FOREIGN DIRECT INVESTMENT IN THE SOUTHERN AND THE NEW ACCEDING EUROPEAN COUNTRIES: REPLACEMENT OF ACTIVITIES?.

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Abstract

In this paper, after a general overview of the economic situation of the new EU countries of 2004, we start by studying the foreign direct investment (FDI) by economic sector in the three Baltic countries (Estonia, Latvia and Lithuania), the five Central countries (Czech Rep., Poland, Hungary, Slovakia and Slovenia), besides Cyprus and Malta. In second place, we will monitor the potential and performance FDI indices for acceding countries and for Spain, Portugal and Greece. Finally, we present some conclusions.

Keywords: Foreign Direct Investment, European integration, Location of economic activities

JEL code: F21, F23, O52

1.Introduction.

From the beginning of the European Common Market, there has been a strong increase in intra industrial trade, reason for which the adhesion of new states has had small costs of adjustment over their industrial structures. Besides, this process has favoured that the EU has increasingly behaved as an optimal monetary area, in which economic shocks have had homogeneous effects over the member states.It is generally accepted that due to a better accessibility from these new states, with low salaries, to the European core, industrial activities may move towards them. Nonetheless, it is also possible that production may concentrate around the areas closer to the markets, although their costs of production were higher. As these countries joined the EU, they will undergo the removal of borders controls, technical barriers to trade and barriers to the movements of factors of production.

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The theories of international (Krugman (1979), Brander and Krugman (1983) and Helpman and Krugman (1985)) trade may explain a reciprocal flow of direct investment among firms located into the more developed markets, to the detriment of firms located into peripheral regions. They also explain that whether the target of the direct investment is to exploit intangible assets, the consequences of European integration over capital flows can be difficult to forecast.

2. The main characteristics of acceding countries

The enlargement that EU has achieved in 2004 has been the higher in number of new states, territorial and population increment (10 countries, 23% of UE territorial and 75 millions people). These states are Cyprus, the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Malta, Poland, Slovak Republic and Slovenia.

Table 1 and table 2 present the main characteristics of new EU countries and the southern countries in 1986, in order to make a comparison.

Table 1. Some indicators of candidate states in 2001

	Popul. x1000	GDP per head € 2001 PPP	Unempl. rate (%) 2002	Agricul. share in Gross VA.	Exports % of GDP
Czech Republic	10285	13700	7.3	4.2	71
Estonia	1364	9240	9.1	5.8	91
Cyprus	762	17180	5.3	4.0	47
Latvia	2355	7750	12.9	4.7	45
Lithuania	3476	8960	13.0	7.1	50
Hungary	10185	12250	5.6	4.3	61
Malta	393	-	7.5	2.4	88
Poland	38638	9410	20.0	3.8	28
Slovenia	1992	16210	6.0	3.1	60
Slovakia	5397	11200	19.4	4.6	73
Candidate states	74850	10700	15.1	4.1	47
EU-15	377850	23210	7.5	2.1	36

Source: Eurostat.

Table 2. Some indicators for Spain, Portugal and Greece in 1986.

	Popul. x1000	GDP per head € 2001	Unempl. rate (%) 2002	Agricult. share in Gross VA.	Exports % of GDP
Spain	38.640	10.360	21.2	5.62	20
Portugal	10.012	5.949	8.3	7.44	25
Greece	9.980	10.074	7.4	14.29	22

Source: IMF. GDP per capita at 2001 Purchasing Power Parities.

In 2001 GDP per head in acceding countries was in every single case under the EU mean (23 thousand €), being their average equal to 10,700 €. Comparing the departure situation of the candidate states with that of Spain, Portugal and Greece at the time of their adhesion to the EU, we can see, first of all, that their GDP per head was in 2001 higher than that of Spain, Portugal and Greece in 1986. Secondly, the ratio exports/GDP was more favourable for candidate states. Thirdly, although the share in the economy of agriculture in the candidate states was higher than the European average - 4 % in 2001, twice the EU average – it was well below the ratio corresponding to Spain, Portugal and Greece in 1986. Also, the weight of service sector in candidate countries is lesser than UE-15.

The new countries have decided reduce their society taxes because the inward FDI had reduced in 2003. Apart from this measure, the low wages, the population with a high level of education and the possibility to achieve to European subventions makes these countries very attractive for foreign investments.

Moreover, the new acceding countries had in general upper levels of productivity than Spain, Portugal or Greece. On the other hand, in the world ranking of Corporation tax, 7 of the 11 countries with lowest level of tax are some of new acceding countries (Cyprus, the Baltic countries, Hungary, Slovak Rep. and Poland). However Spain is one of the 11 countries in the world with higher corporation tax.

3. Importance of FDI in acceding states.

FDI is a way of international loan, by which those countries that have better investments opportunities at the present borrow from those that have capital surplus.

Table 3. Percentage of FDI net inflows over Gross Investment in fixed capital (GIFC) and GDP. Annual FDI net inflows per head 2000 US$ (2000 Exchange rates).1996– 2003

	FDI/GIFC		FDI/GDP		FDI per head	
	1996-99	2000-03	1996-99	2000-03	1996-99	2000-03
Latvia	127.3	57.8	26.5	15.5	680.1	512.9
Lithuania	77.5	64.1	18.3	12.9	544.0	449.9
Estonia	73.8	85.4	20.6	23.6	697.7	976.5
Poland	62.7	59.7	14.1	12.6	547.6	554.5
Czech R.	76.9	119.0	22.2	33.8	1073.4	1757.1
Slovakia	26.8	130.6	8.6	35.5	309.0	1410.7
Hungary	128.8	70.2	29.0	16.5	1169.9	788.2
Slovenia	16.6	34.7	3.8	8.0	316.9	798.0
Malta	156.5	73.8	38.5	21.9	3214.5	1881.3
Spain	-27.4	-11.8	-6.4	-3.0	-863.0	-418.0
Portugal	-3.7	-9.8	-1.2	-2.8	-126.0	-296.4
Greece	7.5	-1.7	1.4	-0.2	133.1	-20.8

Source: own elaboration, UNCTAD, FMI

For less developed countries, FDI can be an important instrument to fuel their economic growth. In this connection, we should bear in mind that FDI can, on the one hand, encourage technological development and, on the other, support the accumulation of physical capital (Borensztein et al , 1998). In the context of the candidate states, which still have a deep technological and development gap with the EU member states, FDI can play an important role in promoting real and technological convergence.

Between 1993 and 2002, candidate states received FDI inflows almost the 20% of their gross investment in fixed capital and around the 5% of their GDP. These figures are higher than those of Spain, Portugal and Greece in the years before their adhesion to the EU: 5% over investment and 1% over GDP. However, FDI inflows in Spain, Portugal and Greece were also higher in the interval between 1993 and 2002, when these ratios were 9% and 2%, respectively (Frías et al, 2005). All candidate states, but Latvia and Lithuania, have received higher FDI inflows than Spain, Portugal and Greece between 1980 and 1986.

The countries that had increased its FDI net inflows: Slovakia, Slovenia, Estonia and Czech Republic. The situation has not changed in Poland. Portugal and Spain have experience an increase in FDI inflows in last years, though at the moment, FDI outflows are higher than inflows. Spain, Portugal and Greece have negatives FDI net inflows.

The weight of inflows of FDI over GDP in Czech Republic and Slovak Republic are 35%. In Estonia there is a great difference between gross and net inflows of FDI: gross inflows represents 32% and net inflows represents 23.5% of GDP. These three countries had inflows of FDI higher than its Gross Investment in fixed capital.
There was a fall down of FDI inflows in 2003 in the new acceding countries; it was because the important drop in Czech Republic and Slovak Republic. These two countries was a core of growth in 2002 because a privatization process in their industries.

4. Analysis of FDI by sector of activity.

It may also be interesting to analyse the FDI broken down by economic activity. The economic sectors of acceding countries that have received the highest amounts of FDI have been: Manufacturing activities, financial intermediation, Trade and Transports and communication.

Last years, the FDI stocks in the acceding countries have been increasing in these sectors (graph 2). In the economy as a whole, Lithuania has the highest rate of growth of the FDI stock; Czech Republic and Estonia have also great values of its annual rates of growth (more than 25% in 1997-2001).

In the Second sector, the Slovak Republic and Lithuania have reached annual rates of growth about 20% between 1996 and 2000, but the Czech Republic was on the top of the FDI stock per inhabitant in 2000, with more of 800 US$. In this branch of activity, only Slovenia has had negative rates some years.

Czech Republic is in the top of FDI stocks in Trade sector, the average rate of increasing of this country is more than 30% between 1997 and 2000 (similar to Poland), and received 300 US$ per inhabitant in the last year, value only reached by Estonia.

In Finance, Estonia was in the top (580 US$ per inhabitant) in 2001, but Lithuania had the highest growth rates in these years. Estonia, the Czech Republic and Poland have also had important increments, with annual rates around 30%.

Table 4. FDI stocks in the acceding countries, by industry, 2001*(2000 US$ per inhabitant)

	Total	Industry	Trade	Finance	Transport & Communic-ations	Others
Latvia	1016	160	228	166	153	308
Lithuania	665	191	151	108	125	90
Estonia	2290	474	302	578	515	422
Poland	1411	543	150	304	142	271
Czech R.	2106	803	317	310	237	440
Slovak R.	691	367	80	83	116	46
Hungary	1188	437	147	135	78	390
Slovenia	1413	574	198	364	22	254
Average	**1392**	**522**	**175**	**258**	**148**	**290**

*Latvia, Estonia and Poland: 2001, other countries: 2000, Cyprus and Malta: not available.Own elaboration UNCTAD/WIR/2003 and Eurostat.

Other important sector in many countries is Transports and communication, with great increments in its value of FDI per inhabitant. Investments in this industry have been very important for Estonia, that has an annual rate of increasing of 80%, and the direct investments reached more than 500 US$ per inhabitant in 2001.

Table 4 presents the stocks of foreign direct investments in eight acceding countries by sector in 2001.

Estonia and Czech Republic are the countries with higher FDI stocks per inhabitant: more than two thousand US$. These countries are over the average in all economic sectors. In the Trade sector, we can also point to Latvia and Slovenia. In Manufacturing and Financial sectors, Poland and Slovenia are over the mean value. Other sectors are important in some countries.

Table 5. Cross-border mergers and acquisitions 1996-2003. (2000 US$).

	Purchases		Sales	
	1996-1999	2000-2003	1996-1999	2000-2003
Austria	2019	6531	5876	11518
Belgium	17648	41119	39222	21903
Czec Rep	339	890	3533	8937
Denmark	7899	12780	8253	14566
Estonia	30	51	329	241
Finland	10992	33209	8460	17856
France	132104	267267	59980	91415
Germany	153500	174975	68541	360502
Grecee	3179	5611	654	2861
Hungary	172	2405	2656	4085
Irelnd	10317	12392	7642	16023
Italy	29343	39224	18935	50180
Lithuania	1	0	1079	672
Litva	0	0	165	396
Luxemburg	5057	14643	10202	10494
Malta	4	42	233	150
Netherland	90981	102645	71592	77381
Poland	613	911	6895	15949
Portugal	5913	4719	1291	5660
Slovak Rep	450	119	241	6210
Slovenia	3	93	151	1755
Spain	45898	60205	15014	42545
Sweden	31284	45847	70147	30841
UK	388785	612011	284157	327896
Total	936530	1437686	685248	1120039

Source: own elaboration from UNCTAD.

We can see the weight that different industries have in the selected countries. The manufacturing sector has a great importance in the Slovak Republic, represents more than half of the FDI stock in this country. Trans-national companies (TNCs) of motor vehicles are the most important industry in this economy (do not forget that Volkswagen and Skoda have a great weight in the Slovak economy).

This sector was also important in other countries, but in Baltic countries where this percentage was lesser.

Although Distribution Trade, Finance and Transports and Communication are important in all countries (except Transport in Slovenia), there are other sectors which are specifically outstanding in some countries. Business activities (real estate, rental activities, computer …) reaches the 16% in Latvia and Hungary, and it is also important in Slovenia and Estonia. We can also mention that distribution of electricity, gas and water reaches 9% of FDI stocks in Hungary.

As we can see in table 5 purchases and sales of Cross-border Mergers and Purchases in 1996-2003 growth in UE-25.
Germany, U.K. and France had the higher volumes, and we can also stress Luxemburg and Netherland. United Kingdom has more than 42% of total purchases and 30% of total sales in 2000-03; Germany represents 12% and 32% respectively; and the data of France are 18% and 8%.

Estonia, Lithuania and Malta and also Belgium are the countries that present a descent of purchases and sales. The purchases fallen down only in Slovak Republic and Portugal. The reason of this is the fall down of unitary amount although the volume of deals increased.

4. Indices of FDI in Southern and new acceding countries.

It is interesting to assess how successful an economy is in attracting FDI after taking size into account which can implicitly capture the effect of other factors to which foreign investors are sensitive. Following the World Investment Report 2002 *Trans-national Corporations and Export Competitiveness* and Vázquez e Iglesias (2009) we have elaborated two indices of foreign investment: the Performance and the Potential index.

The FDI Performance Index is the ratio of a country’s share in the FDI flows of the countries considered to its share in the GDP of these same countries. The FDI Potential Index tries to take into account social, political and institutional factors, which could be relevant at the national level to foreign investors from a competitive point of view. The variables which constitute this index can be looking up in Iglesias (2009).

We focus in the changes that had suffered the southern European countries in their relative positions in relation to new acceding countries.

Table 6. FDI Performance Index and Potential Index. Rankings(1999-2003)

	Performance		Potential	
	1999-2001	2001-03	1999-2001	2001-03
Czech Rep.	2	3	3	2
Estonia	4	1	4	4
Grecee	11	12	8	8
Hungary	6	5	5	6
Lithuania	10	9	12	9
Litva	9	8	10	10
Malta	1	11	2	3
Poland	8	10	11	12
Portugal	5	7	9	11
Slovak Rep.	7	4	7	5
Slovenia	12	6	1	1
Spain	3	2	6	7

Own elaboration from FMI, UNCTAD and Eurostat

FDI performance reflects the strategic position of some enterprises that seek lower costs and market shares in the emergent states economically and geographically well positioned. The countries that are in best positions are one Mediterranean country (Spain) and three eastern economies (Czech Republic, Estonia and Slovak Rep.).Greece is still far from the EU borders and in spite of being members of the EU since 1981, has not improved its investment climate sufficiently to compete effectively for FDI. Also, Portugal is in a poor position. Poland has a transition economy that does not inspire confidence to foreign investors.

The top 3 countries in Potential Index (apart from Malta) include three economies with higher income among the acceding countries (Slovenia, the Czech Republic and Estonia). The 3 counties at the bottom of the ranking are two countries with economies in transition (Poland and Latvia), as well as a developed country (Portugal).

It is useful to compare the rankings based on the two indices as a rough guide to know whether countries are performing adequately, given their structural indicators.

Comparing the two indices we can draw up a four-fold matrix of inward performance and potential indices, as follows (see Vázquez e Iglesias, 2009): Front-runners, Above-potential, Below-potential, Under-performers.

Table 7. Country classification by FDI performance and potential indices (2001-2003).

	High Performance	Low Performance
High Potential	*Front-runners* Czech Republic, Estonia, Hungary, Slovenia, Slovak R.	*Below potential* Malta
Low Potential	*Above potential* Spain	*Under-performers* Latvia, Lithuania, Poland, Portugal,Greece

Source: FMI, UNCTAD and Eurostat

We can see that Spain is a country with Performance index higher than Potential, the capacity of Spain to get foreign investments is above than it can be expected according to its structural economic indicators. But this situation is different from the first period analyzed; Spain has fall down from a position in Front-runners.

The analysis of evolution from 1999-2001 to 2001-2003 also indicates that Slovenia changes its position from *Below potential* to *Front-runners* and Slovak Republic has gone from *Above potential* to *Front runners*. Besides, other *Front-runners* are countries which are located next to large developed economies as Estonia (Scandinavian states) and the Czech Republic (Germany and the Netherlands), this two countries did not change its positions.Portugal changes from *Above potential* to *Under-performers*. The position of Portugal has dropped in 2001-2003 with a decrease of FDI inflows and worse structural indicators. The other countries include in the worst position did not change its position y the years analyzed.

5. Conclusions.

Acceding states received annually percentages of FDI inflows of Gross Investment in fixed capital and GDP higher than Spain, Portugal and Greece in the years before their adhesion.

The economic sectors that have received the highest amounts of FDI have been: Manufacturing activities (the most important in all countries), financial intermediation, Trade and Transports and communication. Estonia and Czech Republic are the countries with higher FDI stocks per inhabitant in overall and also in every economic sector. In the short term is the concentration of FDI inflows in service sector and a increment of transnational.

In this study we did not find movements of FDI from southern countries to new acceding countries. Spain has maintained a good position even though has fallen down in its performance index.

On the one hand, capital has mainly moved towards the countries in the vicinity of the EU core and benefited their economic growth exploiting the opportunities of a relatively low-priced and well educated labour force. The Czech Republic and Estonia have specially rented its geographical position and good indicators to be at the top of the ranking in FDI per head. Nonetheless, the situation was still far from that of industrial dislocation feared in Southern European countries.

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