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## Foreign direct investment in Central and East European countries: State of affairs, prospects and policy implications

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# Kiel Working Papers

Kiel Working Paper No. 633

**FOREIGN DIRECT INVESTMENT IN  
CENTRAL AND EAST EUROPEAN COUNTRIES:  
STATE OF AFFAIRS, PROSPECTS AND POLICY IMPLICATIONS**

by  
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## Contents

I	Introduction.....	1
II	Theoretical Considerations .....	2
1	Economic Theory of FDI.....	2
2	Motives for FDI.....	4
3	Forms of FDI.....	4
4	Transformation and FDI .....	5
5	Hypothesis on FDI.....	6
III	Scope and Limitation of the Data Base .....	7
IV	Assessment of the Current Situation .....	7
1	Conditions of FDI.....	7
2	Performance of FDI.....	10
a)	Overall Trends .....	10
b)	Patterns .....	12
3	Effects of FDI.....	16
V	Conclusions.....	17
	References .....	20

## List of Tables

Table 1 - Obstacles for FDI in Central East Europe (given by a sample of 163 respondents from developed market economies).....	9
Table 2 - Flows of Foreign Direct Investment into CEECs by Host Countries 1989-1992.....	10
Table 3 - Stocks (a) of Foreign Direct Investments in CEECs by Host Countries 1989-1993.....	11
Table 4 - Flows of Foreign Direct Investment into CEECs by OECD Source Countries 1991 and 1992.....	12
Table 5 - Five Top Source Countries in Selected Central East and East European Host Countries 1992/1993 (According to Stocks; in Brackets Percentage Shares)....	13
Table 6 - Structure of Foreign Direct Investment of German Companies in Central and East European Reform Countries by Selected Branches 1989 and 1992....	14
Table 7 - Stocks of Foreign Direct Investment in Percent of Gross Domestic Product in Selected Central East and East European Countries 1991 and 1992.....	17

### **Abstract**

Foreign direct investment (FDI) is rightly considered as an engine in transforming Central and East European Countries (CEECs). Without massive inflows of capital, technology and management know-how a sustainable growth is unlikely to happen.

Although governments in CEECs make more than an effort to create a favourable climate for FDI, the international investors' community has responded hesitatingly. Only the number of projects have skyrocketed, the amount of capital invested has increased only at a slow pace. Foreign investors are "testing the water", but they are not rushing to jump.

The paper attempts to provide an overview of the current state and prospects of FDI in CEECs. First, it briefly reviews the theoretical framework for understanding FDI. Then it focuses on the trends and patterns of FDI-flows. Finally, it draws attention to the policy towards FDI.

## I Introduction<sup>1</sup>

Foreign direct investment (FDI) is rightly considered as an engine in transforming Central East European Countries (CEECs) into western-style market economies. It is hoped to perform a catalytic role in restructuring and privatizing the state industry and in integrating the CEECs into the world economy. Without massive inflows of capital, technology and management know-how over many years to come a sustainable economic growth is unlikely to happen.

Although FDI is still a hotly debated issue in CEECs - the opposition stems not only from orthodox communists who reject foreign capital penetration for ideological reasons but also from ordinary people who are afraid that strangers could steal the national property - governments make more than an effort to create a favourable climate for foreign investment (Dobosiewicz, 1992). By and large the basic legal and institutional framework for FDI has already been established (OECD, 1993; Alter, Wehrle, 1993): in all CEECs joint ventures and fully foreign owned companies are allowed; in some countries and in cases of large-scale investment, however, authorization by the government is still required, and in some sensitive sectors foreign participation is restricted. It goes without saying that CEECs are still far away from being an attractive harbour for international capital. There are still too many uncertainties surrounding the process of transformation which must be considered as an important impediment for attracting foreign capital (Donges, Wieners, 1993).

Actually, the international investors' community has responded hesitatingly. FDI in CEECs has expanded rapidly only with respect to the number of projects. At the end of 1992 70 000 projects were registered in fourteen CEECs - compared with only 2 500 at the end of 1989. Though the volume of capital invested (in value terms) was less impressive. In 1993 inflows into CEECs were estimated for nearly 4 billion dollars, and the stock did not exceed the total of 15 billion dollars at the end of the year. No doubt, foreign investors are still jealously "tasting the water", but they are not rushing to jump. In particular, they are reluctant to realize large-scale investments. This is no reason for surprise. Competition for international capital is keen and shifts in the flows of FDI can occur only gradually.

The paper attempts to provide an overview of the current state and prospects of FDI in CEECs. First, it briefly reviews the theoretical framework for understanding FDI. Then it fo-

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<sup>1</sup> An earlier draft of the paper was presented at the conference "Transforming Economies and European Integration" held in Sofia from 27 - 28 May, 1994. Thanks is due to my colleague Birgit Sander and to participants of the conference for valuable comments on an earlier draft.

cuses on the trends and patterns of FDI-flows since 1989. Finally, it draws attention to the policy towards FDI.

The paper is more a descriptive than an analytical one. For the time being it is too early for a comprehensive analysis: the data base is poor and the period of time under consideration is short. Both trends and patterns are still influenced by accident, e.g. by single large-scale projects of some few multinationals. Nevertheless the paper may serve as a basis for discussing the large variety of issues related to FDI.

## **II Theoretical Considerations**

### **1 Economic Theory of FDI**

Economists and policy makers in CEECs often expect very much in respect to FDI. Investors are not in a hurry to invest their money there. They have several options how to enter a foreign market: they can do it in the conventional way by producing at home and then going for trade in goods and services or they can build up a foreign production base either by a green-field investment, by a joint venture or by acquiring an existing company. And they can opt for an intermediate mode of market entry: they can conclude a contractual arrangement with a foreign producer in form of licensing or offshore processing (Schmidt, Naujoks, 1993).

Although there is an enormous literature on FDI, a generally accepted theory is still lacking.<sup>2</sup> Even the most popular approach, the "eclectic theory of international production" developed by Dunning (1980) and others, is far from a generalization (Parry, 1985; Rugman, 1985). Notwithstanding the reservations it postulates the conditions under which FDI is undertaken at all (Sander, Schmidt, 1993).

According to the "eclectic approach" three conditions are necessary for FDI (OLI-paradigm):

- A company must have ownership advantages in operating in foreign markets that allow it to successfully compete with other, in particular with domestic companies;
- it must perceive some locational attraction of a foreign as compared to its domestic production base in manufacturing all or parts of its products;
- it must believe that these advantages can be best exploited internally rather than by means of non-equity arrangements, e.g., licensing agreements or management contracts.

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<sup>2</sup> For a short review see Agarwal, Gubitz, Nunnenkamp (1991) and Stehn (1992).



Ownership advantages are to be conceived as specific competitive advantages a company has vis-à-vis its foreign competitors. They originate from intangible assets such as superior knowledge in terms of production technologies, management know-how or marketing skills as well as from brand names or access to cheap funds. If ownership advantages are large enough to overcompensate for the additional cost of operating in a foreign market, then the company may feel invited to become internationally active - either by trade, by licensing or by FDI.

Locational advantages may originate firstly from different relative factor endowments on which traditional trade theories are based. The traditional approaches to international trade are: the H-O-S model, the product cycle model and the models explaining intra-industry trade. In the H-O-S model, e.g., the choice between domestic or foreign production is determined by the geographical distribution of immobile factors, such as cheap labour, plenty natural resources or favourable climate. Secondly, locational advantages may originate from

- a country's economic system and legal framework which predetermines the degree of political and economic stability as well as the structure of incentives and constraints which economic agents are facing,
- a country's trade regime (its "openness") which is an important determinant of sales perspectives,
- a country's quality of infrastructure or agglomerational advantages which are important determinants of production costs.

Internalization advantages mainly originate from economizing transaction costs, especially with respect to the cost of internationally transferring and using intangible assets such as technological knowledge. It is well known that international licensing is often insufficient such that the costs of enforcing property rights to intangible goods are prohibitively high. Mostly this is the case for non-standardized production technologies, for advanced technological knowledge, management know-how and other skills to which property rights are not codified but incorporated in an enterprise's employees. Intangible assets to which property rights cannot be enforced are public goods. Private costs are diverging from social costs such that the market mechanism fails to set prices efficiently. This market failure translates into high transaction costs. Companies which are operating internationally can avoid to incur them by establishing or acquiring subsidiaries abroad such as to use and to transfer intangible assets on markets which are internal to their organisation.

Initially it has been stated that the existence of each ownership, locational and internationalization advantages is a necessary and the simultaneous existence of them is a sufficient condition for FDI to occur (OLI-paradigm). More recently it has been argued that locational advan-

tages of a potential host country could be a both necessary and sufficient condition for FDI (Stehn, 1992). FDI may be undertaken even without firm specific advantages on part of the foreign investor if the potential host country's locational advantages are large enough to (over)compensate for only small or even lacking firm-specific advantages. This argument has important implications for economic policy towards FDI as within the OLI-paradigm locational attractiveness is the variable which is most perceptible to economic policy.

## **2 Motives for FDI**

The difficulties in providing a general theory of FDI also stem from the observation that the motives are differing considerably between the different markets in which foreign investors are engaged (Agarwal, Gubitz, Nunnenkamp, 1991). The traditional literature has focused on market access as the main motive for FDI. It states that there is an optimal timing for starting FDI: a company should have reached a certain market share in a foreign market by means of exporting before becoming an investor there. Actually, most multinationals start with exports and follow with FDI - as far as they will gain from specific ownership, locational and internalization advantages. Incidentally, the argument of market access is only convincing if foreign markets are closed; otherwise it may still be more profitable to serve them by exports. Insofar, the motives for FDI are more expected to be on the supply side than on the demand side: in the primary commodity sector investors are mainly interested in finding access to the deposit of raw materials while in the manufacturing sector they mainly look for cheap labour or qualified staff.

The relative importance of labour costs for FDI decisions, however, is not as straightforward as it might appear (Agarwal, 1989). Low labour costs are a necessary, though not a sufficient condition. One factor which is reducing the importance of cheap labour as a locational advantage is the increasing degree of automization in most manufacturing industries. Actually, FDI is more important in industries producing sophisticated products (such as automotive, electrical, machinery and transport equipment) than in industries producing standardized products. In the textile and the clothing industry, e.g., foreign investors prefer sub-contracting rather than FDI as these industries are not characterized by firm-specific advantages which might induce equity arrangements.

## **3 Forms of FDI**

"Traditional" forms of FDI can be described as a package with which foreign investors provide capital, technology and management at the same time. Normally, investors prefer to establish joint ventures in which they are the majority shareholder. The joint venture approach provides some advantages for them: above all, they can benefit from their partner's country-

specific knowledge yet still having full say in running the company. This also conveniently meets the host government's desire to find foreign partners for restructuring ailing state-owned companies.

However, frequently the existing companies in CEECs are in a deplorable state - suffering badly from technological backwardness and overmanning. Restructuring them is risky and expensive. Therefore foreign investors may refrain from the traditional forms of FDI. Indeed, in recent years new forms of FDI have gained importance round the world (Hill, 1985).

- First, there is a greater "un-packing" of FDI, that is foreign firms separately "sell" either technologies (mainly by licensing) or capital (by buying shares).
- Second, there is an increasing number of joint ventures in which the foreign partner is the minority shareholder.

Both forms have become common in developed market economies as well as in some (Asian) developing economies; and they are also emerging in CEECs. An outstanding example is the Skoda-Volkswagen deal, where at present VW holds only a minority share of 31 p.c. (with an option though to acquire the majority) - although actually VW is running Skoda as its own company.

As the theory suggests that investors may have different objectives when investing abroad - short or long-run profit maximisation, risk diversification and widening of the product cycle - we may find different forms of FDI for realizing them. It is controversially debated whether there are country-specific "styles" of FDI. There are no definite answers (Caves, 1993): we find a great variety of FDI-strategies applied by investors from the main source countries such as the USA, Japan or Germany, and the main host regions such as North and Latin America or Europe. But it seems that, e.g., German investors have a longer time horizon than investors from the United States and therefore show a stronger engagement also in politically and economically unstable countries. To some extent this kind of behaviour may explain why German companies are the leaders in FDI in most of the CEECs.

#### **4 Transformation and FDI**

Embarking on the process of economic transformation exposes the CEECs to a major shock. Due to this shock it becomes necessary to straighten out the distortions resulting from former politically determined specialization. The CEECs' new position in the world economy will depend upon

- the specific quality of their resources, namely locational characteristics, natural resources, labour force and capital stock as well as upon
- the specific design of the institutional framework, namely the kind of economic policy they pursue (Sander, Schmidt, 1993).

Transformation by its very nature is a dynamic process. The beginning of this process is usually characterized by a large depreciation of the stock of fixed capital while labour force and natural resources do not have to undergo depreciation to the same extent. This makes the transforming economy relatively richly endowed with labour and natural resources while relatively poorly endowed with capital. With respect to resource endowment and consequently with respect to comparative advantages this economy now easily resembles the economy of a less developed country. By CEECs this is often perceived as a "downgrading" and as a loss of economic prestige.

However, the underlying assumption of the "eclectic approach" is that each type of international economic activity goes along with a specific level or stage of economic development (Dunning, 1991). Accordingly, a transformation economy which is actually experiencing a major drawback with respect to development sees itself invaded by foreign investments which rather seem to fit a less developed country than its own until recently relatively high industrialized economy. This "downgrading" though is not caused by FDI and the specific form in which it occurs. Rather, causality runs reversely: the types and forms of FDI which presently occur are indicating the very stage of development to which the transformation crisis has thrown the economy back. There should be no question which type of FDI the Central East European countries need first: what they need is a rough Jeep, not a luxurious sports car. This can come later.

## 5 Hypothesis on FDI

From the theoretical considerations we can derive some hypothesis: we should expect a high concentration of FDI in those host countries which

- are leading in the transformation process, in particular in establishing a sound institutional framework of FDI, especially in privatizing state-owned enterprises and
- are able to offer a promising economic environment, in particular growing markets, qualified labour and low production costs.

We can also expect that FDI will concentrate on certain sectors - according to the host country's level of development, pattern of specialization and factor endowment (Dunning, 1991).

It is likely that FDI is more important in sophisticated industries than in industries producing standardized goods as these industries hardly allow ownership and internalization advantages to be realized.

### **III Scope and Limitation of the Data Base**

An obstacle for analyzing FDI is the poor data base. Only few CEECs made available data which relate to FDI and even these statistics report on different subjects. Therefore, data collected by international organizations are incomplete and inconsistent so that it is hard to analyse them.

The main inconsistencies stem from different methods of registration and from different times when the inflow of cash is reported. Further problems arise as it is hard to distinguish between direct investment and portfolio investment (OECD, 1993).

In principle, an FDI data base should include

- new equity investments as well as long-term credits,
- reinvested earnings respectively consolidated losses and
- changes in the net value asset.

It should involve only investments stemming from establishing, acquiring or expanding an affiliated subsidiary corporation or branch, but not portfolio investments (Brewer, 1991). In reality though, available data relating to net flows are based on the capital account of the balance of payment statistics. By definition these data exclude invested profits and consolidated losses as well as revaluation of the capital stock.

For the most part this paper uses data relating to cumulated flows (in value terms) which are collected and published by the OECD, the IMF, the UNIDO and the ECE, supplemented by data from national statistics. Despite all shortcomings explained above, these data allow to identify the basic trends and patterns both for the group of CEECs as a whole as well as for single countries.

### **IV Assessment of the Current Situation**

#### **1 Conditions of FDI**

The key to FDI is a legal and institutional framework to set the scene for productive investment in general. After the collapse of the old system all CEECs suffered from such problems

as oversized and overstaffed companies, unclear property rights, seriously distorted prices, irrational tax and tariff systems, weak financial institutions and exaggerated bureaucratic regulations. Meanwhile all CEECs have made major steps towards a market oriented system - though some have moved quicker while some have moved slower. A report prepared by the OECD (1993) identified three groups of countries with respect to provisions regulating FDI:

- The Czech Republic and the Slovak Republic as well as Hungary have already established a comprehensive, sophisticated legal system. It is not without faults and gaps but offers foreigners reasonable incentives for business.
- Romania, Bulgaria, the Baltic states, Russia and, with some reservation, also Poland have created a patchwork of laws which is mixed: some parts are modern while other parts look quite old-fashioned.
- Albania and the other successor states of the Soviet Union have laid down only the basic legal rules for FDI.

All countries have started comprehensive privatization programmes. Concepts and legislation, however, vary widely and public and political support similarly do. The same is true with respect to the current state of the privatization process. It is therefore not easy to examine its impact on FDI. The OECD (1993) again distinguishes three main groups of countries:

- Hungary is considered as the leader although the game is still running. Its privatization policy is more "open" to foreigners than those of other countries. This may explain why Hungary has been very successful in attracting foreign capital.
- Poland, the Czech Republic, Russia and the Ukraine are placed in the midfield. They put more emphasis on distributing vouchers to their people and less on pulling in investors from abroad.
- Albania, Bulgaria and Belorussia are at the bottom of the scoreboard. Their road to privatization is cobbled with uncertainties which may discourage foreigners.

This ranking may be worse in some cases.<sup>3</sup> It can be argued that in respect to privatization there is no point in placing Russia and the Ukraine in the midfield - together with Poland and the Czech Republic. However, each sort of ranking is more or less arbitrary. In this case the

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<sup>3</sup> For an update see OECD (1994).

criterion is the technique of privatization: there is no doubt that the method of voucher privatization poses some impediments to FDI.

It should be noted that all CEECs restrict FDI to one or more "strategic" sectors such as defence, aviation, shipping, energy or banking.

Despite the manifold legal and institutional obstacles all CEECs use a wide variety of instruments in setting incentives in order to influence an investment decision by increasing the profit accruing to the potential investment or by reducing the risks attached to it. The most important are fiscal instruments (such as preferential tax rates, tax exemption and tax credits), but also non-financial instruments (such as import protection or the establishment of free-trade enterprise zones).

In the literature it is controversially discussed how the pattern of international direct investment will be affected by government actions. An OECD report on "investment incentives and disincentives" (1991) came to ambiguous conclusions. However, an unfavourable economic and political climate cannot easily be surmounted by special incentive government actions.

Table 1 - Obstacles for FDI in Central East Europe (given by a sample of 163 respondents from developed market economies)

	in percent
Lack of information about potential partners	97
Difficulties in assessing the potential of local enterprises	89
Complicated legal structure	71
Lack of transparency of the economy	67
Insufficient stability of the political and/or economic situation	44
Lack of transparency of the decision-making process	36
Language barriers	21

Source: Sereghyová (1993).

Apart from enhancing the attractiveness of CEECs to foreign investors by implementing a sound legal and institutional framework, there is much more to do in order to improve the knowledge of foreigners about which opportunities CEECs may offer them. An inquiry among a sample of 163 entrepreneurs, business consultants and bankers of western countries who were regarded as potential investors in Central East European countries indicates that their reluctance is mainly caused by a lack of transparency within the local economy rather than by bureaucratic administrative procedures (Table 1).

## 2 Performance of FDI

### a) Overall Trends

Although some FDI trickled into the CMEA countries already in the seventies and eighties a dynamic development only started after 1989 when new democratic governments committed themselves to economic transformation. From the end of 1989 to the end of 1992 the number of foreign projects skyrocketed - according to a data base of the ECE (1993) - from about 2 500 to about 70 000 (Table 2). Thus it is fairly reasonable to assume that at present more than 100 000 foreign investment projects are registered in CEECs.<sup>4</sup>

Table 2 - Flows of Foreign Direct Investment into CEECs by Host Countries 1989-1992

	Number of projects(a)				Net flows in mill. \$			
	1989	1990	1991	1992	1989	1990	1991	1992
Bulgaria	30	140	900	1 200	..	4	56	42
ex Czechoslovakia	60	1 600	4 000	6 000	257	188	592	1 054
Czech Republic	..	..	..	3 120	..	..	..	983
Slovak Republic	..	..	..	2 875	..	..	..	71
Hungary	1 000	5 700	9 100	13 000	..	311	1 459	1 471
Poland	90	2 800	4 800	10 100	-7	88	117	185 (b)
Romania	5	1 500	8 000	20 700	..	-18	37	73 (c)
Total above	1 185	11 740	26 800	51 000	..	573	2 261	2 825
ex Yugoslavia	..	3 900	..	..	..	189 (d)	137 (d)	..
Slovenia	..	..	1 000	1 650	..	-2	41	113
ex Soviet Union	1 300	2 900	3 900	15 300	..	..	..	..
Belorussia	..	40	280	710	..	..	..	..
Estonia	..	100	1 100	2 662	..	..	..	..
Latvia	..	50	295	1 300	..	..	..	..
Lithuania	..	20	220	2 300	..	..	..	..
Russia	..	1 500	2 022	3 500	..	..	..	100
Ukraine	70	70	400	900	..	..	..	..
Grand total	..	..	..	..	..	..	2 502	3 855

(a) Registered at the end of year. - (b) January-September. - (c) January-November. - (d) January-October.

Source: Economic Commission for Europe (1993, 1994).

Although the large number of registered projects overstates the FDI performance:

- Only an estimated average of only 50 percent of all projects are virtually in operation (OECD, 1993). A large proportion of companies are just an accommodation address.

<sup>4</sup> An analysis of the recent trends in some countries provide Hamar (1993), Sereghyová (1994), Sadowska-Cieslak (1994b), Gradev, Bobeva (1994) and OECD (1994).



- Only a minority of companies have made substantial investments. The average size of foreign equity involvement is minimal. The typical FDI in CEECs is rather small.

The mushrooming of projects formally registered must be attributed to foreign activities in trade and other services. In these sectors foreigners mostly invested just the minimum deposit demanded by law. Large-scale investments have usually been made only in the raw material and the manufacturing sector and they are small in number.

Consequently, flows of capital have increased at a much slower pace than the number of projects registered. In 1992 flows to CEECs amounted to just 3.8 billion \$ or a little bit more (Table 2).<sup>5</sup> For comparison: at the same time global FDI financed by OECD countries reached about 175 billion \$; flows to CEECs amounted to less than 2 percent of the total.

Table 3 - Stocks (a) of Foreign Direct Investments in CEECs by Host Countries 1989-1993 (in mill. \$)

	1989	1990	1991	1992	1993
Bulgaria	..	..	300	320	..
ex Czechoslovakia	256	436	1 100	1 900	-
Czech Republic	..	..	..	1 669	2 100
Slovak Republic	..	..	..	231	366
Hungary	550	1 450	3 300	4 300	6 500
Poland	100	352	680	1 400	2 100
Romania	..	113	269	538	685 (b)
Total above	..	..	5 649	8 458	..
ex Soviet Union	837	1 328	5 500 (b)	..	..
Belorussia	53	101	..	..	..
Estonia	45	48	180 (b)	..	..
Latvia	9	27	121 (b)	..	..
Lithuania	14	15	120 (b)	..	..
Russia	617	959	800 (b)	..	..
Ukraine	24	52	670 (b)	..	..

(a) Cumulated flows at the end of year. - (b) October.

Source: OECD (1993, 1994); several national sources.

Stock figures (derived from cumulated flows) indicate that at the end of 1992 not more than 15 billion \$ were invested in CEECs (Table 3). In respect to total world-wide FDI stocks - approximately 1.5 trillion \$ - a quantité négligeable (Jungnickel, 1993). From this one could imagine what an enormous potential for FDI in CEECs still exists.

<sup>5</sup> The preliminary figure for 1993 recently published by the ECE is 3.9 billion \$.

b) *Patterns*

aa) Geographical Distribution

With respect to host country preferences there is a clear-cut ranking: foreign investors favour the Central East European countries and among them Hungary, Poland and the Czech Republic. Hungary has been able to attract the lion's share (30 percent) of foreign capital but Poland and the Czech Republic are making up mightily. According to recent national statistics the amount of FDI stocks in Poland jumped from 1.4 billion \$ at the end of 1992 to 3 billion \$ at the end of 1993 and in the Czech Republic from 1.7 billion \$ to 2.2 billion \$. In these three countries accumulated FDI flows accounted for about half of FDI attracted by all CEECs.

It is remarkable enough that the successor states of the Soviet Union are more and more becoming an attractive place for western FDI, too. Especially the Ukraine and the Baltic states could raise their share in total FDI projects significantly. At the end of 1992 in Estonia, Latvia and Lithuania together nearly 6 000 joint-ventures were registered, much more than existed at the same time in Russia (3 500).

Flows of FDI to CEECs stem mainly from western developed market economies. The geographical pattern differs widely, but on the average there is a clear predominance of Germany: in 1991 and 1992 more than two fifths of reported FDI came from there (Table 4). The other most important source countries were Austria, the United States and the Netherlands.

Table 4 - Flows of Foreign Direct Investment into CEECs by OECD Source Countries 1991 and 1992

	1991		1992	
	mill. \$	percent	mill. \$	percent
Total OECD countries	1 654	100	2 366	100
of which:				
Austria	361	21.8	397	16.8
France	210	12.7	167	7.0
Germany	725	43.8	988	41.6
Japan	185	11.1	..	..
The Netherlands	145	8.7	364	15.4
United States	..	..	397	16.8

Source: Love (1993).

Germany is ranking among the top five in all CEECs, but it is not the champion everywhere. On the contrary, in Bulgaria we find Greece at the top, in Slovakia Austria, in Hungary and Russia the USA, in Romania France, in Estonia Finland and in the Ukraine Italy (Table 5). That means: fears about "German domination" in CEECs are basically exaggerated. Recent

statistics indicate that even in the Czech and in the Slovak Republic the predomination of its two western neighbour nations - Germany and Austria - is apparently becoming a matter of the past (Sereghyová, 1994).

Table 5 - Five Top Source Countries in Selected Central East and East European Host Countries 1992/1993 (According to Stocks; in Brackets Percentage Shares)

Source country	1st	2nd	3rd	4th	5th
Host country	rank				
Bulgaria(a)	Greece (..)	Germany (..)	Austria (..)	Italy (..)	Russia (..)
Czech Republic(b)	Germany (31)	USA (28)	France (13)	Belgium (7)	Austria (6)
Slovakia(c)	Austria (..)	Germany (..)	USA (..)	Netherlands (..)	France (..)
Hungary(d)	USA (..)	Germany (..)	Austria (..)	UK (..)	France (..)
Poland(e)	Germany (37)	Sweden (8)	USA (8)	Austria (7)	France (5)
Romania(f)	France (..)	USA (..)	Germany (..)	Italy (..)	UK (..)
Estonia(g)	Finland (51)	Russia(i) (22)	Sweden (11)	USA (3)	Germany (3)
Russia	USA (61)	Italy (6)	..	..	Germany (4)
Ukraine(h)	Italy (..)	USA (..)	Germany (..)	Sweden (..)	Spain (..)

(a) 31 March, 1993. - (b) 31 December, 1993. - (c) 31 December, 1992. - (d) 1 August, 1993. - (e) 1 July, 1992. - (f) 1 January, 1992. - (g) 1 January, 1993. - (h) 31 March, 1993. - (i) CIS.

Source: OECD (1993).

There is no simple explanation for the different clusters: geographic proximity as well as traditional economic and cultural links are perhaps the major cause of that. The high share of French investment in Romania or of Finland in Estonia, e.g., may be explained by language ties. Sometimes, though, the ranking is strongly influenced by accident such as large-scale engagements of single investors.<sup>6</sup>

The bulk of FDI in CEECs has come from western European countries. The only important overseas investors are those from the USA which hold not only the top in Russia and Hungary but are among the leaders in all other CEECs, too. Japan, one of the leading investing countries in the world, has been conspicuously reluctant to enter the CEECs. This is in line with the typical wait-and-see attitude of Japanese investors observed in other parts of the world.

<sup>6</sup> Especially flows can be "biased" by such transactions. For instance, in the Czech Republic the share of US-American capital in overall FDI undertaken in 1993 jumped to 45 percent while the share of German capital decreased to 14 percent. This was due to a large-scale investment of Philip Morris (about 190 million \$) into a joint venture with the Czech company Tabák Kutná Hora (Sereghyová, 1994).

Noticeable is the high regional concentration of investments within the single countries. Most of the foreign investors go either to the capital city or to regions of industrial agglomeration. In Russia, e.g., the bulk of FDI is concentrated on Moscow City and the Central Region, in Hungary on Budapest City and the western parts of the country. This does not come as a surprise: it is the best way to take advantage of externalities which are strategically important for foreign investors.

#### bb) Sectoral Concentration

A general trend in world-wide FDI is that "it started everywhere in services" (Inotai, 1992). The CEECs are no exception to this. The bulk of projects is in commerce, transport, banking, insurance and other consumer and business services. However, in this respect we have to make a distinction between the number of the projects and the amount of investment made inside and outside the service sector. In value terms the sectors of energy, mining and manufacturing attract most of the capital. This is due to the fact that in those sectors the capital required is much higher than in the services.

Table 6 - Structure of Foreign Direct Investment of German Companies in Central and East European Reform Countries by Selected Branches 1989 and 1992 (percent) (a) (b)

	1989	1992	Note:	
			Spain 1992	Portugal 1992
Manufacturing	89.7	58.2	66.0	66.0
of which:				
Chemical industry	3.8	3.3	17.3	11.6
Engineering	13.8	9.2	6.4	4.2
Vehicle building	n.a.	26.7	22.9	5.7
Electrical equipment	2.9	5.2	7.3	28.3
Trade	3.6	10.2	2.9	3.0
Banking and insurance, investment funds(c)	6.7	32.6	31.1	31.0

(a) Stocks, end of the year. - (b) Incl. China. - (c) Incl. others.

Source: Deutsche Bundesbank (1994).

Due to the insufficient data base it is difficult to draw conclusions of the industrial composition of FDI in CEECs which could be generalized. From German FDI statistics (which appear to be fairly reliable) we can conclude that on average manufacturing is the major recipient of foreign capital: at the end of 1992 about 60 percent of stocks of German FDI in CEECs were allocated to this sector (Table 6).

Although it could be expected that labour- and capital-intensive industries such as production of consumer goods and food processing offer the best opportunities, these industries generally seem to provide only limited scope for FDI: 45 percent of total investment in manufacturing were concentrated on just four branches, namely chemical industry, engineering, vehicle building and electrical equipment. There are at least two explanations for this (Schmidt, 1993).

- First: in labour- and capital-intensive industries technologies are mostly relatively simple, hence the possibilities that foreign firms may gain firm-specific advantages are quite limited. In those industries subcontracting is the dominant form of foreign investment.
- Second: the main interest of foreign investors is not to take advantage of sweat-shop labour. Most of them look for a long-term engagement. This may explain why the structure of German FDI in CEECs differs significantly from the structure which is typical for developing countries. It is rather similar to that of Spain and Portugal, two of the preferred western European target countries for German FDI.

Presently, the main strategy of German companies is to build-up "prolonged workbenches" in human labour-intensive industries. They hire firms, e.g. producing industrial switches, computer keyboards or headlights and brakes for cars, which can be employed as suppliers for their home production base. The relatively short distance between domestic plants and foreign subsidiaries makes it easy to meet even tight delivery schedules. This gives producers in most CEECs an edge on their Asian rivals.

#### cc) Commodity Specialization and Trade Orientation

First the structural pattern of FDI was more or less of accidental nature. Recently, a relatively big share of fresh investment has been channelled into the manufacturing sector (and into manufacturing subdelivery bases). This indicates that a reorientation of foreign investors is under way: the structure of FDI comes closer to the comparative advantages of the countries than it was in the past. Consequently, we have to expect different patterns in different countries according to their respective comparative advantages and levels of development (Dunning, 1991; Sereghyová, 1994).

A lot of research has investigated the contribution of FDI to industrial restructuring and especially to establishing an export base. By and large, FDI seems to be more export oriented than oriented towards local markets, but due to lack of data this point remains controversial in the literature. Presumably, it is correct to say that multinationals generally start FDI as export bridgeheads for securing their own domestic markets or for serving international markets; but later they turn to supplying the host countries' markets when local demand has increased as a

result of industrialization and growing income and the host countries' markets offer new sales opportunities. In this respect foreign investors have often been criticized that their exports of resource-based and labour-intensive products have a much larger share in total trade than their exports of "sophisticated goods". However, the obvious importance of inter-industry exports at the early stage of industrialization does not come as a surprise: the pattern is fully in line with the theory of economic development. Mostly, this will change when the host countries have approached the state of intra-industry production.

Intra-firm trade plays an increasingly important role in foreign trade orientation of FDI. This has a strong impact also on imports of host countries. Intra-firm imports consist mainly of capital goods to establish foreign affiliates and of "sophisticated" intermediate products used for local processing which is often considered as a factor which weakens the progress of industrialization in the host country. However, this pattern of intra-firm imports rather reflects the local availability of inputs at the respective stage of industrialization. It will change quickly in the ongoing process of industrialization.

### **3 Effects of FDI**

It is often criticised by CEECs that the contribution of FDI to build up the host country's new capital stock is relatively small. Indeed, at first sight the FDI performance remains disappointing if measured against the expectations and needs of the CEECs. The amount of invested capital was still low at the end of 1992: on the average about 1.5 percent of GDP (Table 7). Only in two countries, in Hungary and - by a wide margin - in the Czech Republic, stocks of FDI already accumulated to a significantly higher share.

Whatever is the reason for the poor capital inflows, such magnitude that they could close the "capital gap" should not be expected (Stern, 1994). Historical experience of LDCs in the seventies and eighties shows that annually net flows of FDI averaged only 0.4 percent over a twenty year period. In addition, only few countries' inflows were persistently clear above (e.g. Malaysia), most of the others were clearly below the average (e.g. India); some countries' shares exhibited stability while others experienced significant changes from one year to another (Brewer, 1991).

Even if there were major increases in FDI flows in the next two or three years - which is unlikely - it would take several years before the cumulative effect could be substantial. Insofar the CEECs cannot rely on growing FDI-flows alone, the bulk of capital must be mobilized at home.

Table 7 - Stocks of Foreign Direct Investment in Percent of Gross Domestic Product in Selected Central East and East European Countries 1991 and 1992

	End of	
	1991	1992
Bulgaria	..	0.3
ex Czechoslovakia	3.4	5.8
Czech Republic	..	7.0
Slovak Republic	..	2.6
Hungary	10.0	11.4
Poland	0.6	1.3
Romania	0.6	1.3
ex Soviet Union	..	..
Estonia(a)	..	1.8
Ukraine(a)	..	0.3
Russia(a)	..	0.9
(a) October 1992.		

Source: OECD.

## V Conclusions

Economists and policy makers in CEECs always complain that foreign companies are too reluctant with respect to large-scale investments. They are right. The number of projects started is actually impressive but the amount of invested capital is still relatively low. The question arises: do we need to rewrite the textbooks on FDI? The answer is no. FDI in CEECs appears to be fully consistent with conventional wisdom. Therefore, nobody should be disappointed.

From economic theory we learn that FDI is only one out of several possible forms of international involvement. A company in search of such an involvement faces a trade-off in the method of entering a foreign market: it will opt for an equity arrangement only under certain conditions - if it can identify significant ownership, locational and internalization advantages. Otherwise it would choose a strategy like exporting or contracting. Apparently, the conditions for western investments in CEECs still leave much to be desired (Donges, Wieners, 1993; Welfens, 1993; Sadowska-Cieslak, 1994a):

- Legislation which guarantees private property (or a prompt and full compensation at market values in the event of expropriation) and the repatriation of capital seldom come up to western standards. In this respect further improvements should be made.

- Acquisition of real estate and land is handled in a different way in different countries, but everywhere it is still more or less restricted. FDI would well be encouraged by allowing foreigners to acquire the real estate necessary to the business.
- Registration and licensing procedures are often fathomless and sectors submitted to authorization or barred to foreigners frequently unclear. Formulas as "prejudicial to the country's economic interest" should be stated more precisely.
- Legislation on taxes and duties often lacks transparency. Somewhere foreign investors are preferred to local investors, somewhere they are discriminated against. Rules, procedures and preferences should be clarified.
- Privatization is still a sensitive issue in most countries. In principle, foreign investors are welcome to participate in the privatization process but, in fact, they may be often discouraged by intransparent and complicated procedures. Governments in CEECs should recognize that the market for the run-down and overstaffed state-owned enterprises is by far no seller market. More efforts should be made to privatize these enterprises directly to foreigners.

Actually, the policy framework of the CEECs in search of FDI appears to be ambivalent. It consists of various forms of concessions and subsidies on the one hand and a complex system of controls and regulations on the other hand. This reflects the governments' desire to obtain the highest possible benefit from FDI in terms of technology, capital and management know-how, but at the same time to restrict foreign ownership and control of the economy. The concern of host countries to preserve economic sovereignty may be understandable. But the economic effect of most regulations and controls imposed on multinationals is detrimental, reducing rather than increasing the benefits from FDI. There is some evidence in the literature that many governments are obliged to offer concessions and subsidies only to compensate for the controls and regulations they impose on foreigners.

A considerable number of studies dealing with incentives to FDI have finally concluded that they are presumably more harmful than useful (Brewer, 1991):

- Incentives may be inappropriate with respect to the host country's factor endowment. A common contention in the literature is the high capital intensity of multinationals in host countries (especially in LDCs) relative to that of locally owned firms. It is argued that such capital intensive techniques are disregarding relative scarcities, that is not "appropriate" to the (mostly) labour rich and capital scarce countries, and may adversely affect employment opportunities.



- Incentives may influence the host country's trade performance. A crucial point is the demand of multinationals for protected markets. Granting protection host countries may be pushed towards a strategy of import substitution (IS) instead of an export promotion (EP). It is a matter of fact that many LDCs which were successful in attracting FDI followed IS. Under IS, however, multinationals will consider the incentives provided by tariffs and quotas as "artificial" and only limited in time. Indeed, these incentives may not be a strong inducement for foreign investors to go abroad.
- Incentives may also have an impact on the forms of inflow of foreign capital - whether multinationals choose grass-root investments, joint ventures or mergers. In many CEECs governments have a preference for joint ventures - although the welfare effects of this strategy are uncertain.

Several studies based on interviews with managers of multinationals report that they regard factors such as resource endowments, level of economic development, future growth performance, market size, infrastructure facilities and political stability to be much more important in their investment decision process than concessions and subsidies (Sadowska-Cieslak, 1994a). Studies based on regression analysis come to the same result. Obviously, most multinationals regard such incentives to be too volatile, transitory or even illusory. Tax holidays, e.g., are usually given to firms only during the early days of their operations when they are least likely to show profits. Therefore, governments in CEECs should primarily pay attention to creating a general and consistent framework for foreign investors - only then can they hope to participate adequately in international capital flows. They must learn that FDI cannot be switched on like an electric light. To get the reputation of an attractive harbour for FDI needs some time - and some effort, too.

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