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## Columbia FDI Perspectives

Perspectives on topical foreign direct investment issues

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### **To what extent has FDI benefited the transition economies of Central and Eastern Europe?\***

by

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The theoretical case for a positive impact of FDI on economic growth seems strong, but the empirical evidence has been mixed. Despite the numerous alleged benefits of FDI to the host economy, empirical studies have failed to establish a significant, unconditional, positive impact of FDI inflows on the growth of GDP. Some studies identify a positive impact conditional on the existence of a minimum threshold of human capital, or of institutional and financial development. At the microeconomic level, the evidence on positive spillovers from FDI on domestic companies and industries has been sparse.

The transition economies of Central and Eastern Europe (CEE)<sup>1</sup> may be an exception in terms of FDI having a more unambiguously positive impact on growth. FDI has long been seen as a crucial factor in the transition to market economies. These economies started out in 1989 far away from the international technological frontier. Yet, unlike many developing countries, they had a relatively developed industrial structure, a highly educated workforce and proximity to rich Western European markets.

In a model prepared by the author for this *Perspective*, several variables explain over 90% of the inter-country variation in GDP in 2017 relative to output in 1989 for all 28 CEE transition economies.<sup>2</sup> An index of initial conditions at the start of the transition and an indicator of whether the country was affected by war in 1989-2017 explain some 50% of the variation in transition economies' growth in 1989-2017. Other control variables, all statistically significant, include income per head at the start of the transition, natural resource wealth, the ratio of external debt to GDP, an index of corruption (a measure of the quality of institutions), and an index of progress in economic reform. Debt flows had a significant negative impact, in line with the results for emerging markets in general. The results for FDI, measured by FDI stocks in 2016 per capita, show a positive impact on growth, but were only on the edge of statistical significance and not especially strong or robust. The estimated impact of FDI was much stronger for the 1989-2008 period alone, suggesting that the role of FDI in the post-crisis period after 2008 has been less favorable.

According to UNCTAD data,<sup>3</sup> the inward FDI stock in CEE relative to GDP—a median value of 49% in 2016—was higher than the global (42%) and EU (47%) median values. In a recent blog, Thomas Piketty talked of the “colonisation” of CEE and called these countries “foreign-owned”.<sup>4</sup> For several countries in the region he compared net outflows of profits and incomes from property with net transfers received from the EU and found that the outflows have been much higher. For example, on average in 2010-2016, annual net outflows of profits and incomes from property amounted to 4.2% of GDP in Slovakia, 4.7% in Poland, 7.2% in Hungary, and 7.6% in the Czech Republic. By comparison, over the same period, the annual net transfers from the EU amounted to 2.7% of GDP in Poland, 4% in Hungary, 1.9% in the Czech Republic, and 2.2% in Slovakia. It should be noted, however, that Piketty’s indicator includes all interest incomes, including the interest paid on external debt, and reinvested profits, and thus does not necessarily reflect FDI-related “outflows”.

Progress in convergence with income levels in the developed EU has been relatively modest, especially since the 2008 global crisis. The average ratio of GDP per head for the 16 CEE countries relative to the developed western EU 15 countries rose from 44.1% in 2008 to 48.6% in 2017. Importantly, for the population, personal income growth and living standards are more crucial than GDP growth.<sup>5</sup> The rate of convergence of wages has been slower than the rate of convergence of GDP, and growth in consumption has generally lagged behind growth in GDP. The rewards from growth have gone disproportionately to the owners of capital—in these countries, that tends to mean foreigners.

Looking forward, the countries in the region will need to develop growth strategies that do not depend so overwhelmingly on FDI. Even if FDI is important, it is unlikely to lead to sustained convergence with developed economies. The priority tasks for policy-makers in the region will be to improve access to finance for domestic companies, further deregulation in select areas and increasing incentives for domestic innovation, as well as to encourage foreign investors to upgrade their operations.

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<sup>1</sup> These 16 countries are the 11 EU members from the region (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia, Slovenia) and 5 western Balkan countries (Albania, Bosnia and Herzegovina, Macedonia, Montenegro, Serbia).

<sup>2</sup> The model also includes 12 former Soviet Republics.

<sup>3</sup> UNCTAD, *World Investment Report 2017* (Geneva: UNCTAD, 2017),

[Annex table 07. FDI inward stock as a percentage of gross domestic product, 1990-2016.](#)

<sup>4</sup> Thomas Piketty, “2018, the year of Europe,” *Le Monde*, January 16, 2018.

<sup>5</sup> [Simon Tilford, “All is not well in the Visegrad economies” \*Centre for European Reform\*, November 29, 2017.](#)

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