SEEJE

Book Review

## *Foreign Direct Investment in Central and Eastern Europe*

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reviewed by Dimitrios Kyrkilis*

Since the early 1990's the countries of Central and Eastern Europe (CEE) and of the Commonwealth of Independent States (CIS) have been undergoing a wholesale economic transformation from a centrally planned economic system to a market oriented economy integrated into the world economic system. As part of this process private capital flows to transition economies and this reflects investment opportunities in excess of those that can be financed by domestic savings, while capital inflows finance current account imbalances associated, to varying degrees, with relatively high levels of investment spending, inefficient production structures, and even, in some cases, increasing consumption and fiscal imbalances. Foreign Direct Investment (FDI) has been a major component of capital inflows facilitating, among other things, the transfer of technology and management techniques, the restructuring of production towards internationally competitive sectors and activities, and the modernization of enterprise governance. Many transition countries have seen FDI as a catalyst in promoting sustainable economic growth and have introduced favourable policies for attracting foreign investors. These policies include the relaxation of currency regulations, free repatriation of capital and foreign ownership, investor and market friendly institutions, etc, facilitating at the same time domestic investments and business.

"Foreign Direct Investment in Central and Eastern Europe" is a collection of essays addressing FDI in the framework of transition. The book consists of four parts, each one investigating a different - but complementary to the others - aspect of the FDI phenomenon in the transition countries. Part One contains five essays that analyse the geography and motivations of FDI inflows to CEE as well as to Russia and Ukraine. There has been an uneven distribution of FDI among the transition countries in the first decade of transition, with those countries bordering the EU, namely Hungary, Poland and the Czech Republic emerging as the prime destina-

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tions attracting some 60 % or above of FDI in the region while some of the countries newly acceded to the EU or negotiating their accession, e.g. Slovakia, Slovenia, Bulgaria, and Romania have attracted another 30 % or so. If the Russian Federation (and more recently Ukraine) are also taken into account it is obvious that some transition countries receive no, or negligible, flows of FDI. However the total volume of FDI flowing into the region, including the CIS countries, is far below what other regions, e.g. Latin America, or Asia-Pacific receive, although in terms of FDI *per capita* the region received more than any other region except Latin America and the Caribbean.

The bulk of FDI has come from the EU, especially Germany, followed by the Netherlands, Austria and France. The USA is the second most important source region, while FDI originating in Japan has been negligible. The distribution of FDI by country of origin indicates that historical, cultural, and business linkages existing before communism, the psychic distance as they are called in the FDI literature terminology, determine the pattern of FDI inflows to the region. Half of the FDI in transition countries, and in some cases even 2/3 of it, is associated with the large scale privatization that took place, and in some countries still continues as part of the transition process. As risks associated with transition, e.g. political instability, macroeconomic imbalances, volatile business environment, poor market institutions, inadequate infrastructure, etc are being eliminated, green-field FDI gathers pace. That may explain the FDI concentration in the CEE countries neighboring the EU, since they are the most advanced in their transition process, with less psychic distance with Germany, the main EU investor, and with large scale privatization completed. However, the relationship between relatively higher FDI inflows and success in the transition process may be also interpreted as running from the former to the latter. Increasing presence of foreign investors may amplify the pressure stemming from the private sector for accelerating the reform process, the establishment of new institutions aiding the functions of markets and of a reliable and functional financial system, then consolidating transition. In fact some dual causality between FDI and transition speed and success should be expected. At the same time FDI in CEE is market seeking, targeted at building a long-term position in the host market; and this is by far the main motive of FDI in the region. That conclusion is in line with similar conclusions drawn by empirical research conducted on other occasions.

The empirical investigation of FDI determinants in CEE lacks an explicit link with the existing body of theory explaining FDI flows, although references to such theories are made, especially in the introductory chapter. In some instances models and variables seem to have been developed *ad hoc*. Furthermore, the discussion fails to conclude with the proposition of a rigorous analytical framework for interpreting

FDI during transition. Such a framework would point to deviations and adjustments to the existing literature necessary to account for the peculiarities of transition.

Part One concludes with a chapter investigating the relationship between FDI and trade flows in Ukraine. FDI is an explanatory variable for both an exports and an imports function, which are tested using pooled regressions. The results indicate that the complementarity relationship between FDI and trade flows is dominant. Subsequently, the Grubel-Lloyd index of bilateral trade between Ukraine and the EU, and Ukraine and other transition countries is calculated. Then, regressions testing the influence of FDI on the respective Grubel-Lloyd index for trade between Ukraine and each of the aforementioned regions were run distinguishing between primary industries and secondary industries. The results show that FDI positively influences the level of intra-industry trade between Ukraine and investing countries. In the case of bilateral intra-industry trade with the EU, FDI exercises a positive impact only for secondary products while in the case of other transition countries this is true for both groups of industries.

Part Two begins with the analysis of Russian outward FDI in and outside CEE. The authors conclude that there is an increasing outflow of Russian FDI to the West, as well as the CEE and other former Soviet republics heavily involved in the energy sector, oil and gas industries in particular. As a matter of fact the energy related sectors attract a considerable part of Russian domestic industrial activity and investment. The authors do not discuss to what extent the dominance of the energy sector in the Russian economy has resulted in Russian firms developing competitive advantages used for their internationalization through FDI. Again, this is another manifestation of the already noted lack of a rigorous analytical framework that makes any empirical investigation incomplete and ad hoc.

The following chapters of Part Two examine the specifics of Japanese FDI in CEE, which is infinitesimal compared to FDI sourced in other industrialized countries, e.g. Germany. Japanese firms have adopted a very cautious and risk-averse attitude in investing in CEE, an attitude which has led them either not to invest at all or to direct some FDI to the less risky countries, namely the Czech Republic, Hungary, and lately Poland, while in Bulgaria, Croatia, and Slovakia Japanese multinationals have established sales representative offices.

The final chapter of Part Two studies the Turkish outward FDI in both CEE and the CIS. The authors adopt Dunning's eclectic paradigm adapted to a developing home country framework for assessing the patterns, types and motives of Turkish FDI, in both regions. The empirical investigation concludes that "while capital intensive Turkish firms with market knowledge and experience have invested in Western Europe, more risk-taking smaller firms have invested in the CEE and CIS countries.

Both home country conditions…(including)… radical liberalization of the foreign exchange regulations, economic slow-down in Turkey, and the customs union agreement between the European Union and Turkey…. (and)…location specific advantages (such as) economic liberalizations …….. and the emerging consumer demand" may explain the Turkish FDI in transition countries. The study confirms the empirical result presented in the first part of the book - that FDI in transition countries is primarily market seeking - while it suggests the eclectic paradigm as modified for developing home countries as a model for studying FDI in transition countries.

Part Three begins with an exposition of the argument that although FDI may create markets, transfer technology, management and entrepreneurial skills, international networks, and culture - all having positive impact on national competitiveness - it may also give rise to imperfect competition that excludes potential or even existing competitors from the market in the long-run. In that way it may reduce the overall domestic value per resource used. In addition, in an era of competitive bidding for attracting FDI, multinationals acquire increasing bargaining power vis-à-vis states, especially weak ones; thus the former gain excessive concessions in local markets, ultimately enhancing their oligopolistic rents at the expense of local competitors and consumer welfare. The author suggests measures and policies national states should adopt, he calls them supply side strategy, for assisting development and overcoming the limitations and shortcomings of FDI. For instance, he suggests that the implementation of an active and efficient competition policy could take care to some degree of the oligopolistic situations foreign multinationals may impose, while appropriate institutional settings, education and training policies, R&D policy, etc. may facilitate technological spill-overs running from foreign subsidiaries to the local economy.

The next three chapters of Part Three assess the impact of FDI on the Polish, Hungarian, and Slovakian economies. In the case of Poland FDI inflows have financed to a significant extent the country's chronic current account deficit, created mainly by imports increasing more rapidly than exports. Although FDI inflows to Poland increased spectacularly in the 1990's, the transnationality index, which measures the significance of FDI in the economy, is only slightly above the regional average. In the chapter on Hungary the author concludes that the empirical research verifies that the performance of foreign subsidiaries is consistent with that suggested by the literature and empirical investigation into other countries, meaning that foreign firms have a higher capital intensity, productivity, wage level, and better export performance than domestic firms, but they fail to contribute significantly to state tax revenues or to improve the current account balance. The latter implies that they import to a large extent their inputs, failing to establish linkages with domestic

producers and/or to trigger such indigenous production. As far as Slovakia is concerned, the empirical research conducted by a questionnaire addressed to a sample of 208 foreign subsidiaries - accounting for over 92 % of total FDI in the country - shows a poor impact of FDI on exports and the emergence of linkages with local suppliers, the latter being a common finding with the study for Hungary.

The final part of the book presents the case of Finnish FDI in CEE and Russia in three chapters. Chapter 13 analyses the motives of Finnish FDI in Russia, and the approach Finnish subsidiaries take towards corporate governance, management, and operation structures. In the next chapter, chapter 14, the patterns and effects of organizational learning in Russian-Finnish joint ventures in Russia are examined, while the last chapter discusses the entry mode and the market expansion strategy of Finnish firms in the Visegrad countries.

Overall, the book offers an interesting discussion of various FDI aspects in transition countries, covering a diverse range of CEE countries. Although in some instances the exposition lacks analytical rigor, the book provides a comprehensive study of the motives of multinationals for entering CEE, the entry mode and its connection with characteristics of both home and host countries, the degree of satisfaction investors achieved through their operations, and the effects these operation have on particular economies.