

Improving Competitiveness of the European Economies in Transition: Importance of Foreign Direct Investment

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Abstract

European economies in transition, within the last two decades have undergone an extensive economic restructuring along with numerous institutional and regulatory reforms. Domestic funds have to some extent played a limited role in their financing. Thus, foreign capital inflows had to replace the inland investment in case of frequent market malfunction and credit rationing restrictions. Structure of foreign capital affects the degree to which the capital flows involve externalities or the level they are subject to unexpected U-turn. Foreign direct investment's (FDI) side effects, however, effusively differ from the other funding, such as direct lending and portfolio investment. Moreover FDI is equally less reversible, but also proceeds to be a channel for technology and managerial know-how transmission. Thus, it may surely improve the productivity in addition to other positive spillovers caused by the corporate linkages (market access). Several European economies in transition have recently shifted from stabilization and recovery to growth and prosperity. FDI in particular is considered to be the major driver aimed at achieving and sustaining their convergence throughout the competitiveness improvement. Hence, the main purpose of this paper is to assess the rising importance of investment liberalization for the European transition economies, principally by means of comprehensive and large data set. Analyzing competitiveness as an "ability to grow in an open setting", the paper will also address some of the main straits which FDI has been augmenting through the growth and export performance of European economies in transition.

Keywords: European economies in transition, competitiveness, foreign direct investment

Introduction

In the process of global economic integration, foreign direct investment (FDI) affects to a great extent the growth, advancement and economic restructuring of the European economies in transition. Those take an advantage either from the inflows of foreign capital or the transfer of technology and organizational forms. In other words, FDI raises the domestic savings at a macro level, imposing an immediate positive impact on budget and external financial position of the particular economy. Thus, early privatization-related FDI inflows helped financing the large current account deficits within the most European economies in transition, in addition to strengthening their foreign reserves position. FDI, associated with more dynamic exports,

may also improve the insight of the economy's creditworthiness, thus accessing more stable capital inflows and wider array of financial instruments. On the other hand, it has been seen as an element of industrial policy and instrument to improve the competitiveness, principally among the countries lately hastening the economic reforms. Namely, FDI may support the technical change and technological learning throughout the transfer of the organizational skills. Therefore, this kind of capital inflows may possibly transform the productivity, industrial structure and composition of exports. At the same time, it might result into positive spillovers to the host economy when linked with the local suppliers and competition.

The flows and benefits of FDI, however, are not always straightforward or automatic. Evidence suggests that merely few European economies in transition have appeared as host countries which benefited from the FDI inflows. Thus, the expected positive gains are found to be few and far between. Moreover, many FDI resulted into negative spillovers since forced the domestic companies to close down or they did not occur at all due to the institutional obstructions or shortage in the absorptive capacity of the host companies. On the other hand, despite the FDI inflows, some European economies in transition have resumed the balance of payments deficits. The particular problem emerged from the FDI flows into non-tradable sector, bringing on a real exchange rates appreciation which undercut the export competitiveness. Thus, the countries have been forced to create foreign exchange asset elsewhere, since relying to further FDI inflows appeared to be an unsustainable process.

Therefore, we will be looking at the linkage between FDI, export performances and economic growth, but also in the national policy measures that might support the positive spillovers of FDI inflows.

FDI and competitiveness: theoretical and empirical reflection

Many empirical studies have confirmed the positive impact of technological spillovers on economic growth. Namely, FDI may contribute to economic growth if it is more productive than domestic investment or by increasing the total capital accumulation within the host economy (Borensztein - De-Gregorio - Lee, 1995). The neo-classical stance, however, point out that FDI does not affect the long-term growth rates, but the level of income. They suggest that technological progress and growth of labor force as exogenous variables might have an impact on long-run economic growth. In accordance with the recent endogenous growth theory FDI could impinge on the growth by variables such as R&D and education of human capital (Romer 1986, Lucas 1988). Namely, they suggest that different externalities can make available the long-term growth despite diminishing returns that might prevail inside the company. Furthermore, transnational corporations possibly will build up those externalities either by technology transfer to the affiliates or indirectly throughout imports of capital goods and various forms of strategic alliances. These growth models, also, underline that FDI could accelerate developments of intermediate products diversity, increase the quality and bring in some new forms of human capital

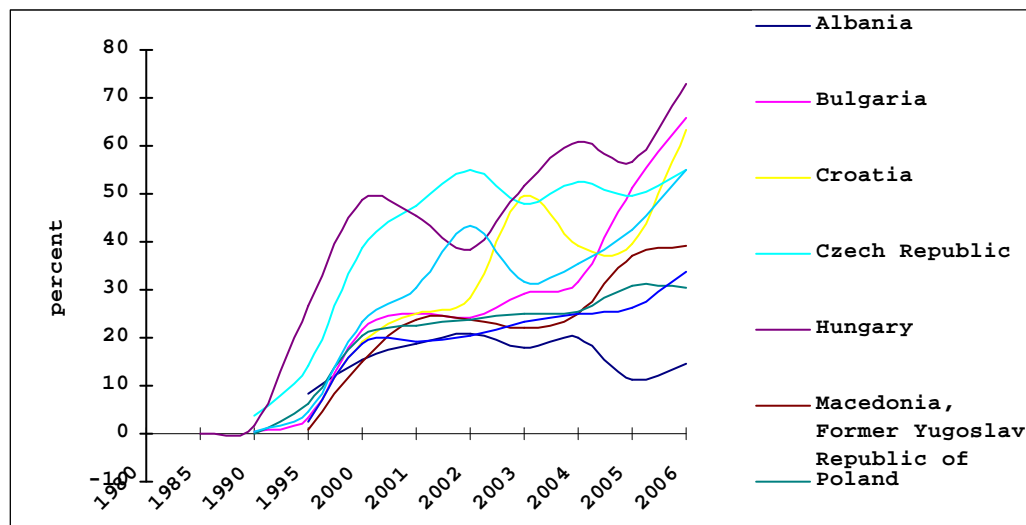
(Grossman and Helpman, 1991).¹ The wide range of intermediate products, as well as the greater access to technology and local spillovers could prevent declining the marginal productivity of capital and make endogenous long-term growth possible.

Although the scope and impact of various externalities is being a common subject matter of most endogenous growth models, very few of them reflect on the role of FDI in creating those (Mello, 1997). Recent evidence suggests that besides the composition of imports, domestic R&D affects the productivity growth more than the foreign (Coe and Helpman, 1995). Finally, many studies confirm that transfer of technology and technology spillovers from FDI can encourage the long-term growth to the extent on the human capital stock and absorptive capacity of the companies within the host economy (Borensztein, De Gregorio and Lee, 1998).

Scope and Developments of FDI Flows within the European Economies in Transition

Foreign direct investment in European transition economies has increased at a modest rate within the early 1990s. Second half of the previous decade, however, has recorded accelerated FDI inflows, which have reached nearly 4% of GDP in 1999 (Figure 1).

Figure 1: FDI inward stocks as a percentage of GDP

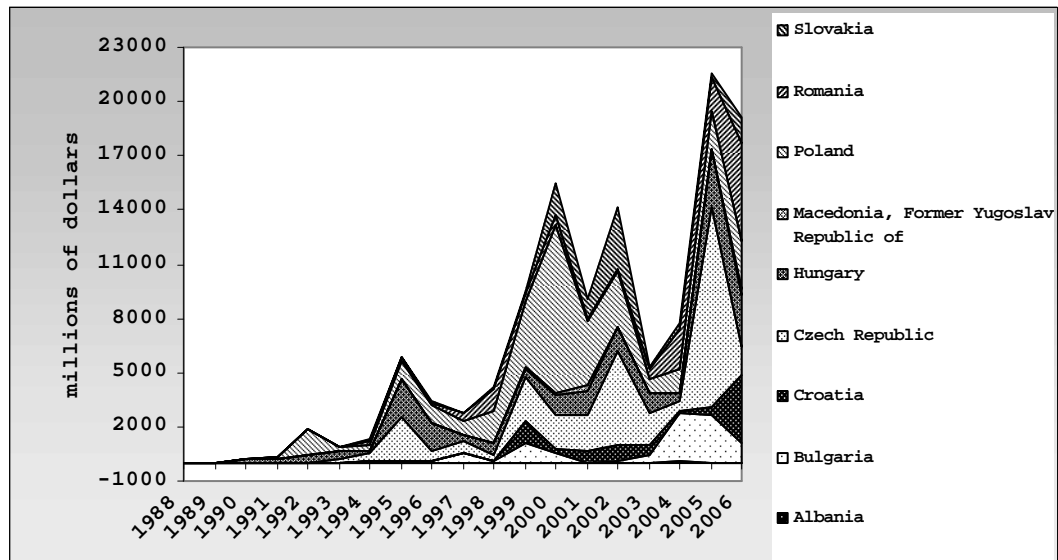


The growth was to some extent influenced by the process of privatization, whereupon Hungary, Poland and Czech Republic have appeared as leading economies. They have reached the highest concentration of FDI distribution and accounted for two thirds of the total FDI inflows in 1995. In other words, purchases of equity capital, such as Greenfield investment and mergers & acquisitions

¹ Grossman and Helpman describe the process of growth as a quality stepladder that firms climb, depending on the stochastic nature of the R&D process.

(M&A) have been the major forms which the international capital crossed the borders through (Figure 2). Foreign acquisitions have brought capital mainly into the service sector (telecommunications and finance), as well as the industry structure, such as electronics, food industry and projects carrying out extraction of fuels and raw materials (Table 1).

Figure 2: Cross-border M&A purchases in European transition economies



The bulk of FDI in manufacturing was the highest in Romania (78.1%), Poland (63.3%) and Czech Republic where FDI was mostly attracted in the sectors, such as car industry, chemicals and food processing. On the other hand, FDI in telecommunications was mainly deliberate on Hungary and Czech Republic, which pulled towards more than 90% of capital flows into the particular sector. Despite off, FDI in finance participated to a grate amount in Poland and Slovakia (19% in 1995), but Hungary, as well (11.2%, with 5% into the real estate and related businesses). Yet, rapid fall of the stocks value on the world markets has imposed a decline of mergers and acquisitions (M&A) in some European transition economies to one half of the value in 2001. At the same time Greenfield investment has also decreased, so the FDI flows increase was carried on mainly by the reinvested profits. It is noteworthy that FDI has lagged far behind the initial ledge despite the major comparative advantage, such as the chip labor force i.e. few countries have appeared as the major FDI recipients. The main reasons are to be found in the lack of inadequate political and legal institutions, financial instability, insufficiently protected property rights etc.

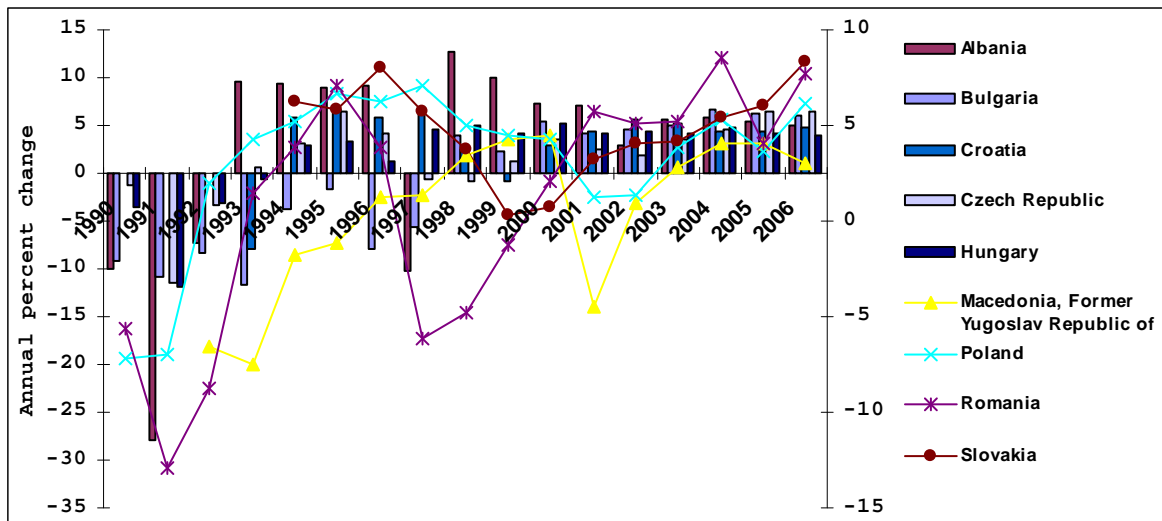
Macroeconomic Implications of FDI in the European Transition Economies

Macroeconomic inference of FDI within the European economies in transition can be observed relative to economic growth and the gross fixed capital formation.

Within the early nineties, economic performances of the European economies in transition have turned down, principally caused by the

transformation of economic systems, as well as the loss of the traditional markets. Consequently, many emerging economies faced very modest growth rates, which have been noticed in Poland at first (1992), followed by Romania (1993), as well as Slovakia and Czech Republic in 1995. After implementing the so called "austerity package", Hungary has finally left the languishing growth rate of 2% in 1995. Every single one, apart from Croatia became newly member state of European Union in 2004. The particular county was plunged into political instability and war within the period of reforms onset. Consequently, Croatia has left behind its peers in precession process towards European Union, although the country has not differed much with respect to economic performances.² Dependent relative to their starting point, some transition economies went beyond the 1990 level, but the others left lower than it (Figure 3). The reasons are to be found in the structural instability imposed by the disequilibrium between the gross domestic savings and investment.

Figure 3: Annual GDP percentage change of the European transition economies



Looking at the evidence suggested (Figure 4), we can find positive, but vaguely significant relation between FDI and dynamism of economic growth in the European transition economies, principally caused by the importance of some other factors such as import demand, economic reforms and success of stabilization polices.³ The economic performances improvement in some of these countries was certainly achieved pursuing the "classical" doctrine of FDI-driven export growth. Exports were the most dynamic factor of the final demand, deeply going beyond the consumption and investment.

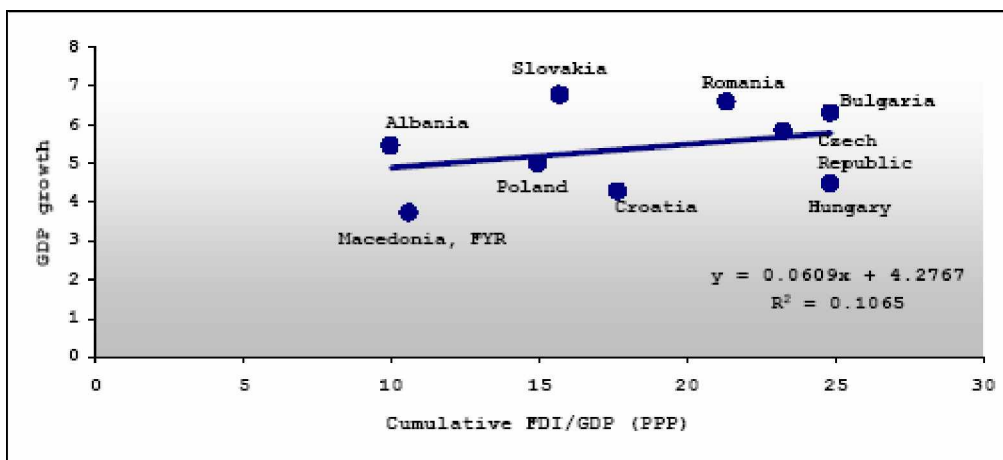
The positive results obtained from the analysis about FDI inflows into some developing economies put forward the possible long-term growth rates of the transition economies, as well. Thus, FDI/GDP ratio of

² After short recession within the period 1998-1999, Croatia has achieved high growth rates in 2002, followed by Hungary and Slovakia.

³ The period taken into analysis includes declines in domestic output, but also many external shocks. At the same time, inward FDI was not too large within the previous decade and could not contributed much to the economic growth.

Eastern Europe has increased from 0% to 4% during the period 1997-1999 (in nominal GDP terms). In addition, elasticity estimated by Borenzstein suggests an increase of some 0.7-1.3 percentage points in the long-term GDP/capita growth, particularly within the Czech Republic and Hungary. This elasticity, however, reveals the stock of human capital in developing economy. In other words, FDI has a positive impact in those countries with a higher average level of human capital. Transition economies have not been faced with the lack of the particular capital, but had certain problems with the process of reforms. Thus, Borenzstein elasticity is not reliable enough to referee for the countries which haven't established long-term market system, such as transition ones.

Figure 4: GDP growth and ratio of cumulative FDI inflows to GDP (PPP)⁴



The above mentioned is considered to be the main reason one could not determine a direct linkage between amount of FDI inflows and dynamic economic growth. In other words, countries with high FDI inward stocks have run off lower growth rates (Hungary, Czech Republic), despite those vigorously growing economies (Slovakia and Poland) which have recorded smaller amount of foreign capital (Figure 4). The reason behind emerged from the basic premise that FDI inflows in European economies in transition were motivated from the cheap labor force. Nevertheless, the most FDI aimed at gaining market access while the labor costs seemed to be of the secondary importance.

The form of FDI undertaken in European economies in transition stands for another reason for the particular findings. Thus, M&A, whose share in FDI is very high, suggest smaller impact on economic growth, since they correspond to a transformation of ownerships, rather than a new capital addition. They certainly will improve the economic performances of the manufacturing firms' positive spillovers but within a longer period of time.

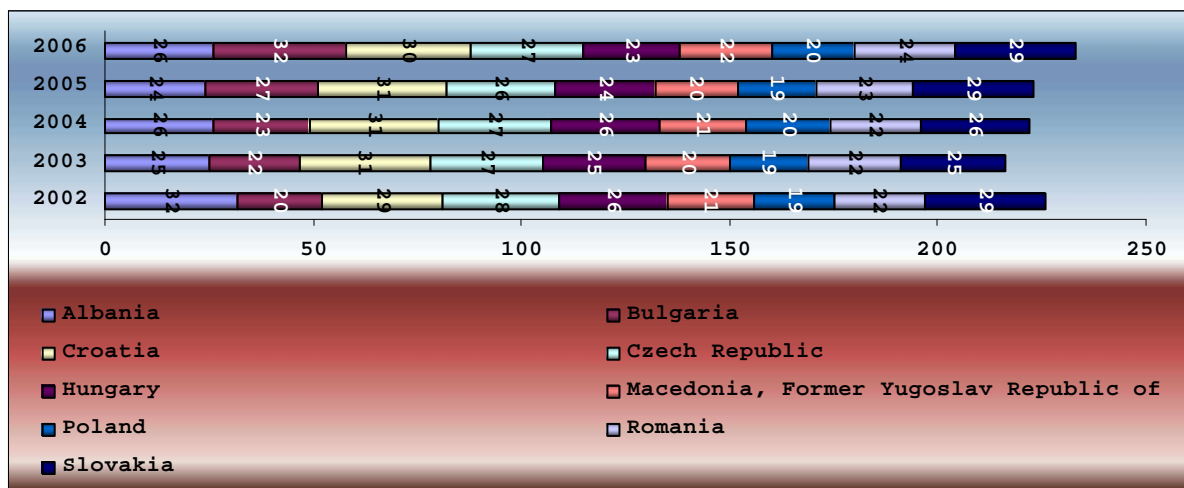
Importance of FDI is being also observed relative to gross fixed capital formation⁵ (particularly the private corporate investment) and

⁴ Average growth of real GDP, 2003-2006 (estimates). FDI inflows are cumulated from 1996 to 2006. GDP (PPP) refers to 2006.

⁵ Gross, since it is calculated before depreciation; domestic, because it is at home rather than overseas; fixed means does not include

expressed as a proportion of GDP (Figure 5). Thus, apart from the revenues of privatization, private sector investment in Hungary declined from 29% to 17% in 1991 and 1994, respectively (Hunya, 1995). On the other hand, foreign shares were estimated to 10% in Czech Republic and Poland within the period 1992-1993, as well as 4% in Slovakia (Stankovsky, 1995). In addition, analyses on investment financing carried out by Quaisser (1995) and Nesvera (1995) confirm that foreign capital did not exceed 10% as a proportion of the real investment in Czech Republic, while FDI in Poland has started with 11,4% of gross fixed capital formation (GFCF) in 1993, but come out to fall below 10% in 1994.⁶ The evidence suggests that investment rates varied among the countries, but they are much higher compared to those of Latin America and lower with respect to Asia, particularly if China included. Albeit the fact that European economies in transition have not achieved very high investment rates, they are considered satisfactory to converge with the European developed states. Nevertheless, transition economies, equally to middle-income developing ones have to reach investment rates approximately to 25% of GDP if want to achieve sustainable growth rates (ELAC 2000 and UNCTAD 2001).

Figure 5: Gross fixed capital formation (% of GDP)



Yet, the exacting growth rates could not be reached relying upon the gross domestic savings only, as it produced a great disequilibrium distinct for the most part of private sector. Consequently, many European economies in transition have looked towards foreign capital inflows in order to set off the private and public domestic investment in GFCF (Figure 6). Noteworthy is to say that despite the other source of finances, FDI internalizes the foreign savings and does not produce any subversive side-effects for the host economy. Thus, the increasing share of FDI, as a long-term source of finance can have a great impact in locking the gap between gross domestic savings and investment in the European economies in transition. The increased capital stock, however, is considered to have more instantaneous pressure on economic growth relative to technology transfer (Eichengreen, 2004). Affecting the domestic savings as a supplementary source of finance, FDI would

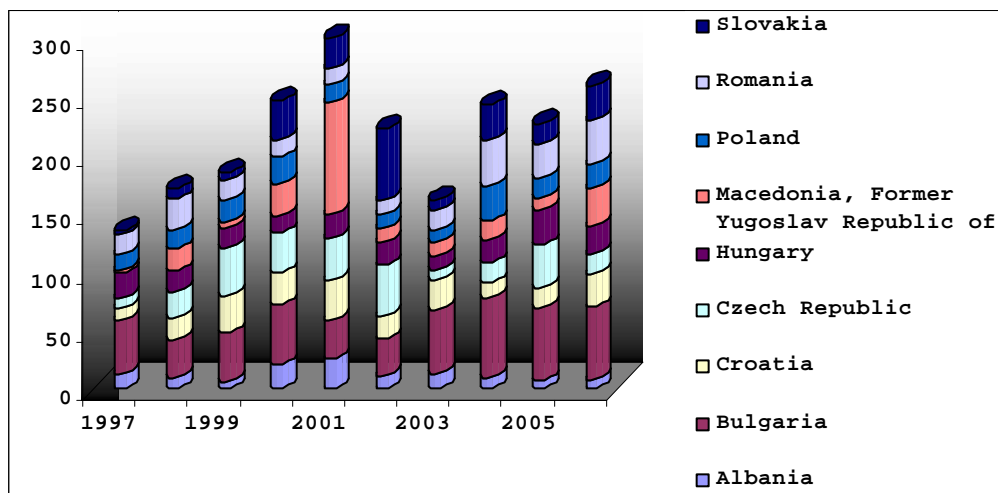
stocks of goods; capital formation refers to physical and not financial investment.

⁶ World investment report, 2002

surely create a suitable environment to get on the trail of further technological improvement.

Recently published EU studies, however, point out that FDI is certainly important in the process of transformation within the European economies in transition, but further investments will be principally financed by enterprises themselves. Their resources would emerge from the large productivity gains boosted from the foreign investment undertaken before, growth of wages mentioned above, as well as the increase in producers' prices (ECE, 1995).

Figure 6: FDI inward flows as a percentage of GFCF

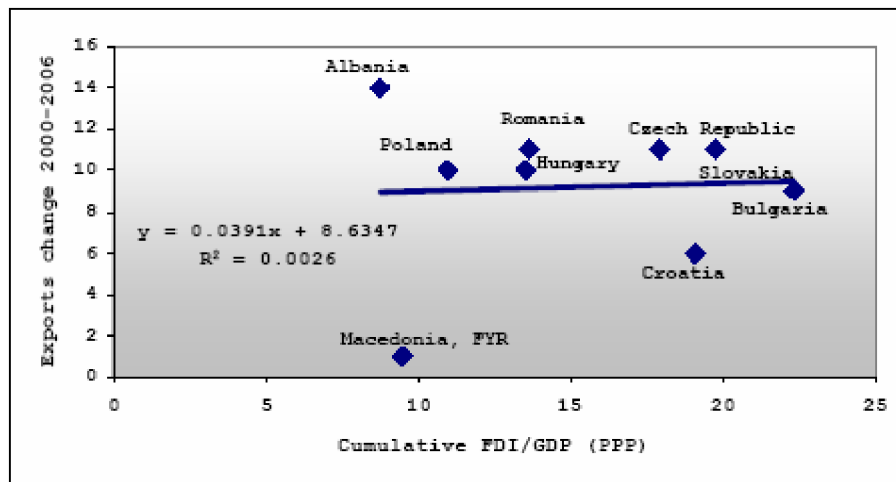


Sectoral Composition of FDI and Related Implications on Export Performances

The long-term growth of the European economies in transition depends upon the productivity and efficiency improvements. Thus, sustainable growth and convergence might be achieved if the capital accumulation is attended by productivity and efficiency gains. Intra-industry augmentation in productivity plays the mayor role within the developed economies (Bailey, 2003). On the other hand, transition economies rely upon the restructuring as a key element towards higher economic growth, although the intra-industry increase should not be undermined, since many distinctions emerge in the prospective of the different sectors for technical progress and economic growth. FDI facilitates increasing the productivity by technology spillovers in the sectors of entrance. If those are export-oriented, foreign capital stock might add to the value of total exports. Thus, FDI growth is seemed to assist financing the current account deficits. In other words, FDI has financed 86% of the fourfold increase in the current account deficits of Eastern European economies during the 1990s (Table 2). This indicates that foreign investment is quite favorable, since is considered to be more stable than the other financial flows, as well as largely non-debt creating. The potential benefits of FDI should not be widely appreciated since the rising tendency of exports in the European economies in transition was partially imposed by the upswing in Western Europe in 1994, but also the domestic (supply) factors. In other words, private consumption, stimulated by the real wages increase, has played an important role (Table 3).

Yet, despite the FDI positive impact on balance of payments, this kind of financial flows might cause the same risks as the others. In other words, FDI inflows may cause a real exchange rate appreciation, particularly if enters into non-tradable sector and undermine the exports competitiveness.⁷

Figure 7: Exports growth and ratio of cumulative FDI inflows to GDP (PPP)⁸



Thus, from international competitiveness point of view, European economies in transition should reach inflation rates approximately accorded to the rest of the world. A country introducing inflation rates over the international average will lose the competitiveness in terms of prices. Therefore, transition economies, among the others, have to pay prime attention to the price competitiveness of the sectors which have the largest share in their exports.

FDI in the sector of services is not promptly assessable in terms of productivity gains. Thus, inflowing the sectors such as banking, might increase the efficiency of the broader business climate. In addition, developments in the services of physical and technological infrastructure, as well as the local-bound tourism may be also an important resource of revenue. On the other hand, the process of FDI liberalization has brought many inflows in the manufacturing sector. The reasons behind subsist in the vicinity of the larger European market, existence of highly skilled labor force, but above all the labor costs per production unit (ULC), as a proxy for the level of productivity (Table 4).

Evidence suggests that countries which have recorded more FDI inflows in the manufacturing sector, proved greater amplification in their export competitiveness compared to those with FDI inflows in services (Figure 7). Consequently, Hungarian exports have been tripled during

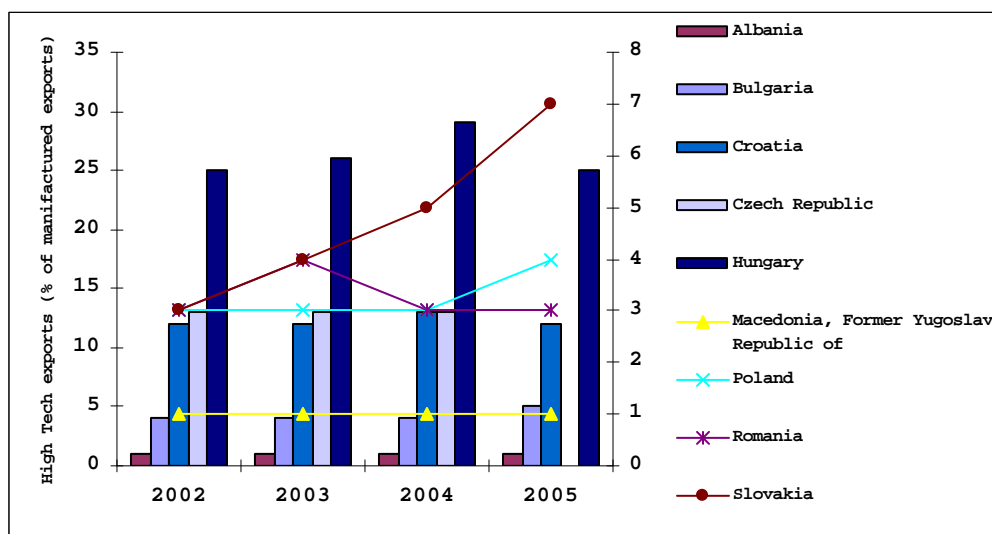
⁷ Large capital inflows imposed by the process of privatization in Poland and Czech Republic led the authorities to make special foreign currency accounts aimed at evading the distraction of the currency markets.

⁸ Exports change in 2006 relative to 2000. FDI inflows are cumulated from 2000 to 2006. GDP (PPP) refers to 2006.

the period of 5 years due to the FDI entrance into the export-oriented manufacturing sector attracted by special perks, like tax holidays. On the other hand, FDI sectoral composition in Czech Republic has been equally distributed between services and manufacturing, thus the country has less frenetic growth in exports relative to FDI. Similarly, Croatia faced smaller effects on exports competitiveness, although the country experienced large FDI inflows. Those, however, have been mostly of the local market seeking type, such as retail and financial intermediation, with no large perspectives to change the export structure immediately. At the same time manufacturing comprises just one third of FDI in Bulgaria.

The general belief is that international competitiveness of the European economies in transition in average has increased since they have opened to FDI (Table 5). Thus, foreign owned firms have participated within the Hungarian exports in almost 90%. Yet, the total factor productivity assessment indicates more productivity gains in the foreign owned firms, while negative side-effects for the domestic ones (Sgard, 2001). The particular condition might be caused by the technological lag of the domestic firms, which makes them to be more stock-still in comparison with those receiving boosters of foreign technology and organizational skills. The closure of this gap between the foreign and domestic owned firms might only improve the competitiveness of the economy as a whole and makes the growth and convergence sustainable.

Figure 8: R&D contents of exports



Another important fact is that countries which have accepted FDI in manufacturing, have also changed the R&D contents of their exports (Figure 8). Thus, the premature reformers such as Poland, Hungary and Czech Republic have increased the R&D composition of their exports, although they stayed within the low value added section of the high technology sectors. Time and again, the lack of FDI manufacturing inflows in Croatia was effectuated in no technology transfers and less changes in value added composition of Croatian exports.

FDI and Possibilities for Economic Policy

FDI may certainly improve the performances of the host economy, but one should also consider the possibility of some adverse side-effects imposed by this kind of capital inflows.

In point of fact, foreign-owned firms have a great importance in increasing the competition, as well as restructuring the economy by setting up many linkages with the local companies. Thus, transition economies in particular have to define a long-term development strategy aimed at attracting foreign capital and better utilizing the investment's positive effects. This includes coordination among various economic policies, since many investment decisions are sensitive to some of their elements, such as interest rates changes (Feenstra, 1998) or the exchange rates (Blonigen, 1997).

In addition, policy incentives have to be accorded to the type of investment. Consequently, investment projects in Hungary were mainly supported by shifting to financial incentives, rather than the fiscal ones. Governments should also improve the general investment environment on the regulatory side if intend develop the ability to attract foreign capital.

The limitation of regional incentives competition might be beneficial in investment promotion, but sometimes could also have negative side-effects. Thus, it might be used effectively if needed to correct the market failure, which is quite a difficult task that may not always yield a success.

Nevertheless, one shouldn't undermine the fact that FDI positive spillovers might be absent in some transition economies. On one side, they need time to develop, but also domestic enterprises have very little time to adjust in terms of sudden foreign competition exposure and liberalized local trade regimes. Thus, additionally to the efforts aimed at attracting FDI, policy makers have to develop more active measures in order to maximize the long-term benefits of FDI, particularly those that can alleviate the improvement of backward and forward linkages. Domestic firms have to be also reinforced so as to compete more effectively with the foreign ones (escape negative spillovers, such as bankruptcy or become more dynamic partners). The particular proceedings are more than needed since FDI related incentives in parallel with the EU accession driven reforms enabled many transition economies to become fully-member states of the European Union.

Conclusions

The evidence in the paper suggests that many European economies in transition have attracted significant FDI inflows, but also there is an increasing tendency of dissimilarity in FDI distribution. In other words, the first group considered as EU candidates (Czech Republic, Hungary and Poland) received almost 60% of the total annual inflows, while many others failed to attract much FDI due to the unfavorable domestic political and economic position.

The analyses carried out have also shown a positive direct FDI impact on growth in the European transition economies. Yet, the countries where FDI appears to have a great influence, GDP growth rates are still not satisfactory to rapidly narrow the income gap with some of

EU 15 countries. Many studies for developing countries, however, indicate that FDI affects the GDP growth on a long-term, thus the very same may well be expected for the transition economies. Foreign capital inflows have also stimulated the total factor productivity increase, principally by augmenting the gross fixed capital formation. At the same time, FDI may certainly contribute in locking the gap between gross domestic savings and investment in the European economies in transition. The increased capital stock, however, is considered to have more direct pressure on economic growth relative to technology transfer, since the linkages with the domestic market take time to develop.

FDI impinge also on the productivity and efficiency improvements in European economies in transition, principally affecting their exports composition. The analyses indicate that countries which have recorded more FDI inflows in the manufacturing sector, pronounced greater amplification in their export competitiveness weighed against those with FDI inflows in services. Yet, estimation of the total factor productivity points toward efficiency gains in the foreign owned firms, caused by the technological lag of the domestic ones. Consequently, competitiveness of the entire economy might be only improved by locking up the particular gap in order to make the growth and convergence sustainable.

Taking into consideration the positive FDI effects on economic growth and exports performances, policy makers have to consider more active measures to attract foreign capital and maximize the long-term benefits. Thus, they have to put further efforts to promote the positive spillovers creating sound stabilization policies, as well as the investor-friendly environment. The effective competition policies may protect the domestic firms from any predatory practices, but also reinforce their capacities so as to compete more effectively or to become attractive partners in upstream and downstream operations.

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Appendix 1

Table 1: FDI in Eastern Europe by industry (1994)

	Percent shares
Electronics	11.4
Heavy industry	4.4
Transport	9.0
Chemicals	4.5
Construction	4.0
Clothing	3.8
Food	10.3
Mineral raw materials, energy	9.4
Other industry	13.2
Industry	70.0
Financial services	8.2
Other services	21.8
Services	30.0
Total	100.00

Source: EBRD, 1994 (East European Magazine database)

Table 2: Ratio of FDI inflows to current account deficits

	1993-1996	1997-1999
Eastern Europe	58	86
Baltic States	97	64
CIS	45	77
Asian CIS	66	84
European CIS	21	59

Source: UN/ECE Secretariat

Table 3: Average Monthly Gross Wages EUR (PPP), 2000 and 2005

Country	2000	2005	Change 2000-2005 (%)
Bulgaria	365	444	21.6%
Czech Republic	833	1112	33.5%
Hungary	718	1053	46.7%
Poland	915	1070	16.9%
Romania	397	563	41.8%
Slovakia	626	817	30.5%

Source: WIIW

Table 4: Unit Labor Costs, 2000 and 2005, PPP adjusted (Austria=100)

Country	2000	2005	Change 2000-2005 (%)
Bulgaria	16.93	19.32	14.1%
Czech Republic	31.59	42.77	35.4%
Hungary	27.74	40.96	47.7%
Poland	43.81	43.43	-0.9%
Romania	31.31	36.10	15.3%
Slovakia	25.35	33.41	31.8%

Source: WIIW

Table 5: Shares of companies with FDI in total exports (%)

	1998	1999	2000
Czech Republic	47	60.5	n/a
Hungary	85.9	88.8	n/a
Poland	52.4	59.8	n/a

Source: Hunya, 2002