

Fine-tuning foreign investment: Differentiating FDI and portfolio investment in post-communist East Central Europe

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Zoltan Adam

z.adam@ssees.ac.uk

Abstract

The paper attempts to provide an understanding of the role of foreign direct investment (FDI) in East Central Europe (ECE), which is defined as to consist of the Czech Republic, Hungary, Poland, Slovakia and Slovenia. The paper first looks at the structural economic changes evoked by FDI and the spillover effects that mediate its externalities towards domestic enterprises. Next a discussion on two possible institutional responses, network alignment and State co-ordination provided. Considered both of them insufficient on their own, the paper proposes an alternative solution based on the co-existence of FDI and domestically controlled portfolio investment-based companies.

1. FDI in ECE

As we know from Alexander Gerschenkron (1962), different stages of economic development require different institutional actors to organise economic activities. This paper assumes that in post-communist East-Central-Europe (ECE), that is in the Czech Republic, Hungary, Poland, Slovakia and Slovenia foreign direct investment (FDI) is the most important organisational agent of development (Hunya 2000). It is also assumed, however, that a massive presence of FDI might evoke structural distortions in host economies. In this case, development of domestic companies requires State intervention.

As Barry Eichengreen and Richard Kohl (1998) argued, FDI integrates ECE countries into the global economy and promotes economic convergence towards the EU. This convergence has been featured by an increasing role of multinational companies'

(MNCs) local subsidiaries who carry out technically demanding production functions and engage in higher value-added activities such as R&D. FDI upgrades production capacities by which an increasing share of technology intensive goods is produced in ECE (Estrin et al. 2001). In fact, a strong correlation appears to exist between the level of economic development and the amount of FDI in post-communist countries (EBRD 2000).

This correlation, however, contains a remarkable controversy: While the stock of FDI in proportion to GDP in 2000 was 43.2% in Hungary, 40.4% in the Czech Republic, 20.1% in Poland and 19.3% in Slovakia, , it was only 16.1% in Slovenia (IMAD 2001). Thus, ECE's arguably most developed country, Slovenia has employed the least foreign investment proportionally. Indeed, as comparative data indicate, FDI in Slovenia so far has played a restricted economic role in comparison to other ECE countries. This suggests that, despite its primary importance, FDI act as a substitute for domestic companies if the latter were not able to carry out economic restructuring sufficiently.

This is in line with economic theory that attributes substantial developmental role to FDI. Factor-cost advantages seeking motivations by definition make FDI complementary to host countries' human and capital resources (Vernon 1966, Dunning 1981, Ozava 1992, Meyer 1996). According to empirical evidence, FDI has indeed contributed to attaining increased allocative as well as technical efficiency and hence structural upgrading in ECE (Rojec 2000).

Although economic theory suggests that by exhibiting market seeking motivations FDI might also create distortions in the host economy through monopolies and high barriers of entry (Hymer 1976 [1960], Kindleberger 1969), this does not appear to be a serious danger in ECE. Except for Poland ECE economies form relatively small markets

which in many industries prevents foreign investors from pure market seeking motivations. Association to the EU, moreover, ensures the international openness of ECE, reducing chances for monopoly creation.

In turn, factor cost seeking FDI, in line with the theory, has raised additional demand for ECE's relatively cheap but qualified labour and extended local industrial capacities. FDI contributed to promoting economic growth and exports (Hunya 2000) as well as to decreasing unemployment (Mickiewicz et al. 2000). Moreover, due to its ownership-specific advantages (Dunning 1993), FDI represents higher technical efficiency in terms of both labour and capital intensity in comparison to domestic companies (Rojec 2000).

Apart from direct macroeconomic influence, however, FDI can also exercise indirect economic effects towards host countries. These indirect effects are considered to be externalities and called 'spillovers' in the literature (Blomstrom and Persson 1983, Blomstrom et al. 1999).

Spillovers can exercise either positive or negative impact on domestic companies, stemming from economic gains or losses not internalised by foreign companies. The most important positive spillovers increase domestic companies' technical efficiency through market competition, subcontracting, alliance formation, technology transfer or transfer of labour skills. The most important negative spillovers diminish domestic companies' market share and hence, assuming downward sloping marginal cost curves, reduce their efficiency and push them towards technologically less demanding activities.

In spite of FDI's predominant role in ECE, the research on spillovers in the region, apart from very few instances (Damijan et al. 2001, Konings 2001) is rather

premature. The present paper intends to reduce this shortage by analysing externalities of FDI as well as potential responses of host countries in ECE.

In chapter 2 and 3 the paper evaluates macroeconomic impacts and spillovers associated to FDI in ECE. Having identified potential problems, it discusses two possible institutional responses in chapter 4 and 5. Finding both network alignment and primary state co-ordination insufficient in the current circumstances, the paper concludes by offering a third one instead. This is a development path, described in chapter 6, based on the co-existence of FDI and portfolio investment-based companies in ECE.

2. Structural impact of FDI in ECE

The following chapter discusses the structural impact of FDI in ECE. Beforehand, however, it is important to clarify the notions of ‘economic structure’ and ‘structural impact’ here. The present paper understands ‘economic structure’ as a particular configuration of formal and informal institutions producing and regulating economic activities (North 1994). ‘Structural impact’ refers to the impact that FDI exercises on an existing configuration. In other words, the paper assumes that a massive presence of FDI transforms the economic structure of the host country that receives it. By this, however, it does not take an extremely high risk. As it is clear from the below statistics, FDI has indeed transformed the institutional configuration of ECE economies in the past 10-12 years. In the form of foreign direct investors and especially by MNCs a new type of major institutional actor appeared which exhibits distinctively different characteristics to those of domestic companies.

In line with the literature, FDI-led companies will be called 'foreign investment enterprises' (FIEs) subsequently. According to international standards and scientific common sense, any company that is owned by foreign investors at least to 10% qualifies into this category. As a major setback, however, this definition fails to differentiate between FDI and portfolio investment, the latter being driven by financial considerations without aiming at managing target companies directly which is a key feature of FDI in turn. Resulting from FDI's ownership specific advantages, already mentioned, this difference carries enormous consequences in terms of corporate governance. Due to the lack of sufficiently sophisticated databases, the literature so far has appeared to ignore this.

As a result of both FDI and portfolio investment, FIEs play a major role in ECE economies. The structural importance of domestic companies (DEs) has consequently been diminished in ECE, particularly in manufacturing industries and banking. In Hungary, where FDI plays the most pronounced role, FIEs accounted for 48.2% of employment and 73.2% of sales in manufacturing industries in 1999 (Hamar 2002). In comparison, in 1998 FIEs accounted for 41% of sales and 26% of employment in Polish manufacturing industries while FIE's share in the Czech manufacturing industry's sales and employment was 32% and 20% respectively (Hunya 2000a). FIEs' role must have increased since then considerably, having in mind that the stock of FDI increased by 117% in Poland and 98% in the Czech Republic in the period of 1999-2000. In Slovenia, where the penetration of FDI has consistently been the slowest in ECE in 1999 FIEs accounted for 23% of sales and 13% of employment in manufacturing industries (Rojec et al. 2001).

However, FIEs have not only had an increasing quantitative impact in ECE's manufacturing industries but have also presented a superior qualitative performance in comparison to DEs. Foreign companies across ECE operate at a significantly higher level of labour and capital efficiency, producing proportionally more value added, and attaining proportionally larger profits and export sales (Hamar 2002, Rojec and Jaklic 2002, Rojec et al 2001, Rojec 2000, Hunya 2000).

In attaining a superior performance, FIEs could obviously rely on their ownership specific financial, technological and human resources based abroad. By this, however, FIEs could raise significant danger vis-à-vis host economies' technological development. For as Magnus Blomstrom and Hakan Persson suggested, „[i]t is possible that a considerable amount of foreign subsidiaries retards the more fundamental process of local technological development in the host country. [...] [P]roduction efficiency may be improved at the expense of basic design and development activity, with the latter being continuously imported from abroad” (Blomstrom and Persson 1983, p. 499).

FIEs, on the one hand, seem to spend more on R&D than DEs. According to Inzelt (1998), proportion of R&D expenditures to sales in FIEs was 0.68% as opposed to 0.57% of DEs in 1995 in Hungary. On the other hand, however, FIEs tend to rely more on imported technology than on genuine local development. Data presented by Farkas (2000) show that the share of domestically based R&D decreased from 37.3% to 27.3% between 1994 and 1997 in Hungary. The share of foreign based 'imported' R&D consequently increased from 62.7% to 72.7%. This is, again, in line with FDI's ownership specific advantages, which, however, a large proportion of industrial capacities being controlled by foreign investors might reduce domestic research activities. This can even be more

likely if, as we will see in the next section, positive spillovers from foreign to domestic companies seem to be rather weak.

3. Spillovers

Among the modest amount of papers touching upon the issue of technology spillovers in ECE, Farkas (2000) and Damijan et al. (2001) regarding Hungary and Slovenia agree on weak technological spillovers from FIEs to DEs. Konings (2001) even reports negative spillovers regarding Bulgaria and Romania between 1993-1997 and 1994-1997 respectively, in the form of crowding out local companies from the market, hence pushing them upwards on their marginal cost curve by producing smaller quantities.

As it is argued by Knell and Radosevic (2000), technological spillovers from FIEs to DEs are rather hard to attain in countries of relative technological backwardness. Absorption capacity being one of the most important determining variable on the side of DEs, very few domestically owned enterprises are actually able to use technologies deriving from FIEs efficiently. Moreover, there is little scope for policy making in this field due to „a variety of country and industry-specific factors” which prevents from establishing any „automatic mechanism to ensure a technology transfer” (Ibid, p. 45). Knell (2000, p. 194) has also found „no direct evidence of widespread productivity spillovers from FIEs to domestic-owned firms”. Instead, he identified a negative relationship between the share of sales of FIEs and the rate of productivity convergence between foreign and domestically owned companies in 1993-1996 in four ECE countries. This confirms that a large presence of FIEs can actually prevent DEs from developing technologically.

Analysing FIEs' impact on DEs in a somewhat longer period, however, provides reason for a bit more optimistic view. Comparing the performance of Hungarian DEs with FIEs in the early and the late 1990s, both Hamar (2001) and Pitti (2001) found a considerable of DEs in terms of productivity, export performance and investments. This suggests that a Schumpeterian creative destruction might have taken place, resulting in a much better performance of a nevertheless significantly shrunk domestic sector. This would confirm Blomstrom et al. (1999)'s assumption that market competition can be instrumental in facilitating efficiency spillovers. Providing further empirical evidence pointing to this direction, O'Connor (2001) reported a similar development trajectory of Irish DEs during the 1980s and 1990s.

However, there seems to be a consensus in the literature both theoretically and empirically that spillovers on the short run occur relatively rarely, and, even more significantly, there is little scope to facilitate such occurrences by policy tools. This can further increase the efficiency gap between foreign and domestically owned companies, resulting in a dual economic structure discussed by Hamar (2001). In such a situation DEs become insulated from most resources required for attaining technological development an extended scope of operations. If such an outcome becomes empirically conceivable it is legitimate to ask: how can this be avoided? Is there any other institutional actor who can reasonably promote the development of the domestic sector? Institutional analyses have identified at least two such possible agents: network alignment and the State.

4. Networks

Various authors have suggested various ways to interpret the role of inter-firm relationships or networks in economic development. Some, like Stark and Bruszt (1998) identified networks as an alternative to both state- and market-co-ordination, arguing on the empirical basis of firm realignment in the early part of post-communist transformation that companies maintain strategic relationships to each other following other than profit-seeking motivations. Others, like Dyker and Tunzelmann (2002) identified networks as non-hierarchical relationships „that help to overcome market uncertainties and aid in communicating need and capabilities”. One can assume that if networks operated as such non-hierarchical relationships DEs should be able to enter MNC-led production chains and the problem of dual economy would be non-existent.

Sereghyova (2000) suggested that well-endowed DEs have a considerable chance to being promoted within value chains associated to EU-based MNCs due to ECE companies' locational advantages. de Sousa (2000) arrived at a similar point, arguing that Hungarian DEs performed rather successfully as subcontractors of FIEs in the 1990s, due to considerable amount of trust accumulated between transacting partners.

Although successful co-operation with FIEs has certainly been the case at a considerable number of technologically more advanced DEs (e.g. Radosevic and Yoruk 2000), not much evidence has been presented about the network-based development of less advanced domestic companies. On the other hand nothing indicates that MNC-operated networks are not hierarchical and that DEs compete with MNCs' established FIE suppliers on an equal footing. Instead, European MNCs first tend to rely on foreign sourcing, then prefer their established FIE suppliers to be at hand in the host country if they nevertheless opted for local sourcing.

This is, again, in line with FDI's ownership specific advantages that include the internalisation of a large part of transactions and the maintenance of established inter-firm relations. Moreover, local sourcing from DEs in technologically more demanding industries does not seem to be a part of locational advantages in ECE. Thus another, non-market type institution might be required in order to facilitate DEs' accession to more advanced forms of co-operation.

5. State co-ordination

Analysis of State co-ordination has been an integral part of development studies since at least the emergence of the largely state-managed structural transformation of East Asian economies (e.g. Haggard 1990). From a strongly related although conceptually somewhat different point of view Latin America's far more moderate success in economic modernisation can be attributed to the lack of effective state co-ordination either in an institutionalist (e.g. Stallings 1990) or a Marxist/dependentista (e.g. Cardoso and Faletto 1979) discourse.

Due to essentially altered global circumstances, however, a 'developmental state' approach does not seem to fit ECE countries' current economic co-ordination needs (Moran 1998). What, nevertheless, states can and indeed must provide in the course of structural transformation within the context of a global economy is giving right incentives to private economic actors including FIEs and DEs (e.g. Kornai 2001, Boltho 2000, Soos 2000) and responding to their needs carefully (e.g. Evans 1997, Evans 1995). Moreover, contrary to neoliberal assumptions, states can engage in carrying out industrial policies despite their external and internal constraints (Landesmann and Abel 1995, Chang 1994).

States also play a fundamental role in ensuring market competition both in terms of allowing FDI to enter and preventing it from creating monopolies, hence significantly enhancing the chance of spillovers to occur (Blomstrom et al. 1999). Safeguarding the rule of law and protecting ownership rights especially in knowledge intensive industries is an indispensable role of the State as well (Evans 1997).

Nevertheless, the scope of State co-ordination in an environment of free capital flows is severely limited. The question is, therefore, under what circumstances and by which policy tools can the State intervene effectively, promoting network alignment of FIEs and DEs.

6. Differentiating between FDI and portfolio investment

Instead of elaborating on circumstances and policy tools, however, the present paper intends to identify a potential development trajectory whose analysis can provide some advancement in understanding economic development of ECE. This trajectory is based on a particular institutional actor: portfolio investment-based companies. The specificity of these enterprises that they are owned by foreign investors but still controlled domestically by local managers.

Shares of such enterprises are usually traded publicly on ECE and, in a significant number of cases, foreign stock exchanges. These are among the most volatile securities in ECE capital markets since domestic as well as foreign institutional investors tend to be interested in them for they are not controlled by a particular strategic owner, i.e. FDI. Hence these companies, according to the mainstream literature on FDI (Dunning 1993), exhibit fundamentally different ownership specific characteristics. They are, to a large

extent in contrast to FDI-dominated companies, embedded in the local society and economy and act as domestic enterprises. Local networks are of primary importance in their case, and the State has vis-à-vis them a far greater leverage than towards MNCs' local subsidiaries.

It is clear, however, that portfolio investment-based enterprises do not carry out restructuring unless they are exposed to market competition and being cut off state subsidies, that is to say they face a hardening budget constraint (Kornai 2001). Consequently, FDI and portfolio investment based-companies are complementary to each other in ECE. Efficient portfolio capital-based companies operate across a number of ECE countries, in economic sectors as diverse as pharmaceuticals, oil distribution, electronics, retail trade, banking and food processing. It is a common denominator of them, however, that all are exposed to severe domestic and/or foreign market competition. The success of such enterprises suggests that the key to a feasible development path of ECE economies might be the proper composition of FDI and portfolio capital-based companies.

The latter group of enterprises, while exhibiting comparable performance characteristics to that of FDI, might rely primarily on local sourcing and promote genuinely local technological development to a larger extent than MNC-subsidiaries. Having promoted more intensive local network alignment, portfolio capital-based companies can also provide much more positive spillover effects to DEs. Clearly enough, however, empirical research has to examine this.

Comparing the performance characteristics and the functional role of foreign to that of domestic companies is a relatively usual exercise in economics. It has been done

by using qualitative (Evans, 1979) as well as quantitative (Willmore 1986, Kirim 1986) methods. The latter includes both matched pair analysis and regression models, depending on the characteristics of the sample and the interests of the study. Following these studies, a comparison of FDI and portfolio investment-based companies seems to be also possible in ECE.

Due to a relatively small number of significant portfolio investment-based enterprises matched pair analyses (Willmore 1986) looks like the most fruitful method in the current ECE circumstances. Regression analysis, however, might be also revealing in comparing spillover effects of FDI and portfolio investment-based companies.

In contrast to previous studies this research would place emphasis on the conceptually acknowledged but practically curiously ignored difference between the two different types of foreign investment. By this method one can desegregate the empirically so far mixed complex of FIEs and to check hypotheses about the advantages of portfolio investment based companies in a massive presence of FDI.

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