, export their services and increasingly deal in R&D, IT programming and other more advanced tasks. In several EU-11 countries, foreign manufacturing assemblers have added service centers, including large stand-alone R&D units, thus broadening the participation of these countries in global value chains.

The average rate of return on inward FDI in the EU-11 countries was 10% in 2015-2017, much higher than the interest rate for international loans, an alternative source of external investment financing. But out of every 10 dollars of MNE profits, only half was transferred abroad; the other half was reinvested. Thus, the real cost to the economy was 5%.<sup>4</sup> Given that this is not only remuneration for capital but also for technology, management, marketing, and access to international markets, this cost is moderate.

A growing number of EU-11 domestic firms are developing or acquiring and mastering technology, and gaining and maintaining access to foreign markets. However, domestic firms will not drive out FDI in manufacturing and business services exports in the foreseeable future. Meanwhile, there is further scope for FDI in the EU-11 countries to contribute to income convergence through productivity convergence. For now, despite recent wage increases due to low unemployment, EU-11 countries remain competitive in terms of wage costs.

Beyond that, whether FDI can lead to sustained income convergence with developed economies depends on government policy. It is difficult to say whether the EU-11 have the policy capability to emulate the success of Ireland and Singapore, which joined the group of high-income countries, relying heavily on FDI. Minimum sound policy would be to continue to attract export-oriented FDI to more advanced activities; encourage existing foreign affiliates to modernize and upgrade, including through incentives; and support domestic enterprises wherever feasible and provide them with opportunities for international expansion. “Developing growth strategies that do not depend so overwhelmingly on FDI” in activities critical for economic development, as suggested by Kekic, would be rather difficult. Governments can order state-owned enterprises to buy foreign banks or power companies, but they can do close to nothing to design replacements for the Volkswagens, Samsungs, Michelins, Microsofts, or IBMs of this world.

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<sup>1</sup> ["To what extent has FDI benefited the transition economies of Central and Eastern Europe?", \*Columbia FDI Perspectives\*, No. 236, October 8, 2018.](#)

<sup>2</sup> Author's calculations, based on [Eurostat, Structural Business Statistics](#).

<sup>3</sup> For example, Martin Bijsterbosch and Marcin Kolasa, "FDI and productivity convergence in Central and Eastern Europe: An industry-level investigation," *European Central Bank Working Paper Series*, No. 992, January 2009.

<sup>4</sup> Author's calculations, based on [OECDStat FDI Statistics](#).

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