GROUPEMENT D'ÉTUDES ET DE RECHERCHES
NOTRE EUROPE
President: Jacques Delors

FOREIGN DIRECT INVESTMENT IN THE NEW CENTRAL AND EASTERN EUROPEAN MEMBER STATES: WHAT COULD CHANGE WITH ENLARGEMENT

Bérénice PICCIOTTO

Research and Policy Paper No. 24
May 2003

AVAILABLE IN FRENCH AND ENGLISH

http://www.notre-europe.asso.fr/Publications/Etud24-fr.pdf

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Bérénice PICCIOTTO

Born in Prague in 1978.
Graduated from HEC (Paris) with a specialisation in economics. Wrote her final-year dissertation on the 1998 Russian financial crisis.
Currently taking a postgraduate degree (DEA) in international economics and finance at Université Paris Dauphine, while participating in a project of the Organisation for Economic Cooperation and Development (OECD) on the liberalisation of financial systems in south-east European countries.
Also worked in Moscow for the firm of auditors Mazars et Guérard.
As part of a period of training at CDC-IXIS in the department for risk research on emerging countries and markets, she has carried out a study on privatisation in the infrastructure sector of central European countries.

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FOREWORD

The treaty providing for enlargement of the European Union (EU) to 10 new States was signed in Athens, on 16 April 2003, and is now undergoing ratification in the 25 countries involved. During these few months, which will soon be over, the former candidate countries find themselves in a kind of limbo: no longer candidates, but not yet full members. This is the ideal time to consider the foreseeable consequences of this change in status.

Notre Europe asked Bérénice Picciotto to attempt to shed light on one of the major aspects of this issue by analysing the predictable effects that integrating the new members into the single market will have on investment flows and production locations. She has obliged with a sound and well-researched study, which provides a valuable insight into potential developments without claiming to hold certainties. I have noted two considerations in particular.

The first is that we are not starting from scratch. The years of economic "transition" and preparation for accession to the EU have enabled the candidate countries to adjust to foreign direct investment flows and adapt their economic policy accordingly, with varying degrees of success. The second is that the progress made is extremely fragile, has already been marked by significant setbacks and reflects major potential imbalances between countries, regions and sectors, within both the new members and some of the current ones.

The Union therefore has a major challenge to take up. No-one would understand if it were less successful in bringing about convergence after enlargement than before. In this respect, it has a decisive instrument at its disposal in the shape of the structural and cohesion funds, even though the accession negotiations were able to deal only with their overall budget. There is now a pressing need – notably in the context of the plans for 2007-2013 – to take a closer look at the role these funds are to play in the context of *this* enlargement. I trust that studies such as this one by Ms Picciotto will help draw attention to the issue and provide the first pointers towards future progress.

Jacques Delors

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INTRODUCTION

On the eve of the European Union's inclusion of the eight most advanced central and eastern European countries (CEECs), public opinion – and sometimes even politicians – in some of them are giving few signs of caring. All the countries that are set to join the European Union (EU) in May 2004 must organise a referendum on accession before that date. Malta, Slovenia and Hungary were the first to deliver a massive vote of approval on becoming EU Member States. The outcome of the next referendums will give a more precise idea of where public opinion in the future Member States stands on the European issue.
But the current context is one of economic slowdown in western Europe, and in particular in Germany, a country which is both one of the main economic powers in the EU and the leading trading partner of the future members. This will undoubtedly influence the debate on the effects of enlargement, in the current EU Member States and the CEECs alike. Economic considerations are becoming more important in this debate, and the role of foreign direct investment (FDI) is, in a way, acting as a focal point for the fears and hopes of the various parties involved.

After having largely completed their transition from planned to market economies, the CEECs are now in the final phase of the pre-accession process that began three years ago, during which they have negotiated the terms of their accession and were required to take on board the entire Community *acquis*, or body of Community law.

The countries are now set to become full members. Yet there remain risks of macroeconomic imbalances, and convergence with the EU's current members has not been achieved. The question therefore arises as to whether this new phase will make it possible to resolve some of the old problems or, on the contrary, whether it will expose new ones.

FDI became crucial to the CEECs as soon as their planned economy regimes collapsed. In 1989, productive capital and infrastructure in these countries needed to be renewed and modernised, and investment thus emerged as a fundamental variable in development. But since domestic saving was not sufficient to provide all the capital required and external financing (through markets or banking institutions) was not very developed, the contribution of foreign capital played an essential role in financing investment.
FDI flows into the CEECs thus made a deeper and more lasting contribution than trade flows in terms of transforming the industrial and social structure of the receiving countries. The question now is the extent to which accession will affect FDI flows, in both quantitative and qualitative terms.

Unlike during the first phase of transition, where foreign investment took place mainly as part of a privatisation process that is now largely completed, the current challenge is to attract foreign investment in the already privatised sector. The predominance of FDI from the EU indicates that the economies of the CEECs are on the way to being integrated into the single market. At least, some of them are. For FDI is flowing into and accumulating in the most advanced CEECs, while the countries of south-east Europe (Romania and Bulgaria) have not yet managed to attract significant investment flows. These discrepancies between CEECs shed some light on the factors that make a country attractive to foreign investors: political and macroeconomic stability, an appropriate and observed regulatory and legislative framework, the absence of corruption, labour costs that are lower than in the investors' country of origin, a

skilled workforce, and lastly the availability of sound physical infrastructure and financial systems allowing efficient resource allocation.

The evaluation of the effects of FDI on the CEECs and the EU Member States yields a mixed and somewhat unexpected picture. As regards the EU countries, outward FDI does not consist solely of unemployment-generating relocations. As for the candidate countries, inward investment alone is not enough to ensure development and a stable economic situation.
Likewise, the theoretical benefits of FDI – such as technology transfer and enhancement of human capital – do not always materialise in practice. For them to actually come about, a number of conditions must be met. That is where public policies – possibly supported by Community resources – can play a significant role. We will look at the type of policy required to maximise the benefits of FDI and minimise its adverse effects.

Integrating the CEECs into the EU will probably have other effects. The CEECs that join in 2004 will become more attractive to foreign investors (increased creditworthiness, impact of the Structural Funds on the economic environment, etc.) and will probably experience an increase in inward FDI. In qualitative terms, we can expect an impact on the specialisation of these countries and an increase in regional inequality. The question of specialisation trends will arise in the coming years, for labour costs in the CEECs are bound to move closer to those of western Europe. This will make specialising in unskilled labour-intensive industries uneconomic in the longer term.

Unlike the many other studies that have looked at the impact of enlargement on the economies of the current EU members, this paper will focus on analysing the post-enlargement issues relating to FDI mainly from the point of view of the CEECs (i.e. the region's eight countries which will be joining the EU in May 2004, plus Bulgaria and Romania).
Part I summarises trends in FDI flows from the beginning of the transition period and analyses the main determining factors. Part II focuses on evaluating the positive and negative effects of FDI on the economies of the CEECs. The final part looks at the possible impact accession will have on FDI flows into the CEECs, first from a theoretical point of view, then in the light of the previous enlargement exercises.

I – BACKGROUND

1. Definitions

Investment flows into the CEECs are almost exclusively of two types, which differ in financing needs, in determining factors and in effects on the host economies: FDI – the subject of this study – and portfolio investment, which is defined below.

Through FDI, the foreign investor aims to gain management powers and a lasting interest in a company, while the primary purpose of portfolio investment is short-term financial returns.

For statistical purposes, operations are counted as FDI if they result in a holding of at least 10% of the equity and/or voting power in a company, and as portfolio investment if they do not reach that threshold. In theory, three types of operation count as FDI: acquisition of an equity holding in the company; short- and long-term loans from the foreign investor to the beneficiary company; and reinvestment of profits in the latter. In practice, however, DFI statistics do not always take reinvested profits into account[1].

FDI is therefore productive investment carried out looking to the medium term, and it is less volatile and less easy to reverse than portfolio investment. This explains why it plays such an important financing role in the CEECs.

2. Concentration of FDI flows within a group of countries

The geographical breakdown of inward FDI in the CEECs shows considerable differences between countries. This is the case both for the stock of FDI (cumulative flows since the country concerned opened up to foreign investment) and annual inward flows.

The two sets of data are complementary. The first table shows the stock of FDI in each of the candidate countries in 2000. It indicates the countries which have received most foreign investment since the beginning of the transition phase (pre-1990 flows were very low – even non-existent in some countries). But it does not show how the FDI attractiveness of each country has changed over time.

The time pattern for annual inward FDI in each country can be seen in the table presenting the annual inward flows (Table 2).

This second table indicates that, while the overall FDI flows towards the CEECs have increased, they have not grown at the same rate in all countries. There are several reasons for this, that we will describe further on in this paper (privatisation strategy, opening up to foreign competition in certain sectors, policies to promote FDI, etc.). The countries which have made most progress along the transition route, and where the privatisation process is now completed

[1] On the issue of taking reinvested profits into account when calculating DFI flows in Hungary, see *Macroeconomic and Sectoral Aspects of Hungary's International Competitiveness and Trade performance on EU Markets*, G. Oblath and S.Richter, Research Report of the Vienna Institute for International Economic Studies (WIIW), No. 228, September 2002.

or at a very advanced stage, have experienced a slowdown in the growth of inward FDI. In Hungary, for instance, the flows levelled off around 1999 – the year privatisation was completed.

Table 1: Stock of FDI in 2000

	$ billion	% of total (CEEC-10)	$/head
Bulgaria	3.4	3.3	411
Czech Republic	21.1	20.6	**2,056**
Estonia	2.8	2.7	2,011
Hungary	19.9	19.5	1,971
Latvia	2.1	2.1	871
Lithuania	2.3	2.2	634
Poland	36.5	**35.7**	942
Romania	6.4	6.3	287
Slovakia	4.9	4.8	909
Slovenia	2.9	2.8	1,440
CEEC-10	102.3	100.0	

Source: DREE, *Revue Élargissement*, special issue on FDI, May 2002

Table 2: Flows of inward FDI ($ billion)

	Annual average 1985-1995	1997	1998	1999	2000	Average growth per annum, 1997-2000
Bulgaria	0.031	0.505	0.537	0.819	1.002	27%
Czech R.	0.54	1.3	3.718	6.324	4.595	76%
Estonia	0.06	0.267	0.581	0.305	0.398	34%
Hungary	1.035	2.173	2.036	1.944	1.957	-3%
Latvia	0.042	0.521	0.357	0.348	0.407	-6%
Lithuania	0.013	0.355	0.926	0.486	0.379	30%
Poland	0.768	4.908	6.365	7.27	10	27%
Romania	0.089	1.215	2.031	1.041	0.998	5%
Slovakia	0.08	0.206	0.631	0.356	2.075	215%
Slovenia	0.055	0.321	0.165	0.181	0.181	-13%
CEEC-10	2.713	11.771	17.347	19.074	21.992	24%
World	180.3	477.9	692.5	1075	1270.8	39%

Source: UNCTAD, *World Investment Report 2001: Promoting Linkages*

Within the CEECs, we can observe that the FDI flows and stocks are concentrated in the countries of the first wave of accession to the European Union[2]. Romania and Bulgaria account for only a small proportion of the total.

The countries that have received the greatest stock (in per capita terms) of FDI since the beginning of the transition phase have been Hungary, Estonia and the Czech Republic. In

[2] Czech Republic, Hungary, Poland, Slovakia and Slovenia in Central Europe, plus the Baltic States: Estonia, Lithuania and Latvia.

terms of absolute values of FDI, Poland tops the charts. Bulgaria and Romania come far behind, however the FDI is measured.

The FDI originates mainly from the EU countries and the United States. Other countries such as Japan have also engaged in FDI in the CEECs, but to a far lesser extent than the EU and US.
The breakdown of countries involved in FDI in the CEECs has to do with historical factors (France is the leading investor in Poland and Romania, two countries with which it has long-standing relationships), geographical proximity (Germany and Austria are substantial investors in the Czech Republic and Hungary), and the need to be present in highly promising markets (which explains, for instance, the efforts of French companies to increase their presence in the Czech Republic in recent years).
Thus in 2000, Germany was the main investor in the region, holding some 18% of the total stock of FDI. The United States came second (12% of the stock) and France third (10%), before the United Kingdom (6%) and the Netherlands (a little over 5%, offshore investment not included)[3]. If we take outgoing FDI in relation to the size of the economy, Austria is the leading country of origin.

The values of the FDI flows are relatively substantial for the receiving countries, but not for the EU Member States. They accounted for only 0.15% of the EU's GDP and less than 1% of gross fixed investment in the 1990s.

The next table shows the importance of inward FDI in the CEECs in relation to their GDP. The percentages vary between the countries but are in all cases higher than the ratio of outgoing FDI from the EU relative to the Community GDP. There is therefore clearly a lack of symmetry between the current Member States and the candidate countries.

Table 3: FDI flows as a percentage of GDP

	1998	1999	2000	2001
Bulgaria	4.4	6.1	8.4	4.9
Czech Republic	4.7	9.1	8.8	8.5
Estonia	11.0	4.6	6.4	6.4
Hungary	3.1	2.9	2.4	4.3
Latvia	5.0	5.8	5.6	4.0
Lithuania	8.6	4.5	3.3	3.8
Poland	3.2	4.3	5.1	3.6
Romania	4.9	2.4	2.9	3.0
Slovakia	1.8	3.7	10.7	7.6
Slovenia	0.8	0.2	0.6	1.8

Sources: for 1998 and 1999, *Enjeux économiques de l'élargissement pour l'Italie*, DREE, *Note du PEE de Rome*, January 2002, p. 66. For 2000 and 2001, EBRD (2002).

The major changes from one year to the next are usually due to the privatisation of a large company (in particular in the infrastructure sector).

[3] Source: DREE (2002).

We can also see large differences between the candidate countries, and it is difficult to establish a clear link between a country's development and the value of FDI flows relative to its GDP. For example, the most advanced countries of the region (Slovenia, Czech Republic and Hungary) differ greatly in the ratio of FDI to GDP.

Thus Slovenia is both the country where the ratio is lowest every year, and the highest-income country in the group (highest per capita GDP – see Table 4). That is due to the particular strategy of the Slovenian authorities, who were reluctant to let foreign investors take control of part of the country's economy. Furthermore, at the beginning of the transition phase, Slovenia's level of development was already higher than that of the other CEECs, so foreign capital was not as necessary there as in certain other countries. So a number of measures to curb inward FDI applied up to 2000: restrictions on capital movements, restrictions on the activities that could be undertaken by foreign companies, privatisation processes with very little access for foreign investors, etc.[4] And the authorities were also anxious to promote local companies when they seemed to be efficient and able to hold their own in the world market. Gorenje, a white goods manufacturer, is an example of a local company that has been able to export without benefiting from foreign capital. However, in 2000, the government adopted a four-year programme designed to lift the barriers to FDI, in particular by making it easier for foreign investors to buy industrial land and participate in privatisation exercises. The programme led to increased FDI in 2001 and 2002 (flows of 503 million, or 1.8% of GDP, and 1,110 million dollars respectively[5]), but these flows (as a percentage of GDP) are still low compared with the other countries in the region.

In Hungary, FDI accounted for 2.4% of GDP in 2000 and 4.3% in 2001 – figures which are also below the regional average. But not for the same reasons. Hungary was the first country to engage in massive privatisation, by calling on foreign capital (direct sale of State assets), and FDI flows were very high from the outset. Today, the privatisation process is virtually complete. FDI flows are levelling off and have reached a fairly mature level. This explains why they are low relative to GDP.

In the Czech Republic, FDI flows accounted for 8.5% of GDP in 2001, which is the highest ratio among the ten countries under consideration. The explanation for this high rate is similar to that for Hungary. Owing to the strategy adopted at the beginning (coupon-based privatisation), the privatisation process was slower than in Hungary and there still remained many State companies to be sold in 2001, in particular in the infrastructure sector (transport, energy and telecommunications). Furthermore, the launch of programmes to encourage FDI in 1998 and 2002 also contributed to the recent increase in the flows. So in 2000, for the first time, the Czech Republic overtook Hungary in terms of the stock of FDI, since flows there remained at the high levels of 1999[6].

[4] OCDE (1997).
[5] WIIW (2003).
[6] DREE (2002), article of *Revue Élargissement* No. 13, October 2001.

3. What factors have determined the FDI flows to the CEECs since 1989?

The breakdown of FDI flows and stocks since 1989 gives some indication of the factors that have helped attract foreign investors. A detailed analysis of these factors will help us to predict certain trends that the CEECs' accession to the single market will have on the flows, relating to both qualitative and quantitative aspects.

We have already looked at the state of progress of privatisation and the method adopted as significant factors in how FDI developed. But they do not explain all FDI flows, and in particular the more recent ones.

Hungary, for instance, is still among the CEECs receiving most FDI, even though it has run out of enterprises to privatise. To understand this, we must make a distinction between investing by taking over existing enterprises (often as part of a privatisation exercise) and investing in new company start-ups (greenfield investment). In Hungary, even at the beginning of the 1990s, a substantial proportion of FDI went into new companies, on account of the country's business-friendly regulatory and economic framework.
So thanks to greenfield investment, the end of privatisation did not herald the end of FDI in Hungary. The flows levelled off at 1.9 billion dollars per year in 1999 and 2000. And while 34% of FDI went into new projects in 1995, this figure had risen to 92% in 1998[7].

The ability to attract greenfield investment is thus vital for all CEECs in the future, as the number of companies to be privatised begins to diminish.

The many studies in this area point out several other factors behind FDI, in addition to the state and speed of privatisation.

The regulatory and legal framework, and the absence of corruption

Political stability and the existence of a regulatory and legal framework protecting investors and shareholders are significant factors in persuading foreign investors that a country is safe. And laws on bankruptcy, transparent property rights and the possibility of repatriating profits and dividends also play an important role in determining to which countries FDI will go.

For example, despite its many advantages (skilled labour, good geographical position, macroeconomic stability, etc.), the Czech Republic is considered to be relatively risky because of corruption. The Prague Economic Mission gave us one example. A major French investor had bought land to build a plant, but the local authorities decided shortly after the transaction took place that no building was permitted in that area. So considerable sums had to be paid to the officials responsible in order to secure a building permit[8]. This form of corruption generates an insecure climate for foreign investors, who are very often unfamiliar with the workings of this informal economy.

A study on Romania, where corruption is widespread, shows that the lack of transparency in administrative practices tends to encourage foreign investment in the form of joint ventures[9]. This form of investment allows foreigners to enlist the help of local partners who know more about how the local bureaucracy works. On the other hand, such an environment of corruption

[7] World Bank (1999).
[8] Example given by Milena Raskova, head of sector at the Prague Economic Mission, Czech Republic.
[9] Hunya (2002b).

clearly discourages FDI in new companies, notably in high-technology sectors since the substantial initial outlays required mean there is a lot at risk. Yet it is precisely this type of FDI, in high-technology sectors, which has the greatest positive effects on the economy and development of the host country, in particular in the form of technology transfer.

Corruption therefore hamstrings development by affecting not only the volume but also the nature of FDI, and by discouraging the type of investment that is most beneficial to the host country's economy.

Physical and financial infrastructure

Financial systems, and in particular an efficient banking sector, are other factors which encourage FDI.

Lastly, the existence of modern and appropriate physical and intangible infrastructure (transport, telecommunications, etc.) is an advantage. In particular, dense and well maintained road and rail networks are crucial elements in encouraging foreign companies to move into a country or region, given the cheaper transport costs they allow. For companies that import part of their equipment or inputs, and export their products, transport costs are a critical variable. Thus the "*excellent accessibility (by railways and motorways)*" of the Trnava site in Slovakia was presented as one of the reasons that location was chosen for PSA Peugeot Citroën's central European plant[10], that will soon be supplying the entire European market.

Labour costs or domestic market?

Furthermore, contrary to what is generally believed, empirical studies have demonstrated that an ample supply of cheap labour is not the main factor behind FDI in the CEECs. More specifically, for certain types of investment, differences in wage costs can make a CEEC more attractive than one of the current Member States, but they will not be a factor in the choice of country within central and eastern Europe. The tables of FDI stocks and flows clearly show that labour costs alone cannot explain the distribution of FDI among the various CEECs, and that other elements play a role. For example, Bulgaria and Romania, where wages – like productivity – are still low, attract less FDI than countries with higher labour costs such as Hungary and the Czech Republic. Unlike the latter two countries, foreign investors do not consider Romania and Bulgaria to be safe. Corruption, an unfavourable regulatory environment, macroeconomic imbalances and delays in adopting the Community *acquis* are discouraging the establishment of foreign companies, and the low labour costs do not make up for these disadvantages[11].

Among the CEECs, the local market plays a greater role in attracting investment. This explains the level of FDI in a large country such as Poland, for instance. In the Czech Republic and Hungary, what makes the domestic market attractive is the relatively high standard of living (see the table below). In an EBRD[12] survey carried out in June 2000, of

[10] PSA explained that its choice was due to the following factors: a vast area of land with building authorisation allowing a supplier estate to be created next to the plant, with easy access (by motorways, railways, etc.); a tradition of available labour with a good level of skills; and the proximity of major markets in which the group is rapidly expanding (Fainsilber D., "*PSA choisit la Slovaquie pour implanter sa nouvelle usine en Europe*", *Les Échos*, 16.01.03).

[11] However, wage costs, when adjusted to take account of labour productivity, are similar in all CEECs. For example, labour costs are lower in Romania and Bulgaria, but so is productivity.

[12] European Bank for Reconstruction and Development.

over 400 companies that had invested in the CEECs, about half listed access to a highly promising market as their primary motivation. The second most important factor explaining investors' choice of location was the combination of cheap and skilled labour.

Table 4: Per capita GDP

	1994	1995	1996	1997	1998	1999	2000	2001
Bulgaria	1,152	1,583	1,179	1,230	1,490	1,513	1,476	1,657
Czech Rep.	3,997	5,049	5,620	5,109	5,529	5,291	4,920	5,473
Estonia	1,544	2,417	2,980	3,174	3,617	3,609	3,508	3,786
Hungary	4,052	4,359	4,425	4,495	4,641	4,757	4,589	5,121
Latvia	1,442	1,779	2,070	2,293	2,494	2,799	3,019	3,249
Lithuania	1,143	1,623	2,129	2,588	2,904	2,882	3,064	3,249
Poland	2,399	3,085	3,483	3,511	4,066	3,987	4,108	4,654
Romania	1,323	1,564	1,563	1,551	1,688	1,512	1,644	1,796
Slovakia	2,721	3,423	3,679	3,802	3,970	3,650	3,556	3,668
Slovenia	7,231	9,418	9,439	9,103	9,793	10,050	9,073	9,416

Source: EBRD, Transition Report update, May 2002 (dollars).

To get a clearer idea of the relative importance of low wage costs and the size of the domestic market as determining factors for FDI, we must make a distinction between vertical FDI and horizontal FDI. These have distinct purposes and are therefore governed by distinct factors.

When the costs of production factors differ between countries, firms have an incentive to organise their production processes in such a way as to exploit these differences. In such cases, countries receiving FDI tend to each be specialised in specific production stages (for instance, companies may be seeking to exploit labour cost differentials). This is vertical FDI.

Conversely, horizontal FDI occurs where there is no great difference in the cost of production factors, but where access to certain markets is expensive owing to trade barriers or high transport costs. Companies then tend to produce within each country for the domestic market. Horizontal FDI in the CEECs is motivated less by the wish to overcome trade barriers (which are negligible owing to the association agreements and the EU accession process) than by the need to be among the first with a presence in markets that have a strong growth potential.

In short, the cost of local labour is an essential criterion for vertical FDI, while the size or potential of the domestic market is the prime consideration for horizontal FDI.

Most European FDI in the CEECs is of the horizontal type.

Labour skills: a mixed picture

Sectors other than the unskilled labour-intensive ones are also affected by other factors, such as workforce skills, the quality of the education system, etc.

The level of training in the CEECs is generally believed to be high. The truth is less clear-cut. A distinction needs to be made between types and levels of education – two fundamental characteristics in a country's ability to attract FDI. A breakdown by level of education (low = basic secondary school education; medium = higher secondary school education; high = higher education) yields the information in the table below:

Table 5: Breakdown by level of education in the CEECs and the EU

	Level of training of the working population		
	Low	**Medium**	**High**
CEEC average	18%	67%	15%
EU average	36%	43%	21%

Source: DREE

The table shows that, on average, the share of the population with a low level of education is lower in the CEECs than in the EU. This may explain the popular conception that the CEEC population is highly skilled.
However, the share of the population with a high level of education or training in the CEECs is also lower than the EU average (which is itself deemed insufficient by the Community authorities). And it is precisely the proportion of people receiving higher education which counts in attracting activities with a high added value.
Lastly, the share of the working population with a medium level of education is much higher in the CEECs than in the EU. This is essentially due to the weight of the industrial sector in the economies of these countries.

The CEECs involved must therefore make an effort to increase their share of highly skilled workers in order to promote the economic catching-up process.

There are nonetheless substantial differences between the CEECs.

Lithuania, Latvia and in particular Estonia are close to the European average in terms of high levels of training.

The figures for Slovenia and Hungary are about 15%. In Poland, the Czech Republic and Slovakia, very high proportions of the population (over 70%) have a medium level of education.

And in Bulgaria, Romania and Slovakia, the proportion of the working population with a high level of education or training is under the Community average (only about 10% in the case of the latter two countries).

Education policy in the candidate countries will be crucial in promoting high-level education and training over medium-level education. And the highly skilled workers are those who attract the FDI with the best development potential.

Ireland is a good example of a country that has overcome its economic handicap to a large extent by improving the skills of its workforce. The country devoted more than 6% of its GDP to public spending on education over the last 20 years, compared with an average of 5.4% in the CEECs and 5.6% in the EU in 1997. And education policy in Ireland also focused on steering the population towards higher education and training in leading-edge technologies. The efforts of the authorities in the education sphere should therefore not be measured only in terms of the share of public education spending in GDP, but also in terms of the ability to develop training that will attract foreign investment with a high added value. This qualitative aspect is a determining factor in explaining the Celtic tiger's success.

Measures taken by governments in the CEECs to attract foreign investors

The authorities of certain countries (Hungary and the Czech Republic) have also conducted deliberate policies to attract foreign investment. The measures take the form of tax incentives and advantages awarded on a case-by-case basis to win over companies that are hesitating between different countries, etc.

Generally speaking, policies to improve the skills of the workforce and the quality of infrastructure are often intended to attract FDI. These types of incentives have beneficial effects for the development of the country involved – less because of the inward FDI attracted by the incentives than because these measures are intrinsically good for growth and development.

Macroeconomic situation

The macroeconomic situation is also a significant element in investor confidence. In addition to per capita income, already mentioned, GDP growth, inflation, the budget deficit, the external trade balance, the exchange rate system, etc., all influence the assessment that potential investors will make of the country. We should add that what matters is not only the macroeconomic performance as such, but also the progress made over time and the ability of the authorities to keep their promises (on inflation, regulatory reform, adoption of the Community *acquis*, etc.).

The economic crises the CEECs have experienced have always been accompanied by a slowdown in FDI into the countries involved, until the authorities adopted measures that the investors deemed effective and credible.

For instance, after a three-year phase of strong economic growth, the Czech Republic encountered structural problems in 1996 (wage rises that were excessive given the productivity levels and the drawn-out industrial restructuring process, unsatisfactory corporate governance, overly easy access to credit, etc.) which led to macroeconomic imbalances in 1997 and 1998. Exports slumped and, at the end of 1996, the current account balance and trade balance reached very high deficit levels (7.6% and 10% of GDP respectively). Real GDP fell by 1% in 1997 and 2.2% in 1998. These macroeconomic difficulties were compounded by a very sharp drop in inward FDI in 1996 and 1997 (net flows fell from over 2.5 billion dollars in 1995 to about 1.27 billion dollars in 1996 and 1997[13]). FDI recovered in 1998 (to approx. 3.6 billion dollars), once the government adopted a stabilisation programme in the spring of 1997 and a programme to promote investment in 1998.

4. Sectoral breakdown of FDI

FDI in the CEECs is more or less evenly split between manufacturing industry and domestic non-tradeable sectors, i.e. services and infrastructure (financial services, transport, telecommunications, energy, etc.). Foreign investment in the infrastructure sector essentially involves acquisitions of large State enterprises as part of the privatisation process, and very seldom the creation of new businesses.

[13] Source: EBRD (2002).

More specifically, out of the 50% of FDI that went into manufacturing industry, 30% was apparently intended to increase market shares in the CEECs and only 20% was in industries that are relatively labour-intensive (textiles, clothing, vehicle manufacturing, electrical equipment, etc.) and export-orientated[14]. In other words, according to this estimate, and using the terminology given above, some 50% of FDI was generated by the privatisation of former State monopolies while the other half divided into 30% horizontal and 20% vertical investment.

- Services and infrastructure

The services sector was under-represented in the CEECs at the beginning of the 1990s on account of the priority given to industry under the planned economy regime. Furthermore, the economy was entirely based on production – functions related to marketing the products were non-existent.

The services sector is still less developed in the CEECs than in the current EU Member States, in terms of both GDP and employment, but it has expanded (notably thanks to FDI). Foreign investment does not provide only financial resources. It also contributes know-how and expertise that local operators in the CEECs lack in the field of services. At the beginning of the transition phase, the workforce in the CEECs was not familiar with the services sector, and foreign companies frequently sent out expatriates. This is no longer always necessary, in particular in the central European countries which have a skilled workforce.

There are few precise statistics on FDI in services. The flows are therefore difficult to analyse in detail.

However, several factors can explain the extent of FDI in the infrastructure sector. First of all, the countries must liberalise and open up their energy, telecommunications and transport markets in order to join the EU. Secondly, conforming to the Community *acquis* requires considerable investment for modernisation. The EU is financing part of this through pre-accession aid, but most of the funds must come from the countries themselves and notably from private sources.

Privatisation appears to be the simplest means of achieving the necessary degree of liberalisation and standards compliance, while also bringing some money into the State coffers. But, as we will see, it does not necessarily lead to more competitive markets.

- Manufacturing industry

As we have seen, manufacturing industry has received about half of the FDI inflows since the beginning of the 1990s, except in the Baltic States. The table below shows that, among the CEECs that are set to join in 2004, inward FDI has been high both in sectors targeting the domestic market (farming and food industries) and in export-orientated industries (electrical and electronic equipment, transport equipment, etc.).

If we make a distinction between three industrial sectors according to technology content (low-technology, medium- to high-technology, and natural resource-intensive industries, see Annexes), and calculate the share of sales from enterprises with foreign capital in the total sales of the industry involved, it appears that for all countries for which data are available (central Europe and the Baltic States), enterprises with foreign capital account for a larger

[14] European Commission (2001).

share of sales in medium- to high-technology industries than in low-technology or natural resource-intensive industries.

Table 6: Share of FDI-receiving enterprises' sales in various industrial sectors (1999)

	Czech Rep.	Hungary	Poland	Slovenia
Low-technology, labour-intensive	28%	59%	47%	8%
Natural resource-intensive	45%	77%	52%	21%
Medium- to high-technology	63%	87%	58%	45%

Source: Research Report of the Vienna Institute for International Economic Studies, July 2002, No. 286, p. 38.

According to the table above, in the countries considered (which are among the most advanced CEECs), FDI is more attracted to industries which incorporate medium or high technology. Again, this runs counter to popular belief.

In these countries, FDI can in theory have positive externalities. When the purpose of FDI is solely to exploit the availability of unskilled and cheap labour, it has few positive externalities (little technology transfer, little or no impact on employee training, etc.). In contrast, the external benefits are more significant in sectors which incorporate medium or high technology.

Lastly, FDI in industry is often linked to FDI in services. For instance, FDI in services (financial services, services to enterprises, etc.) may be geared to making subsequent FDI easier in the region. Other forms of FDI may be designed to facilitate exports (either wholesale or retail trade) from the country of origin to the host country.

The issue of the CEECs specialising within Europe is dealt with at more length in Part III of this study.

II – EVALUATION OF THE CONSEQUENCES OF FDI

1. Positive effects of FDI in the host countries – theory and practice

According to economic theory, FDI can have several positive effects: immediate increases in productivity following takeover of a business by a foreign investor, and spillover effects on the rest of the economy through technology transfer, human capital development and the shaping of a more competitive environment.

But the macro- and microeconomic conditions within the country also have an impact on the emergence and extent of these theoretical effects.

Increase in productivity in companies taken over by foreign investors

FDI involving takeover of a local company leads to increased productivity. This is true both of enterprises sold as part of the privatisation process and local private-sector companies. However, the largest restructuring prompted by the arrival of foreign capital has occurred in the major public-sector enterprises.

First of all, foreign investors quickly take steps to reduce the overstaffing found in most of the enterprises inherited from the previous ownership. Next, the often obsolete production equipment is steadily replaced by more productive facilities. Finally, new management and working methods are introduced. These three elements explain the relatively fast increase in productivity noted in enterprises taken over by foreign investors

We should point out, however, that in certain cases restructuring takes place before privatisation, and therefore before the arrival of FDI. In such cases, the State carries out the restructuring itself while it still owns the enterprise. This allows it to secure a higher price when the business is privatised. This is what happened in Poland, for instance, with the national railway company PKP. A law which entered into force in 2001 allowed the Polish railways to be restructured and reorganised by splitting operations into distinct companies (infrastructure management, passenger transport and goods transport), with a view to privatisation. Under the law, the overstaffing – estimated at some 50,000 people before restructuring – was to be in part reduced before privatisation.

The effect of FDI on employment depends on the type of investment. Where FDI is in the form of a takeover, restructuring almost invariably results in redundancies whose purpose is to reduce or eliminate overstaffing, as we have just seen.

Conversely, by definition, business start-ups create jobs. However, it is difficult to estimate the number of jobs actually created thanks to this type of FDI since the statistics do not provide detailed enough information.

Positive externalities: technology transfer and human capital development

In theory, FDI (whether involving privatisation, merger/acquisition or greenfield investment) has a spillover effect on the rest of the economy. One of the positive externalities put forward by economic theory is technology transfer. FDI introduces new technology, which is likely to be disseminated among local companies.

The technology brought by FDI spreads to the rest of the economy above all through the vertical relationships between foreign and local companies. Enterprises with foreign capital require their local suppliers and subcontractors to meet high quality standards, and provide them with technical assistance and/or training to this end.

On the other hand, there is no evidence to indicate that this type of spillover effect occurs between foreign and local companies engaged in similar activities (spillover effect through horizontal relationships). Foreign businesses have nothing to gain by improving the productivity of the local competition through the provision of information on their production methods or organisational procedures[15].

This means that one precondition for FDI to result in effective technology transfer is the existence of vertical relationships between foreign and local companies. These do not always exist. Foreign-owned businesses sometimes import all inputs and equipment from the owner's country of origin or a third country, and thus do not share their technology with local businesses. Local authorities have a role to play in this respect by implementing measures to strengthen the links between foreign and local businesses[16].

Empirical studies have highlighted another factor governing technology transfer: FDI is more likely to result in positive externalities in the form of technology transfer if the host country is not lagging too far behind. If the technological gap is too wide, local companies will be unable to incorporate the technology brought by FDI.

Lastly, the banking sector also plays an important role in disseminating technological advances. Inadequate financial mediation makes it hard for local companies to acquire financial resources. This can curb investment and prevent the firms from seizing the opportunities opened up by the presence of foreign companies.

Another theoretical positive externality from FDI has to do with human capital, and more specifically improvement of the local population's skills and know-how in both industry and services. This potential benefit derives from the fact that foreign companies bring new abilities and working methods, and are on average prepared to spend more than their local counterparts on training their employees.

But, as for technology transfer, experience has shown that the dissemination of knowledge and skills to the workforce in general cannot be taken for granted. Here again, if the gap between the local skills and those brought by foreign businesses is too wide, the dissemination of knowledge may well be negligible or non-existent.

In industry, the effect of FDI on human capital is closely linked to technology transfer. Empirical studies show that the technologically advanced sectors are more likely to benefit from spillover effects that enhance human capital. And technology transfer occurs more easily in economies which have a skilled workforce.

Therefore, the positive impact of FDI on the local economy is maximised where measures relating to education and those to promote sectors with a high technological content are carried out at the same time.

[15] Smarzynska (2002).

[16] See for example the supplier network development programme set up by the CzechInvest agency in the Czech Republic (OECD 2001, p. 37).

This being said, public education naturally plays a greater role in improving human capital than the training contributed by FDI. Governments should therefore not rely on foreign companies to improve the skills of their population, and should develop their own education policy for this purpose. Such a policy can, moreover, trigger a virtuous circle, in so far as skilled labour attracts FDI, and FDI in turn improves skills.

Strengthening of competition …or oligopolies?

In theory, since it introduces more efficient foreign companies into the local economy, FDI should encourage local businesses to increase their productivity and improve the quality of their goods and services in order to hang on to their market share.

But experience shows that the presence of foreign companies does not necessarily lead to a more competitive environment.

First of all, increased competitive pressure on local companies, while beneficial to a certain extent, can also be dangerous. If local companies are unable to adjust quickly enough, they can suffer a loss in profits and eventually go bankrupt. In such cases, the foreign presence tends to increase concentration by wiping out local companies.

Furthermore, certain sectors are also prone to concentration because of economies of scale that are inherent to the activity. Where the activity has not had time to develop, foreign companies can immediately take over the entire market and shut local contenders out. This notably occurred in the retail sector. In the CEECs, the large-scale retail networks are almost entirely held by western companies, mainly from the EU (Carrefour, Delvita, Lidl, Tesco and others).

This issue relates to the economic theory of infant industries, whereby temporary protection from foreign competition can be justified in developing countries for sectors where economies of scale exist and which have spillover effects on the rest of the economy. The banking sector too is affected by this phenomenon (it is a sector where economies of scale exist, and it has spillover effects on the rest of the economy). Some countries therefore also use the argument of the protection of infant industries to justify restricting the access of foreign banks to their market.

A further point worth bearing in mind is that some takeovers through FDI are aimed at eliminating potential competitors from the market – something that is, of course, hardly conducive to the emergence of competitive markets.

Finally, privatisation in the infrastructure sector is an example of FDI that can serve to strengthen the oligopolistic nature of the market rather than boost competition. The issue is important because, in the absence of suitable regulations, private-sector monopolies are more dangerous for consumers than public-sector ones (whose prices are controlled by the State). The prices asked by State enterprises when selling infrastructure assets, and the modernisation requirements, are such that the only prospective purchasers tend to be foreign investors, and the privatisation exercises tend to be carried out through FDI.

In setting a priority on speed and the short-term maximisation of income, the CEEC governments have sometimes sold all the enterprises in a given sector to the same investor, creating vertically integrated groups which prevent competition. This means such investors are sure that the enterprise they are buying will have a dominant position in the market, and

are thus prepared to pay more for it. The government therefore obtains more than if it had broken the enterprise into parts and sold them to several investors.

And no counterweight to the lack of competition has been established in the form of an independent and sufficiently powerful regulatory authority for each sector.

The gas market in the Czech Republic offers an example of privatisation that could undermine competition. The national company (Transgas) was split into several units, each with its own accounting and legal identity, corresponding to the various operations (production, transport and distribution) as recommended by the EU. But, at the end of 2001, the Czech government sold all the units to one foreign investor, the German enterprise RWE, thus creating a vertically and horizontally integrated group.

The electricity sector in Hungary has also been a target for FDI and has now been partially privatised. But in this case also, the dominant group (MVM) controls all activities and access to the electricity market. It is even involved in defining the market regulation policy, thus creating obvious conflicts of interest.

These examples clearly show that opening the market to foreign companies does not necessarily result in the emergence of a competitive market; in fact, the opposite can happen. It is therefore important that the public authorities of the CEECs should establish independent bodies responsible for regulating competition, in order to counter the anti-competitive effects arising from the demise of weaker companies or the formation of private-sector monopolies further to privatisation.

Regulatory bodies exist in most CEECs for sensitive sectors, but they sometimes lack effectiveness owing to their links with the main market player and because they are given insufficient resources.

2. Negative effects of FDI on the host countries

We have already pointed out the potentially harmful effects FDI can have on competition in the markets when the authorities do not take appropriate precautions. We have also noted that increased pressure on local companies can weaken them, harm their profits, and even drive them to bankruptcy. But FDI can have other unwelcome side-effects, and these are examined below.

It is quite common for FDI, in particular within the framework of the privatisation process, to have negative social consequences in the form of a significant increase in unemployment following restructuring and the elimination of overstaffing. In the short term, these redundancies are not compensated by any spillover effect.

Furthermore, the increased competitive pressure on local enterprises owing to the presence of foreign companies can also increase unemployment, either because of the restructuring of local companies (to resist competition from enterprises with foreign capital), or because of the decrease in profits and resulting bankruptcies.

What types of FDI have the least negative impact on local companies?

As mentioned above, increased competitive pressure on local companies as a result of FDI can result in a drop in profits and bankruptcy. But this effect depends on the type of FDI.

For instance, a survey of a large sample of Hungarian companies by J. Sgard (2001) led to the conclusion that if FDI is targeting the domestic market, the danger for local companies is greater for they are confronted with direct competition. On the other hand, if the FDI is targeting export-orientated industries there is no direct competition with local companies and thus no negative effects of that nature. On the contrary, in the latter case the positive spillover effects (technology transfer, etc.) tend to predominate.

Uncertain effect of FDI on the current account balance

In the CEECs, enterprises with foreign capital are better integrated into international trade than local companies. Empirical studies have demonstrated that, within a given sector, enterprises with foreign capital have a better export performance than the others. However, while that is the characteristic most often put forward, the amount of imports needed to supply the foreign-owned companies must also be taken into account. These companies often import inputs and equipment from their country of origin or third countries.

At the end of the day, the impact of inward FDI on the host country's current account depends on the purpose of the investment. Where the foreign company is targeting the domestic market (horizontal FDI), its exports are low or non-existent and the effect on the current account is usually negative. However, in the case of FDI that is intended to exploit lower costs and is export-orientated (vertical FDI), the exports make up for the import of inputs.

The negative impact of FDI on the current account decreases as the enterprises with foreign capital begin to turn to local suppliers and subcontractors rather than import their inputs. That is an additional argument for encouraging foreign companies to buy their supplies locally. However, the import of capital goods is not necessarily negative. It can bring in efficient technology that is not available on the local market, and thus contribute to modernising the country's production system.

According to Hunya (2002a), foreign enterprises accounted for 74% of Hungary's exports, 71% of its imports and 41% of its trade deficit in 1999. That same year, the figures for Poland were 52%, 56% and 62%, respectively.

The deterioration in the current account balance resulting from inward FDI can also be caused by repatriation of profits. The same study shows that the rate of profit repatriation is low for recent FDI and increases in time as the investment becomes more profitable.

Loss of national independence

In political terms, countries are sometimes reluctant to let foreign investors control parts of their economy that they consider to be strategic (the banking sector, for instance). They fear that foreign investors may not give sufficient consideration to the impact of their actions and presence on the country's economy. As we noted above, this was notably the case in Slovenia. Until recently, the country had various measures in place to restrict FDI.

There are some instances where foreign investors failed to adopt the long-term strategy that the sector required, and moved out of enterprises that they had invested in shortly before.

For example, the Czech national airline CSA was privatised at the beginning of the 1990s, but the strategic investors (Air France and the EBRD) relinquished their holdings two years after having acquired them. The main shareholder is now the Czech State.

Another example of this change of tack can be found in Poland. After having taken over the telecommunications activities of the Polish company Elektrim (Elektrim Telekomunikacja) in March 2002, Vivendi Universal sold its holding in the company to a financial consortium led by Citigroup. This decision was taken for internal strategy reasons; Vivendi's leaders regarded this divestiture as one of the main opportunities for the company to reduce its debt, and deemed that its telecommunications operations in eastern Europe were "non-strategic"[17].

This last example illustrates that the decisions of multinational enterprises in terms of FDI are determined to a large extent by the group's overall strategy (including diversification, concentration on certain activities, financial structure, etc.), and take little account of the interests of the host countries. Hence the latter's fear of being dependent on foreign investors, in particular since, as wages rise in the CEECs, they face increasing competition from countries where wage costs are lower (such as Ukraine) and therefore have to consider that companies might relocate there. Furthermore, to attract FDI, several countries adopted tax incentives that apply for a certain period (usually 10 years). There is a risk that once that period is over, foreign investors will move out.

To minimise the risks related to dependence on foreign companies, the CEECs must establish a sound environment that is intrinsically attractive to foreign investors, rather than rely on temporary tax incentives.

Production in Slovakia, for instance, is highly dependent on two foreign investors. Volkswagen and US Steel each account for 15% of the country's exports. The two together plus their suppliers account for 20% of its GDP. The building of a PSA Peugeot-Citroën assembly plant, which was announced in early 2003, with production scheduled to start in 2006, will further increase the weight of foreign companies in the country.

Nonetheless, despite the risk related to increased dependence on foreign companies, these countries (except Slovenia) seek to attract FDI in general because it brings funds into the economy. And they are particularly anxious to encourage greenfield FDI owing to its beneficial effect on employment.

3. Restrictions on the movement of workers

After enlargement, barriers discouraging migrant workers will eventually be lifted. The current EU members accordingly fear an influx of workers from the CEECs.

In other words, while today EU capital is going towards workers in the CEECs through FDI, in the longer term the trend could be reversed, with the workers going towards capital. This is most likely to be the case for current EU members which share borders with the CEECs: Germany and Austria. Without going into the details of the possible population movements

[17] *La Tribune*, 15.03.2002.

and their consequences for the economies of the current EU members, we will merely recall that studies on the issue predict that the impact of enlargement on worker flows from east to west will be limited (2.5% of the working-age population in the CEECs, and 1% of that in the current Member States, over a period of 15 years). These movements are expected to be concentrated in the regions and countries bordering the CEECs (in Germany and Austria)[18]. However, even if most studies do not expect massive movements of workers to take place[19], the question of migration is politically very sensitive owing to the fears it is generating among the population of the current EU members.

Although the situation was not the same, because living standard differentials were not as great, it is worth remembering that – contrary to what was expected – enlargement to the southern European countries did not result in a significant influx of Spanish and Portuguese workers in northern Europe. In fact, the opposite was true: many Spanish and Portuguese nationals returned to their countries of origin, which had become politically stable and economically dynamic.

The question of migration is an issue not only for the current Member States, but also for the CEECs, because of the risk that a brain drain could undermine their development. Wage differentials could encourage skilled labour in the east to settle in the current EU members, and FDI cannot counter this trend if activities with a high added value (research and development, deciding strategy, etc.) continue to be carried out in the company headquarters rather than in the CEEC subsidiaries.
This is perhaps less likely to happen in Hungary. An increasing number of multinational companies have installed their research and development centres there, thus creating well-paid jobs for skilled workers. But the other CEECs are finding it more difficult to attract FDI which provides for this type of activity.

[18] European Commission (2001), p. 40.
[19] See for example Havlik (2002), pp. 13-20.

III – WHAT WILL CHANGE WITH ACCESSION TO THE EUROPEAN UNION?

Accession will profoundly change the nature of relations between the CEECs and the EU. Up to now, the CEECs had a candidate status which required them to bring their legal and regulatory framework into line with the Community *acquis*. As of May 2004, the eight countries of the first wave of accession will become full members. This entails major new developments: the countries will be fully integrated into the single market, will be subject to close monitoring over the effective application of the *acquis* (efforts to date have concentrated mainly on adopting the laws and regulations rather than putting them into practice), and they will receive Community assistance that will be considerably higher than the funds received under the pre-accession programmes.

Two related methodological difficulties arise when considering the possible impact of accession on the new members.

First of all, it is hard to separate the consequences of the transition phase from those of integration into the EU's legal and institutional framework. Secondly, how can we distinguish between the impact of joining the single market and the effects of the EU's common policies?

Without claiming to provide a definitive answer, we will look at the issue from two additional angles: a theoretical analysis of the distinctions between candidate status and full member status, and an empirical comparison with previous accessions of countries whose economies were also lagging behind.

1. What will be the effects of graduating from candidate to member status?

Quantitative effects

- Difference between the single market and the association agreements

The CEECs are already to a large extent part of the EU area, notably by dint of the European association agreements. These provide an institutional framework for bilateral relations between the EU and each of the ten candidate CEECs. They opened up free trade for industrial goods, and were a step towards liberalisation of the services sector and of capital movements. They also cover movements of people.

But, despite these agreements, the CEECs have not yet become fully-fledged participants in the single market, capital movements have only partly been liberalised and, above all, movements of people are still strictly regulated.

Even as regards goods, certain sectors deemed to be sensitive (textiles, agriculture, etc.) are still subject to restrictions which will gradually have to be lifted with a view to accession.

Part of the FDI flows from the EU to the CEECs might therefore be intended to avoid these remaining non-tariff barriers. If so, one might wonder what will happen to them after enlargement, since all non-tariff barriers will have to be removed. However, this effect will probably be marginal, as trade barriers affect only a very small share of goods and services.

Furthermore, empirical studies have shown that avoiding trade barriers is not among the prime motivations for FDI into the CEECs.

There is another trade barrier between new and old members that enlargement of the single market will remove. Western European countries will no longer be able to invoke anti-dumping procedures against the CEECs once the latter have joined the EU. This change should stimulate FDI, for it will ensure that exports from the CEECs are treated in the same way as exports from the other Member States.

- Effect of implementing the Community acquis

The CEECs that will join the EU in 2004 have virtually completed adoption of the Community *acquis*. The national laws and regulations of the future members have therefore been brought into line with the Community treaties, but shortcomings in their application can sometimes be noted[20].

After accession, monitoring that the *acquis* has been implemented effectively will be stepped up. This will provide investors with an assurance of greater openness and proper functioning of the country's institutions. It will also increase the expectation of reduced corruption and clientelism within the administration (two elements which heighten the risk perceived by investors). Lastly, the establishment of sectoral watchdog organisations (for transport, telecommunications, etc.), and bodies to safeguard competition in general, will also reassure investors. Their fears of falling victim to arbitrary decisions on the part of local authorities – as still happens today – will be diminished.

- Effect of bringing goods and services in line with standards

In addition to institutional reform, the Community *acquis* also has implications for businesses. They will have to make significant investments to meet the regulatory requirements relating to the environment, working conditions and technical standards. This aspect of adopting the *acquis* has not made as much progress as the institutional strand, and companies will have to make the necessary adjustments very quickly after accession.

Part of the costs will be borne by the EU through the Phare and ISPA programmes at first, and then through the Structural Funds, but a substantial share will have to be financed by the countries themselves. And, given the scant self-financing possibilities and insufficient development of banking services and direct financing, foreign investors will have a major role to play in this respect. They can supply a share of the necessary resources, while also contributing technical know-how.

- Increased flows from outside the EU

Lastly, many experts expect enlargement to increase FDI flows to the CEECs from countries outside the Union. Once all obstacles to trade between new and old members have been removed (including the non-tariff barriers), certain non-EU countries may be tempted to use the central and eastern European region as a bridgehead for exporting into the enlarged Union, and therefore establish their European plants and subsidiaries there. This tendency is already apparent in certain Japanese investments in the CEECs. A lot of Japanese FDI is taking the form of joint ventures with subsidiaries of western European companies, with the purpose of supplying the whole of Europe. One example is the plant to be built by Toyota and PSA Peugeot-Citroën in Kolin (Czech Republic), whose the output will be sold on the European market. A study by Cieslik and Ryan (2002) shows that many production units

[20] The inadequate implementation is highlighted in the regular reports on progress made by the CEECs (http://europa.eu.int/comm/enlargement/report2001/#report2001).

established by Japanese multinationals in the CEECs are intended to supply inputs to their west European subsidiaries.

- Increase in Community transfers

The candidate countries are already benefiting from substantial transfers from the EU, but these are set to increase sharply after accession. While private-sector foreign investment greatly exceeded public-sector flows throughout the transition phase and even during the pre-accession period, accession will bring a substantial increase in the Community public investment flows.

The Phare programme amounted to 4.2 billion euros in all during the years 1990-1994. The amount rose to 6.7 billion euros for the period 1995-1999. The funds of the Phare programme are intended to build up public institutions in the candidate countries, and to develop infrastructure.

In 2000, two new programmes for economic assistance to candidate countries were set up:

- the Instrument for Structural Pre-accession Aid (ISPA), which is designed to support structural adjustment in the areas of transport and environmental protection, and will allocate 1 billion euros annually from 2000 to 2006;
- the Special Accession Programme for Agriculture and Rural Development (SAPARD), which has a total annual budget of 520 million euros.

After accession, the Structural Funds and the Cohesion Fund will take over from these programmes. The amounts granted to the new members will be markedly higher than the Community pre-accession flows. For the period 2004-2006, 21.7 billion euros have been earmarked for the funds, i.e. approximately three times as much as the amount of transfers from 1995 to 1999.

To help the beneficiary economies make use of this Community financing, it has been designed to increase gradually. It is expected to reach a ceiling of 4% of the CEECs' GDP in 2006. By way of comparison, FDI flows amounted to 3.6%, 4.3% and 7.6% of GDP in Poland, Hungary and Slovakia respectively in 2001 (see Table 3).

These massive financial transfers, which are intended to assist the economic, institutional and social adjustment process, may have various effects on the economies of the beneficiary countries. They could stimulate domestic demand and, in the longer term, contribute to the development of human capital and physical infrastructure. This longer-term effect is crucial, not just for establishing a favourable environment for FDI, but also for domestic investment.

Furthermore, these instruments could be used to offset the negative social consequences and regional difficulties brought about by restructuring.

Lastly, when used to develop physical infrastructure, the Structural Funds will have a leveraging effect on private-sector foreign investment (in activities related to construction, for instance).

- Tax harmonisation?

Taxation is an important issue for the CEECs – notably those (such as the Czech Republic and Hungary) which have introduced tax incentives for foreign investors. To comply with EU regulations, FDI incentives must meet the following criteria: they must be granted for a

specific period, be appropriate for the volume of investment and not exceed a standard level determined by the EU.

These special tax breaks were therefore discussed during the negotiations. However, since there has not yet been any genuine tax harmonisation within the EU itself, the countries can retain their particular features, such as the corporate tax rate. Furthermore, as we shall see, Ireland is an example of a country where taxes on companies are particularly low. That factor goes some way towards explaining the country's attractiveness for foreign investment over the last 15 years.

Qualitative effects of accession on FDI flows

- Change in specialisation thanks to FDI?

For FDI to contribute to the development of the host countries, it must not only deliver financial resources but also help to increase productivity through the positive externalities we analysed above. This will allow the countries to specialise in activities with a higher added value, as was the case in Ireland.

It is essential for the CEECs not to attract only foreign companies motivated by production cost differentials. Specialisation along these lines would not be viable in the long term, for the wage gap between new and old EU members will tend to close. The CEECs would then run the risk of seeing foreign-owned companies relocate further to the east, or in other emerging countries where wage costs are lower.

To prevent this from happening, it is important that multinational subsidiaries in the CEECs should contribute genuine added value to the production process rather than remaining mere assembly plants. Furthermore, FDI flows in services that are related to industrial investment are evidence of the subsidiaries' successful integration into the international division of labour.

The CEEC that has, up to now, made the best use of FDI to acquire a specialisation with high added value is Hungary. Foreign companies established in Hungary are not just seeking a workforce that is still cheaper than in the country of origin. They are also increasingly transferring functions such as design, research and development, etc. The other CEECs have not really been very successful in this respect. In most cases, the functions with a high added value have remained at corporate headquarters, in the country of origin.

There is some competition between CEECs to attract this type of activity: even if a multinational does decide to decentralise these high-value-added functions, it will choose only one country for the entire region. For the moment, Hungary seems to be best placed to become this kind of regional node.

The effect of FDI on specialisation in the CEECs depends to a large extent on its type. Greenfield investment, in particular in export sectors, is the type that is most focused on high-technology activities and therefore the best able to push specialisation in the right direction. The challenge for the CEECs in securing their future is thus to attract such investment, as Hungary is already doing.

In contrast, FDI involving takeovers of local companies tends, by definition, to maintain the existing specialisation. In Romania, for instance, where there is little greenfield investment, it

would appear that the sole effect of foreign investment is to strengthen the country's specialisation in textiles, metals and shoe production[21].

For the less-advanced CEECs (Bulgaria and Romania), it is therefore crucial to attract greenfield investment in order to develop production in services and industries with a high added value.
However, the environment in these countries is not favourable for this. In terms of the factors tending to attract FDI outlined in the first part of this study, these two countries are poorly positioned. Corruption, the weakness of the domestic market owing to standards of living that remain low, ill-adapted workforce skills and economic difficulties all add to the risk as perceived by foreign investors. And above all, the initial gap in inward FDI is widening on account of the cumulative nature of this form of investment. Foreign companies prefer to move into countries where the stock of FDI is already substantial, because that entails external economies of scale.
Lastly, the delayed accession of Romania and Bulgaria to the EU could send a negative signal to foreign investors (these countries have not made as much progress as others in adopting the Community *acquis*, and their economic situation is not deemed good enough). This will further widen the gap in inward FDI compared with the countries which are set to join in 2004.

The question is therefore how to avoid sidelining Romania and Bulgaria, and what policies should be implemented to foster the emergence of an economic and regulatory framework conducive to greenfield investment, that will in turn encourage a change in specialisation.

In the longer term, experts forecast that enlargement will lead to greater integration between the CEECs, which are currently all looking towards western Europe and have few trade and investment links among themselves. This regional integration could affect not only trade, but also FDI in the form of flows from the more advanced CEECs towards their less advanced counterparts.

The development of Portuguese border areas thanks in part to investment from neighbouring Spanish companies, and the establishment of Portuguese companies in Andalusia, show that this kind of regional integration can emerge between less advanced countries within the EU.

- Widening of regional disparities

FDI plays an important role in regional development for it increases resources while also, in certain circumstances, producing spillover effects for the rest of the economy. It could therefore possibly encourage the development of regions whose development is lagging behind.

Up to now, we have considered the choice of location for foreign investment at country level. However, the choice of region within a country is also an important aspect. In fact, when investors choose their location, they tend to spend more time deciding between particular regions of various countries than on deciding between countries (for instance, before choosing Trnava in Slovakia for their additional central European plant, PSA Peugeot-Citroën hesitated between several specific sites).

[21] Hunya (2002b).

The FDI flows are thus concentrated not only in the most advanced CEEC countries, but also in certain regions within each country, thus creating dynamic focal points. These nodes of development in the host countries are usually located near borders with the current EU members or close to capital cities.

This is the case in Hungary, for instance, where FDI is concentrated in the Budapest region and along the border with Austria. In 1999, these two regions accounted for 75% of inward FDI in Hungary, while the regions in the east and south of the country remained less developed. Some 40% of the FDI stock was concentrated in Budapest alone.
In the Czech Republic in 1998, two regions out of eight accounted for almost 60% of the stock of FDI (47% in Prague and 12% in central Bohemia)[22].

The predominance of capital cities in the regional distribution of FDI can be explained to a large extent by the fact that investment is concentrated in the services sector (finance, insurance, business services, etc.).

The regional concentration of FDI is due to positive externalities, which have a cumulative effect. A region which has already attracted several foreign companies presents many advantages for potential investors: a greater choice of labour, the availability of skilled labour (itself attracted by foreign companies), the presence of suppliers, the potential emergence of a research and development node (through partnerships with local universities, peer emulation among companies in a given sector, etc.), and improved infrastructure.

Conversely, regions where this momentum has not been generated have considerable trouble attracting investment (whether foreign or local), for companies cannot benefit from these cumulative effects.

In theory, regions which are lagging behind could benefit in the longer term from the emergence of growth nodes. On the ground, however, this has not happened as yet. The poorer regions are caught in a vicious circle while their developed counterparts are attracting more and more investment.
Against this backdrop, measures to attract investors to the neglected regions have not had a significant impact. Subsidies and tax incentives cannot make up for the lack of positive externalities in isolated regions, and companies prefer to locate in areas where others have already settled. In regions that have already attracted companies, however, governmental policies to encourage investment or training of the local workforce can have substantial beneficial effects through the virtuous circle described above. The effects of regional development measures based on FDI therefore differ substantially, depending on whether or not they can benefit from cumulative effects.

FDI thus does not appear to be a suitable instrument for reducing regional development disparities. On the contrary, it tends to increase them.
That is why public regional development policies financed by the Structural Funds and the Cohesion Fund are so important. The CEECs' transition from pre-accession to member status will entail a major quantitative change in this respect. Massive Community transfers will make it possible to finance projects that national budgets were unable to cover. By enabling the development of human capital, physical infrastructure (to improve access to isolated areas) and intangible infrastructure (new information technology can also contribute to

[22] OCDE (2001).

opening up regions), these long-term measures will help create an economic environment conducive to attracting investment and generating the resulting positive externalities.

The previous enlargement exercises can also provide useful insights into the possible effects of accession on the economies of new Member States. Even though the development gap between the CEECs and the rest of the EU is too wide to present an exact comparison, the experiences of Ireland and Portugal amply demonstrate the importance of national policy in making the most of the opportunities opened up by EU accession.

2. The Irish and Portuguese precedents: models or competitors?

Effects of accession in changing specialisation

Ireland and Portugal have both experienced strong economic growth since they joined the single market. However, the specialisations of these two countries changed in different ways. This clearly indicates that accession is not the only factor determining the change in specialisation.

Ireland made an effort to change its specialisation after it joined the Community, and this partly explains its economic takeoff. It was already attracting FDI in the 1970s, but because of the lack of links between the foreign and local companies, and the nature of the host sectors, the benefits for the local economy were limited at first.

At the beginning of the 1990s, foreign-owned subsidiaries became more closely integrated into the local economy, and the governmental authorities endeavoured to increase FDI into sectors with a greater added value (new technology, pharmaceuticals, financial services, biotechnology, etc.). They achieved their aim by exploiting several instruments.

The country began by using the Community funds to improve the economic environment and encourage inward foreign investment, through an industrial policy and the development of research, infrastructure and human capital. During the period 1989-1993, annual inflows from the Structural Funds and the Cohesion Fund amounted to 1.9% of GDP on average (a ratio which is well below the 4% planned for the CEECs in 2006), equivalent to 4.6 billion euros. The amount was 10.4 billion euros for the period 1994-1999 and will drop to 3.7 billion euros for 2000-2006.

But the flows of Community finance are not the only explanation. Incentives to encourage FDI, and a highly targeted education policy, were also very important. And, last but not least, the Investment and Development Agency (IDA Ireland), which was responsible for promoting foreign investment in Ireland, played an essential role in this change of specialisation.

We should add that Ireland's success in attracting FDI with a strong development content can be partly explained by the country's cultural ties with the United States (they share the same language, and many Americans are of Irish origin). The United States invested massively in the country; in fact, it accounts for the majority of FDI in Ireland (75% in 1998).

But, above all, the tax policy – and in particular the extremely low corporate tax rate (10%)[23] – goes a long way towards explaining the country's attractiveness for investors. We

[23] By way of comparison, the highest levels of corporate tax in 1997 were 42% in France, 35% in Spain and 36% Portugal, and the average rates applied to American multinationals in 1992 were 5.8% in Ireland, 22.8% in France and 25.3% in Spain & Portugal. Source: Dublin Economic Mission (2001).

can therefore wonder whether this FDI in the country will continue once taxation is harmonised at European level, as will happen in the medium to long term.

The economic success of Ireland is therefore partly due to EU resources, but national policies also played a crucial role.

But can the Irish development model be transferred to the CEECs? While the proper use of Community funds may serve as an example to follow, the low corporate tax rates are not necessarily replicable in all countries.

Portugal too has reduced the share of unskilled labour-intensive industries in its exports, but has not yet radically changed its pattern of specialisation.

The specialisation of countries by industry and product can be determined using the CEPII revealed comparative advantage indicator (CHELEM international trade database)[24]. As regards Portugal, the "textiles" and "wood/paper" industries, which are relatively low-technology, presented revealed comparative advantage indicators of 67 and 22 respectively in 1980, reflecting an extremely pronounced specialisation (in particular in the case of textiles). By 2000, these figures had dropped (to 45 and 12, respectively), but the two industries still had the highest comparative advantage indicators.

Yet Portugal, like Ireland, benefited from major Community transfers. The difference lies in how the funds were used. Portugal, unlike Ireland, gave priority to physical infrastructure rather than education. The governments' choices therefore played a crucial role in the way these economies developed after the countries joined the EU.

Will FDI be redirected from Ireland and the southern European countries towards the CEECs?

For the Member States, the expected effects of enlargement are positive (these are not covered in this study). However, enlargement has also raised some fears among certain less well-developed members, in particular Portugal, Spain and Ireland. The southern European countries are afraid of competition from the CEECs in unskilled labour-intensive industries, and of business being relocated in those countries. Ireland, which has to a large extent based its economic development over the last 30 years on foreign investment, is worried that it may be harmed by FDI flows being redirected to the CEECs. But the situation is different for these two types of country. While the fears of the less-advanced southern European countries are partly justified in certain areas, Ireland will probably not suffer directly from competition from the CEECs in attracting FDI.

FDI in Ireland is not of the same nature as in the CEECs; it has neither the same purpose nor the same determining factors, and targets other industries.

[24] The indicator is calculated as:
1000 x [balance for the industry/GDP - overall balance/GDP x ((X+M) for the industry/total (X+M))],
where X = exports and M = imports.
The aim is to compare the balance for an industry with a standard level (the standard level being the overall balance for the country weighted by the industry's share in total trade for the country).
In view of the way they are constructed, the indicators for a year for all industries sum to zero. If the indicator for an industry is positive, that means the country has a comparative advantage in that industry. Conversely, a negative indicator implies a comparative disadvantage. The greater the absolute value of the indicator, the greater the comparative advantage (or disadvantage).

First of all, as we saw above, FDI in the CEECs is attracted by highly promising domestic markets and the aim of gaining a foothold in a region that will grow in importance. And almost half of FDI in the CEECs is in non-tradeable activities (including community services, which have recently been opened up to competition). Some FDI is also export-orientated, and takes advantage of the combination of a relatively skilled and cheap workforce. But that is not generally the case.
Conversely, in Ireland, FDI is predominantly export-orientated.

The industries into which FDI is directed also differ, and Ireland will therefore probably not face direct competition from the CEECs. In the latter countries, FDI is focused on medium-technology industries (see annexed table), while in Ireland it is concentrated in leading-edge technology activities – an area where the CEECs are not yet very attractive owing in particular to the low level of research and development.

On the other hand, the less advanced southern European countries do have exporting activities that compete with some CEECs. In Portugal, for instance, the textile, vehicle and electrical equipment industries account for a substantial proportion (almost 50% in 2000[25]) of its exports. Yet, as Table 8 shows, FDI is taking place in these activities within certain CEECs. The Portuguese are therefore afraid that companies might relocate to the CEECs, where labour costs are lower than in Portugal. Relocation from southern European countries to the CEECs could also be motivated by a desire to move closer to markets in the centre of Europe – a centre which will be moving eastwards as a result of enlargement.

We should, however, put the danger for Portugal into proper perspective. Unskilled labour-intensive activities are becoming less important to the country's economy. And the specialisations of the more advanced CEECs are changing as well. Furthermore, while enlargement is perhaps amplifying the effect, since it will remove the last remaining trade barriers, competition between the CEECs and the less-advanced EU countries can also be seen as a natural consequence of the increasing integration between national economies. Lastly, we should note that relocation from Portugal, in particular within the textiles industry, is not taking place solely towards the CEECs but also towards certain Asian countries (such as Thailand and India).

In short, we can expect the accession of the CEECs to the EU to increase the volume of FDI flows to these countries.

On the other hand, the qualitative effects – namely the contribution of FDI to long-term economic development – are harder to predict. First of all, foreign investment will not necessarily make it easier to move towards specialisation in activities with a higher added value. Secondly, the cumulative nature of the process could increase regional disparities. These two aspects show the need for national policies, which might be partly financed by Community transfers.

[25] CHELEM database of the CEPII organisation, aggregate export share of codes R03, R08 and R10.

CONCLUSION

FDI in the CEECs has increased as they have progressed towards EU accession, and it will continue to increase after enlargement. Overall, the investment has had beneficial effects on the host countries. In particular, it has brought financial resources that the domestic economies would have been unable to raise, modernised certain industrial sectors, helped to develop the services sector, and enabled these countries to integrate into world trade.

However, the spillover effects so often attributed to FDI have not always materialised in practice. Particular conditions must exist for the benefits of FDI to be maximised and the negative effects kept to a minimum. Increased links between foreign-owned companies and local suppliers (vertical links) is one factor that can increase the beneficial impact from FDI, in terms of both technology transfer and enhanced human capital.

The expansion of FDI in the CEECs during the transition phase from planned to market economy was no doubt an inevitable process dictated by these countries' pressing need for modernisation. However, with the prospect of accession to the EU, it was accelerated by two specific factors. Firstly, the association agreements helped increase integration between the economies of the two regions. Secondly, during the pre-accession phase, adoption of the Community *acquis* improved legislative and regulatory transparency in the CEECs, thus providing a more secure environment for investment.

The question now is what practical changes will occur with the accession of the eight CEECs in May 2004.

Since almost all trade barriers between the future and current Member States have already disappeared, the main change will probably be the massive increase in Community transfers to the new members, once they have joined. These financial flows, which should reach 4% of the CEECs' GDP in 2006, will provide direct support for domestic demand. They will be used to finance research and development, education policy and the development of physical infrastructure, but will also indirectly promote FDI by creating a more favourable environment for investment. Overall, we can expect enlargement to have the effect of increasing the quantity of FDI flows into the CEECs.

However, the qualitative effect is far from certain. After enlargement, FDI will not necessarily accelerate the economic convergence of the new members with the rest of the EU. For this to occur, the CEECs will have to use foreign investment to move towards specialisation patterns that are more conducive to development, as Ireland did. The governmental authorities therefore have an important role to play, by encouraging greenfield FDI and by seeking to attract multinational companies that will engage in activities with a high added value. So far, only Hungary has succeeded in doing this.

Another significant qualitative aspect is the risk that a concentration of FDI could increase regional disparities both among the CEECs and within each country.

These two considerations show that governmental intervention could sometimes be called for. While, up to now, the Community authorities have not intervened very much in the workings of the market, the question therefore arises as to whether enlargement will not

require them to change their approach in order to allow the new members to take full advantage of the opportunities opened up by their accession.

ANNEXES

Table 7: FDI – maximising benefits and minimising adverse effects

Benefits	**… and maximising them**
Increased productivity in the companies taken over	Using Community funds to limit the harmful social and regional consequences of restructuring.
Technology transfer	- Promoting vertical relationships between local and foreign companies. - Guaranteeing a sufficient initial technological level (notably by supporting research and development). - Developing the banking sector.
Human capital	- Conducting public education policies to ensure a level of initial qualification that can attract FDI and encourage the dissemination of knowledge. - Coordinating education and technological development policies.
Emulation through competition (improving the quality and efficiency of production by local companies)	- In the infrastructure sector, avoiding the sale of large vertically integrated groups to a single investor. - Establishing competition watchdogs that are independent from the main players in the market, and ensuring they have sufficient resources.
Adverse effects	**… and avoiding them**
Market concentration and bankruptcy of local companies	See above.
Deterioration of the current account	Encouraging local outsourcing for enterprises with foreign capital in order to limit imports.
Loss of national independence	Development should not be entirely based on FDI.
Widening of regional disparities	Investment incentives targeting less-developed regions? Long-term measures: development of physical infrastructure and training of the local workforce?

CLASSIFICATION OF INDUSTRY INTO THREE GROUPS

The CEECs in the Enlarged Europe: Convergence Patterns, Specialisation and Labour Market Implications, M. Landesmann, R. Stehrer, Research Report of the Vienna Institute for International Economic Studies, July 2002, No. 286, p. 8.

Low-technology industries

Labour-intensive industries:

- food products, beverages and tobacco
- textiles and textile products
- leather and leather products

Natural resource-intensive industries

- wood and wood products
- coke, refined petroleum products and nuclear fuel
- chemicals, chemical products and man-made fibres
- other non-metallic mineral products

Medium- to high-technology industries

- machinery and equipment
- electrical and optical equipment (office machinery and computer equipment, electric machines and equipment, radio, television and communications apparatus, medical, precision and optical instruments, watches and clocks)
- transport equipment

Table 8: Breakdown of FDI stock in manufacturing industry (2000)

Taken from:
M. Landesmann, R. Stehrer, Research Report of the WIIW, July 2002, No. 286, p. 37.

As a percentage of FDI stock in the manufacturing industry

NACE Rev. 1		Estonia	Hungary	Latvia	Lithuania	Poland	Czech Rep.	Slovakia	Slovenia
DA	Food products; beverages and tobacco	23%	25%	29%	40%	25%	17%	12%	3%
DB	Textiles and textile products	14%	4%	9%	16%	1%	3%	1%	1%
DC	Leather and leather products		1%	1%	0%	0%	0%	1%	1%
DD	Wood and wood products	16%	1%	17%	5%	1%	1%	1%	0%
DE	Pulp, paper & paper products, publishing & printing		4%	5%	4%	8%	9%	6%	17%
DF	Coke, refined petroleum products & nuclear fuel	1%	14%	0%	6%		3%	8%	
DG	Chemicals, chemical products and man-made fibres	9%		11%		7%	6%	6%	15%
DH	Rubber and plastic products	1%	5%	3%	4%	3%	2%	1%	12%
DI	Other non-metallic mineral products		6%	7%	6%	14%	22%	5%	6%
DJ	Basic metals and fabricated metal products	4%	5%	7%	2%	2%	9%	43%	8%
DK	Machinery and equipment n.e.c.	3%	5%	6%	1%	2%	3%	4%	13%
DL	Electrical and optical equipment	3%	18%	2%	8%	8%	10%	4%	11%
DM	Transport equipment	7%	10%	0%	7%	27%	15%	6%	12%
DN	Manufacturing n.e.c.		1%	2%	1%	2%	1%	0%	0%
D	Manufacturing	81%	100%	100%	100%	100%	100%	100%	100%
	Manufacturing ($ million)	567.7	3,688.4	345	671.5	19,462.8	6,786.7	1,885.4	1,142.7
FDI total	$ million	2,645.4	1,010.4	2,081.3	2,334.3	45,772	17,552.1	3,692.2	2,808.5
	Manufacturing as a % of total FDI stock	21%	37%	17%	29%	43%	39%	51%	41%

Source: National banks, Statistical Offices and Foreign Investment Agencies.

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