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Industry

Location potential in the CEEC for multinationals

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For a more detailed analysis see: HENRIOT A. (2003), Working Paper n° 61 available on www.coe.ccip.fr

In 1990, the turnover of foreign companies in Central and Eastern Europe was almost non-existent. Since then, the region has caught up very quickly : the sum of the accumulated FDI inflows into the CEEC rose from USD 3.6 to 135 bns between 1990 and 2002; for the purposes of international comparison, as a percentage of the CEEC's GDP, at 32% this amount of foreign direct investment reaches and even exceeds the levels of the most dynamic emerging countries.

But the picture is not uniform, with a particularly strong concentration in the "economically small" countries of Central Europe. In which candidate or acceding countries is this catching-up process being completed, further increases in sales volume by multinationals thus resulting solely from the countries' own economic growth ? In other words, where do the large, untapped, potential business volumes lie for foreign companies, from the domestic as well as the export market point of view ? The estimates presented in this study point towards Eastern Europe but also to Slovakia.

1- Remarkably strong FDI inflows since 1990

A comparison with other emerging regions should provide the proof. Foreign investments have stimulated both CEEC exports and imports. They have reorientated the CEEC's trade geographically and modified its structure.

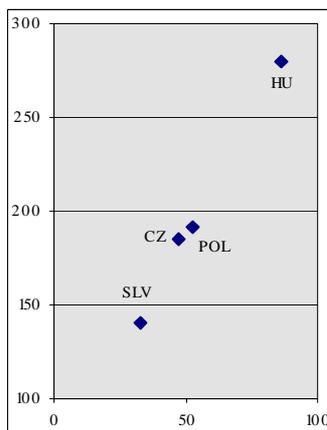
■ Between 1990 and 2000, FDI stock in the region leapt from 2% to 28% of the total GDP. In 2002, it was estimated at 32%. That decade certainly experienced great expansion in transborder investment flows, since the world FDI stock (in % of the GDP) gained 11 points against 4 during the preceding decade. A comparison with other countries or emerging regions illustrates the extent to which the CEEC, helped by the prospect of their joining the EU, became attractive to multinationals: for example, the stock of FDI grew from 13% (of GDP) to 31% on average for all the developing countries, from 11 to 36% in South, East and South-East Asia, including China, and from 10 to 31% in Latin America.

By country and in relation to their size, the 2002 estimates of FDI stocks per capita show that they are concentrated in a number of "small" economies. They are reported to reach 57% of GDP in the Czech Republic, 43% in Estonia and Slovakia, 42% in Hungary and 38% in Latvia. As a proportion of the whole, Poland attracted 30% of the USD 135 bn invested in the region.

■ Another widely observed phenomenon, trade volumes in these countries expanded widely side by side with investments. The link between the share of foreign owned companies in the total sales of the manufacturing sector and a country's export growth is evident where data are available (see graph opposite). Between 1990 and 2000, exports from the 10 CEEC (i.e. excluding Cyprus and Malta) to the EU15 were multiplied by 4.5 (in USD). In a parallel direction, imports were more than 5 times higher, resulting in a positive sum game for the host countries and countries of origin*.

A second consequence for trade is the geographical reorientation of the CEEC towards the EU, nowadays the most important commercial outlet for the candidate countries, as well as the main investor in the region with

Growth of total exports between 1993 and 1999 (y axis, %) and share of foreign companies in the manufacturing sector (x axis, %)



Source : CEPII, UNECE

* See also Lipsey R.E (2003), Home and host country effects of FDI, NBER, WP 9293

CEEC trade by sector

	Imp.		Exp.	
	1990	2000	1990	2000
Total	100	100	100	100
Energie	24,9	10,7	10,0	5,6
IAA	15,0	7,0	19,4	8,4
Textiles	7,9	8,7	12,7	11,4
Bois-Pap.	4,5	6,3	7,4	9,4
Chimie	13,1	15,3	17,7	12,8
Metaux	4,4	3,6	10,1	4,8
Non-fer.	4,4	2,1	4,2	3,4
Mecani.	12,9	15,0	9,7	14,0
Vehicules	3,0	8,7	2,5	10,7
Electri.	2,7	7,4	4,0	8,6
Electron.	4,6	11,5	1,4	9,7

Source : Chelem-CEPII, COE

approximately 65% of the total FDI in 2001. This change has taken place above all to the detriment of the former USSR. On average in 2000, the EU absorbed 65% of the CEEC's sales abroad and provided some 63% of their imported goods and services, against 32 and 33% respectively ten years ago. In comparison, approximately 2/3 of the EU's trade is with other EU countries.

Thirdly, the structure of CEEC trade was profoundly modified, as is indicated by the table opposite, with four industrial sectors whose share in the total increased noticeably, to the detriment of the others: engineering, automotive industry, electrical and electronic components. The weight of foreign companies is particularly heavy in these sectors. In the automotive sector for example, foreign owned companies achieve an average of approximately 90% of the sales in this sector in Hungary, Poland, the Czech Republic and Slovakia. In Hungary, they exceed this level in electronics and stand at around 60% in electrical equipment, if we calculate the average between the Czech Republic, Poland and Hungary. From this dynamics have resulted important changes in comparative advantages (called "revealed", see Special Enlargement Review 27), which are expected to become even stronger in the decade to come.

Should we be surprised at the size of the amounts invested ? Various evaluations show that we should not. The prospect of these countries' accession to the EU as well as the structural reforms undertaken from the very beginning of the 90's have accelerated this process of location in the CEEC.

2- These flows tally with great turnover potential for multinationals in an enlarged Europe

Investment potential can be calculated either by the direct and macroeconomic estimation of FDI, or by the evaluation of the potential sales of foreign companies in those economies. The (gravitational) model used here follows the second method, using the OECD multinational company database, and only deals with the manufacturing sector*.

■ What economic reality does this model describe ?

For transnational companies (TNC), the objective consists in capturing the demand of these markets, either through exports, or by setting up there, possibly also in order to benefit from competitive manufacturing conditions, as in the CEEC. At company level, location strategies can then be classified into two types. The first is known as "horizontal" because of the existence of significant trade barriers or transport costs, since the firm manufactures the same products in different places; market size is thus the determining factor there. In the second, "vertical", strategy, the manufacturing process is split between several locations; here, wage differentials and the production factor content of the products are of major importance.

The developed model integrates both possible strategies through five variables, in order to explain the turnover (or the production) of foreign subsidiary companies coming from an I country to a J economy: the GDP of the I country, that of the J country, the distance between them, the wage differential and the existence or otherwise of a common language **. The coefficients associated with these explanatory variables were calculated for the 24x13 pairs of countries in the data base. They were then applied to the CEEC data (GDP, distance...), thus assuming similar economic structures for the applicant countries to those of the sample on average. Calculations are thus indeed sales potentials (graphs below), those for example of Italian multinationals located in Romania.

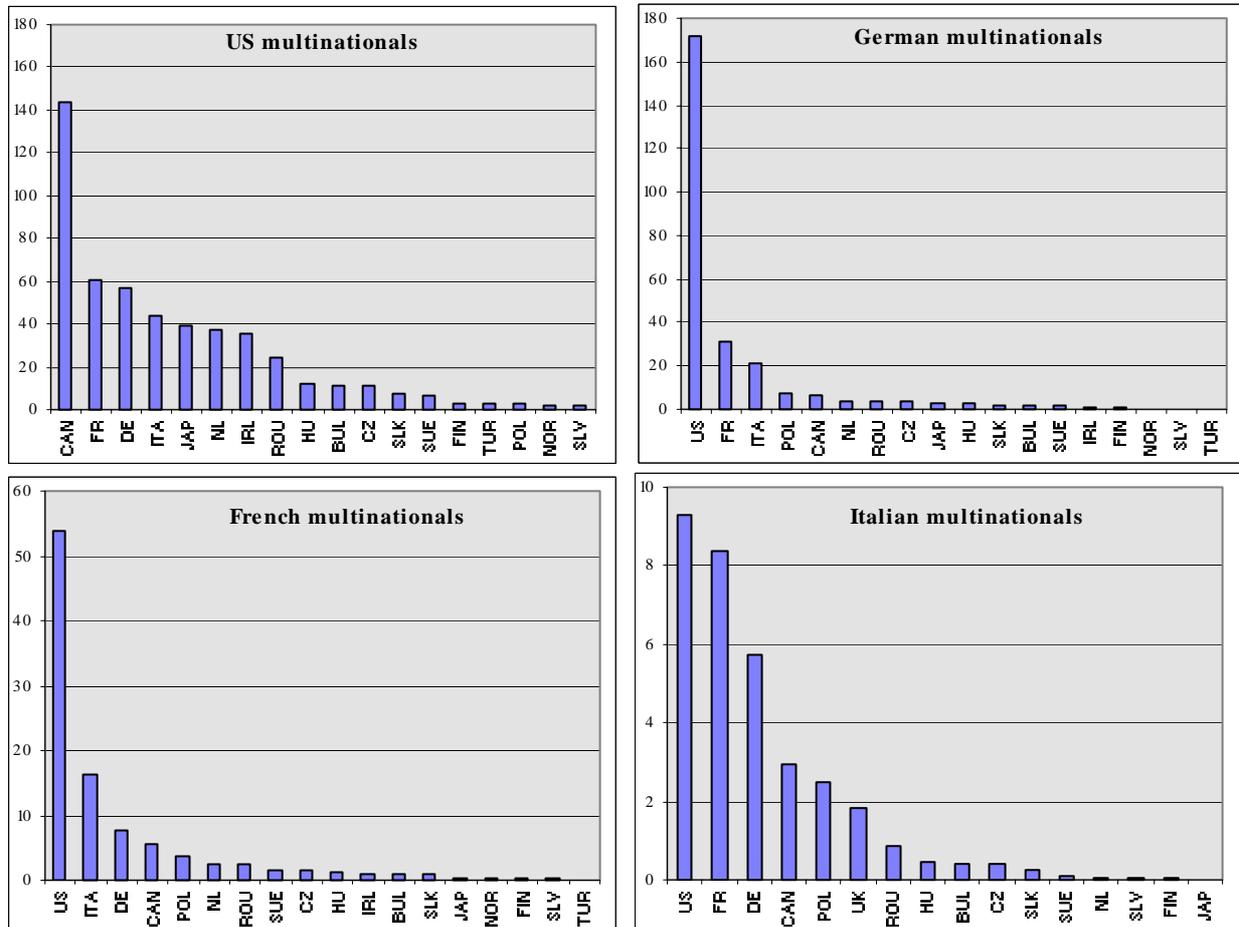
■ The turnovers which the subsidiaries of German, American, French and Italian multinationals should potentially achieve place the CEEC in a good position in the European hierarchy.

* The (OECD) data base gives the turnovers (or the production figures) of TNC from 24 countries in 13 host countries, including Poland on the CEEC side.

** The coefficients associated with the respective sizes of I and J (GDP) economies have, all things being equal, a positive impact on the activity of these subsidiaries. As regards distance, in this estimate its impact is assumed to be negative and the "vertical" scheme thus dominates here: the more the distance is reduced the more a TNC will tend to segment its production process at given production factor costs. In accordance with intuition, if wage differentials rise, the multinationals are encouraged to locate in a country in which labour cost are low. Lastly, the existence of a common language has a positive impact on the development of bilateral trade. Values are available in the study of A. Henriot.

Using estimates of future GDP would not necessarily increase the potential to a significant degree, owing to the accompanying adjustment in wages.. Agglomeration effects and the positive externalities created could on the other hand increase it more appreciably. This might be the case in the automotive sector.

Potential turnovers of multinationals
in 2000 (USD Bn)



For US companies, Romania, Hungary and the other CEEC have a location potential close to that of the Netherlands or Ireland. But the “big” OECD economies remain however the most attractive for those TNC, apart from Canada.

For European companies, potential sales on the domestic and export markets of Poland, Romania, the Czech Republic, Hungary and even Bulgaria and Slovakia could exceed those achievable from Japan (distance effect) or in the Scandinavian countries (wage effect).

Are these countries far from their potential? The picture appears heterogeneous.

3- Potential is still high in Romania, Slovakia and Bulgaria

Actual turnover figures achieved by multinationals in the CEEC being unavailable, except for Poland, the preceding estimates should be used as an indication of international hierarchy. Actual figures are, on the other hand, available for FDI and thus enable a direct comparison to be made with the potential calculated (see table opposite). Crossing the two methods (FDI and turnovers) then makes it possible to test the coherence of the results.

The first important difference is that this second model (FDI) was applied to the whole economy and not just to the industry. Then, the explanatory variables to estimate potential FDI differ slightly from those which were used in the first method: in addition to the respective sizes of the markets, distance and the existence of a common language, it explicitly takes into account the membership of an economic zone regulated in particular by free trade agreements; this variable not being used in the preceding model. Three groups of countries can be distinguished.

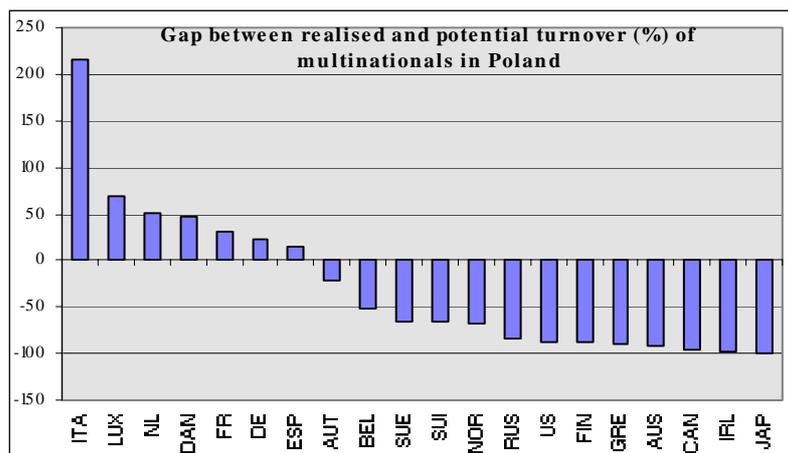
Real and potential FDI stocks
calculated in USD Bn

	Réal		Potentiel	
	2002e	2002	2002	2010p
BU	4,4	8,2	10,6	
CZ	34,7	26,9	38,5	
HU	22,5	20,8	30,9	
POL	38,1	47,0	66,4	
ROU	9,0	15,9	26,5	
SLK	9,5	16,4	25,3	
PC10	131	165	241	

Source : BERD, potential calculation (ME Elargissement) according to Piazzolo & Buch (2000)

■ Hungary and the Czech Republic seem already to be beyond their current potential. Indeed, both have made rapid advances in carrying out the necessary structural reform of their economies.

■ A situation close to the balance in Poland. Turnovers achieved by the subsidiaries of foreign companies from the 4 or 5 countries which are investing most in the region appear slightly higher than their potential. The US companies seem still to be below this level. It means that any further increase in the activity of these TNC should henceforth only be in proportion to the economic growth of Poland. The FDI model indicates a slight margin of progress, which could indeed come from American companies in particular.



■ It seems very probable that in the years to come there will be a rise in the relative share of Slovakia, Romania and Bulgaria in total FDI flows.

The model estimating potential sales ranks Romania ahead of Hungary or the Czech Republic. Bulgaria's position appears closer to that of Slovakia. The calculations of the second model appear less optimistic for these three countries, still some way away from achieving their potential attractiveness for multinationals. The slow rate of advance of the two Eastern European accession candidates in terms of integrating the *acquis communautaire* is one of the essential reasons why they have still to catch up in terms of attracting TNC*. And Slovakia has only recently taken off.

A monitoring of industrial investments in 2002** confirms, in numbers at least, the growing share of Romania and Bulgaria at paneuropean level: approximately 3% of the 1895 investment projects announced in 2002 appear to be going to Romania, that is to say almost as many as to Poland, or Ireland; with a little less than 2% of the total, Bulgaria ranks just behind Austria, Turkey and Portugal. According to the Réseau Elargissement's own monitoring, this dynamics should be confirmed in 2003. Many automotive equipment suppliers have announced plans to set up in Romania: the German companies INA Schaeffer and Continental, and BOS, the Italian company Valvetek, the American companies DCI Walbridge, Trinken and Seton, the Japanese company Yazaki and also the French firm SNR Roulement. In the retail sector, Carrefour, Auchan and Marionnaud should increase their presence, as well as Metro, to mention only the most important.

* A recent OECD study measures econometrically that the removal of barriers to foreign investment would release a potential equivalent to 100% of the existing FDI stock. The removal of the ceilings for foreign shareholding would involve a rise of 78% in the FDI stock, the removal of that of "national interest" would bring an additional 21% and finally easing the criteria regarding the nationality of board members should bring a further 10%. The first type of barrier has already disappeared in the candidate countries in the competitive sectors.

** European Investment Monitor (Ernst & Young, 2003)

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