

# FOREIGN DIRECT INVESTMENT AND ECONOMIC DEVELOPMENT: EVIDENCE FROM CENTRAL AND EASTERN EUROPE

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**Abstract:** *This paper aims to investigate the role of foreign direct investment (FDI) on the economic development in transition countries of Central and Eastern Europe. Statistical analysis is applied to investigate the relationship between FDI indicators and some explanatory variables. Findings show that FDI stock and especially labour productivity significantly stimulate exports. Moreover, the ratio of FDI stock to GDP is found to be the most powerful driver of employment. Outcomes depend however on FDI policies. Therefore, policy-makers need to carefully consider the side effects of the measures they design, to avoid negative effects.*

**Key words:** *foreign direct investment, economic development, transition.*

## 1. Introduction

This study tries to bring a significant contribution to the literature on foreign direct investment (FDI) in transition countries of Central and Eastern Europe (CEE). It highlights linkages through which the evolution of FDI over more than two decades has shaped economic development in the CEE region, from 1991 to 2017. The insights from this research could become valuable lessons for policy makers who design instruments for attracting FDI in emerging countries across the globe.

## 2. The Relationship between FDI and Economic Development in the CEE Countries

The academic literature displays a fair share of papers that have investigated a general causal relation between FDI inflows to a host country and economic growth of that particular country (for an overview, see Lipsey, 2006). While capital invested across frontiers and technological progress foster economic development (Mockevicius, 2014), it should be quite obvious that FDI is a key part of that process. However, scientific evidence on the linkage between economic development and FDI is not clear-cut with respect to this fact.

In a comprehensive literature review on the relation between FDI and economic

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development spanning 1994 to 2012, Almfraji and Almsafir (2014) show that the main findings are consistently positive, but in several observations they prove negative or even zero. Moreover, Borensztein, De Gregorio and Lee in a highly cited research paper from 1998 investigate the impact of FDI on economic development in a cross-country model, using FDI data from a large number of developed and developing countries over the period of twenty years. Their findings suggest that FDI fosters growth by means of technology transfer.

To sum up, Narula and Driffield (2011) find that given technology transfer, and given positive spillovers internalized by domestic firms, and given a certain degree of learning, there will be economic development in the host country.

The Central and Eastern European region comprises around twenty countries. Eleven of these joined the European Union (8 in 2004, 2 in 2007 and 1 in 2013) after fulfilling an established set of criteria (political, economic, legal, and administrative). Throughout the research, the focus and reference is to these 11 countries as “Central and Eastern Europe” (CEE). The total population of CEE amounts to roughly 100 million people, with Poland being the largest country (38 million) and Estonia the smallest (1.3 million).

After the breakdown of communism in the late 80s, foreign investors, mainly from Western Europe and the developed world, found it attractive to establish affiliates or to acquire companies in CEE. The region lured multinationals with a rather large, demand-driven consumer market as well as a production location with a good cost/quality ratio of the workforce, access to a variety of resources and to shipping opportunities, as well as the future membership of the European Union, meant to dismantle trade barriers.

According to expectations, CEE as a whole did rather well in attracting FDI. Given that its contribution to global GDP stands around 1.8 per cent, FDI inflows usually exceeded 2 per cent of the world total (UNCTAD, 2018). More than this, FDI inflows marked a continuously increasing trend during transition, keeping pace above the world average.

When CEE countries started their transition from a centralized economy to the market at the start of '90s, FDI was considered one of the key factors to speed up economic development and thus, the process of transition. What followed was a tortuous period in which CEE countries scored very differently in attracting inward FDI and experienced diverse rates of economic growth across time and in the region.

As such, it is difficult to distinguish a positive relationship between FDI and growth. Hungary for instance was an early performer in attracting FDI, inside the first 7 years after the start of transition. Economic growth followed afterwards. Poland had the opposite experience: it first showed a consistent rate of economic growth, later on FDI started to pour into the country. Contrary to both, Slovenia had some of the most solid economic development among CEE countries, with only modest inflows of FDI.

However, FDI inflows were positively correlated with the privatization opportunities that opened up the possibility of acquiring local companies or assets, sometimes at grossly undervalued prices. As such, individual CEE countries carved their unique path towards economic development, including FDI as an important component.

Policy makers in CEE countries acknowledged that FDI could step in as a vehicle for the economic development and restructuring during the transition period (Kornecki and Raghavan, 2011). As a consequence, one of the key features of receiving FDI was the

constant competition among the countries in the region. Once foreign companies were looking out for the most suitable destination for their investment and announced their decision, CEE countries did not compete with other regions at international level, but rather between themselves.

Even though the investment decision combines a mix of various scoring criteria, usually the better infrastructure, the stable and friendly political environment as well as the past performance and experience of other FDI (agglomeration effects) leaned the decision balance towards the preferred location.

Important criteria taken into account by multinationals in the first decade of transition included economic growth/market potential, low labour cost/cost efficiency and trade openness of recipient countries. The second phase of transition was marked by the search for consistent intellectual/technical capital, a sophisticated industrial supply chain and a conducive/incentivized business environment.

The most important foreign investments in the region were undertaken in the automotive sector, in the oil industry, in electronics, telecommunications, banks, and in the food-processing sector plus retail and wholesale trade. Major FDIs active in CEE countries include Audi in Hungary, Volkswagen in the Czech Republic and in Slovakia, and Renault in Romania, to give just a few examples of the largest foreign companies that expanded their operations in the region.

### **3. Analysis and Results**

This study investigates FDI inflows to the CEE region over a period of over two decades in order to reveal and explain the impact of FDI on macroeconomic variables, and especially on economic development. By means of data for the time span 1991-2017, various tools of statistical analysis were applied to investigate the relationship between FDI inflows, FDI stock/GDP and a number of variables such as exports, employment and productivity for 11 CEE countries: Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, and Slovenia.

FDI annual flows in CEE have grown in a continuous pace, with a slump only during the financial crisis 2008-2010. The peak levels of FDI have been attracted by Poland (2007 and 2011), while the negative outlier was induced by divestments in Hungary in 2015.

Poland, the Czech Republic and Hungary have attracted most of FDI, together accounting for almost 50 per cent of total FDI stock in the region (Guenther and Kristalova, 2016). Slovakia was a strong newcomer to this group in the second decade. The main reasons for the spread distribution in FDI flows stem from different levels in GDP/capita, ease of access to Western markets and the ongoing privatization process.

The impact of FDI on economic growth is measured by the ratio of inward FDI stock to GDP. According to the literature, this ratio needs to exceed the 50% mark in order to indicate a significant influence of FDI on economic growth. Roughly half of the countries in the CEE region passed this mark towards the end of the second decade, including Bulgaria, Croatia, the Czech Republic, Estonia, Hungary and Slovakia.

However, a consistent quantitative analysis undertaken by Bacic, Racic and Sonje (2004) for the first decade of FDI in CEE found that FDI could not be held accountable for

high growth; it appeared rather insignificant. One explanation was that given the high market orientation of FDI, this may have diminished the positive effects of FDI. This is why it renders it interesting to develop a complex analysis to study the outcome of the linkage between FDI and economic development over an extended period and also, bring some more variables into the analysis.

Some explanatory variables include the contribution of FDI to exports of the recipient country and the role of FDI for employment. The relationships between these variables, analysed further, may shed some light on the economic development of CEE countries.

The research could not omit yet another variable of major importance to economic development, i.e. productivity, considered by economists the most significant indicator to reveal the real functioning of an economy. As such, the relation between inward FDI and productivity in CEE countries will be investigated.

Productivity has grown visibly and constantly in the CEE region over the whole period (Figure 1). Romania represents a remarkable positive outlier with a significant boost in productivity after the year 2010.

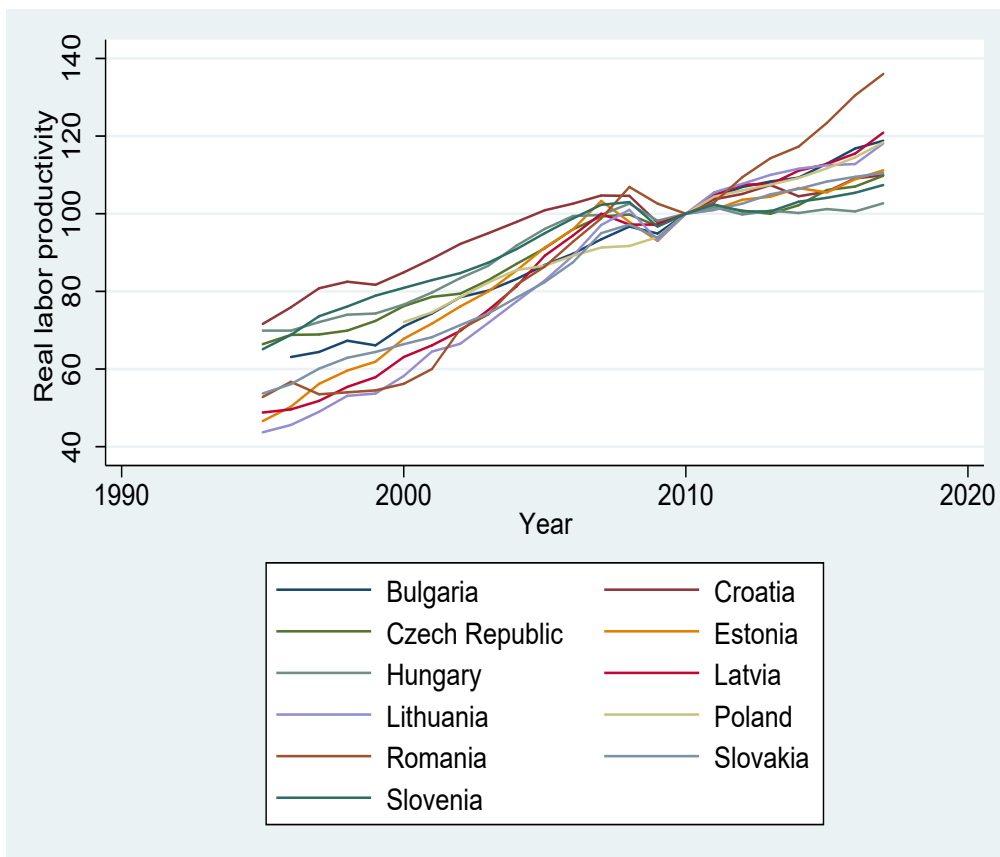


Fig. 1. *The evolution of labor productivity in CEE (per cent, index 2010=100)*

Source: Own adaptation from EUROSTAT data

As for the contribution of FDI to the increase of productivity in CEE, the literature is divided. Despite the catching-up process, after more than 20 years, productivity levels in CEE still remain well below those of Western Europe (Bijsterbosch and Kolasa, 2010).

To investigate what was the outcome of inward FDI into CEE recipient countries over two decades, a statistical model was used to analyse the impact that a number of variables associated with FDI has, alongside other explanatory variables, on several macroeconomic aggregates, i.e. exports and employment. FDI stock and especially labour productivity are found to significantly stimulate exports. Moreover, the ratio of FDI stock to GDP is found to be the most powerful driver of employment. To a lesser extent, FDI inflows determine the increase in the employment level as well.

The preliminary research is based on a restrained number of explanatory variables, which involves a large degree of unobserved heterogeneity. In an extended version of the research, GDP/capita and other significant variables will be included into the analysis.

However, one of the findings so far is to underline the fact that FDI policies in the CEE region carry different effects at macroeconomic level, so that any policy measure in this area should also consider the side effects as well. For instance, a higher ratio of FDI stock/GDP has positive effects for employment, while inducing much lower but still significant negative effects on exports. In turn, a larger amount of FDI stock represents a stimulus for exports, while generating very low and slightly significant negative effects for employment. A large volume of FDI inflows encourages employment, but carries no effect on exports.

#### **4. Conclusions**

Central and Eastern European countries welcomed FDI and even competed to attract major foreign companies in the quest of boosting their economic development. By transferring the much sought-after package including capital, technology and know-how, CEE countries were hoping for foreign investments to improve revenues, productivity, exports, and employment conditions. In their pursuit of benefits, recipient countries sometimes accepted the negative downsides, such as layoffs in the case of foreign-acquired companies, cutting-off local suppliers, crowding-out of local firms, dependency on established international supply chains, or even anticompetitive practices.

Drawing a line, we can assert with widespread approval that positive effects of FDI generally outweighed the negative effects.

However, despite the positive effects of FDI which have been largely addressed and analysed in the literature, when considering a set of FDI indicators, it seems that their effects are contrasting. Moreover, the impact of FDI indicators on several macroeconomic aggregates could be different. All empirical results derived from the research suggest that policy makers in the CEE region should always carefully consider the secondary effects of the policy measures they design, in order to find alternative solutions destined to overcome the negative effects.

One important lesson to be learnt from examples of good practice during the transition involves choosing foreign investors that have the ability to maintain and modernize the acquired plants.

Also, policy makers should insist for investing companies to focus on the existing/desired type of activity according to industry-specific strategies. Authorities can support local entrepreneurs so as to act as satellite firms for multinational companies and stimulate educational facilities to provide specialized skills, in order to build a more intricate business environment. Once they invest in promotional means and design incentives for attracting FDI, they should always establish a measurable ceiling, keeping in mind to strike the right balance between positive and negative side effects of FDI.

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