Preface

Very seldom is one so lucky to find a title for one's book that so neatly captures its central issue and the many perspectives covered. The idea of a 'changing landscape of foreign direct investment (FDI) in Europe' evokes a picture in which FDI is no longer advancing one way, flowing from higher to lower developed countries, basically from the Western to the Eastern part of Europe. Instead, we see a map of FDI routes leading in both directions, not to say in every direction, with the flow being determined less and less by borders and restrictions, but more and more by demand and supply in distant countries.

Against this backdrop this book deals with quite a broad range of topics such as global FDI trends, the effects of FDI on home and host countries, policies to attract FDI and corporate experiences with FDI, all with a special focus on the countries in Central, Eastern and South-Eastern Europe (CEECs). The book is based on the Oesterreichische Nationalbank's Conference on European Economic Integration, which took place from 20 to 21 November 2006 in Vienna. The conference was organized together with the European Bank for Reconstruction and Development, which continues to be the biggest investor/financier in Central and Eastern Europe; at the time of writing the bank was investing about USD 4 billion per year in the region.

At the very origin of the European integration project stood the hypothesis that economic – and later monetary – integration would boost trade and FDI flows, thus enhancing growth and the catching-up process. Indeed, empirical evidence and the most recent data support this hypothesis: in 2005 the European Union (EU) attracted almost half of all funds invested worldwide. The same year, FDI inflows into all ten new member states of the EU rose by 19 per cent, reaching new record levels. And the role of FDI in promoting transition is evident: FDI brings innovation, new skills and risk management techniques; it promotes competition, forces domestic incumbents to become more productive, and provides forward and backward linkages.

In this respect FDI has been and still is crucial for economic growth and the catching-up process in the countries of Central, Eastern and South-Eastern Europe. Basically, there are three channels through which FDI can influence the economic performance of a country: first, FDI increases the capital stock of an economy, which, according to the standard neoclassical growth theory, should by itself lead to higher levels of per capita output. Second, FDI contributes to productivity growth, as foreign firms tend to have better technological know-how and managing skills. Third, FDI potentially also entails a range of spillover effects to the local enterprises through labour mobility, imitation or training of suppliers. Part of the productivity increases seen in catching-up economies can also be related to multinational enterprises purchasing inputs from domestic firms.

All these effects have been at work in the CEECs, contributing to their economic convergence process with Western Europe. Not surprisingly, catching-up countries profit more from FDI than developed countries, especially in the earlier stages of their catching-up process. And – also not surprisingly – FDI seems to play a special role for industries which are capital and skill intensive, depending on the absorptive capacity of an economy. So, the prospect of reaping the benefits of FDI inflows is another reason for policy makers to promote activities that increase human capital. Concerning the negative crowding-out effect again and again attributed to FDI inflows, one should take a dynamic perspective. Even if domestic investments are crowded out in the early stage of FDI inflows, domestic investment will benefit as well once domestic demand increases due to FDI.

Competition for FDI funds is fierce, with actors and instruments having changed significantly compared with what we saw ten years ago, in the mid-1990s. Today, we no longer have different countries or large regions competing with each other – today's FDI projects pitch cities against cities, or narrow regions in one country against narrow regions in other countries. This might be partially due to agglomeration effects, which are present particularly in high-tech sectors. One of the first examples of this trend may have been Silicon Valley, the first IT cluster which attracted a lot of FDI. Today, one would immediately think of the automotive cluster that has evolved in the Slovak Republic. As a result, FDI policies may have to change or extend their mission. Nowadays local investment promotion agencies seem to be an effective instrument in spurring FDI and productivity, especially when they are combined with one-stop shops for administrative matters.

What has also changed significantly is that financial incentives in the form of subsidies have ceased to be the most efficient measures to attract FDI; what matters a lot more these days is the removal of restrictions. In addition, improving governance and creating reliable and predictable legal systems are also key, especially in early stages of transition. In fact FDI in Central and Eastern Europe led to impressive improvements at all levels of governance in the years before EU entry, although – as claimed not only by the European Commission – reform fatigue has set in since.

Overall, the main focus of the academic debate on FDI has shifted from host to home country effects recently. While there is unequivocal evidence of productivity gains by foreign producers, evidence on the crowding out of domestic players or on productivity spillovers to domestic firms is far less clear. Fears of adverse home country effects of FDI may be exaggerated, but there is no doubt that structural adjustment is necessary to move the investor's country up the skills ladder as well.

Once in a while, public opinion points out the negative effects of outward FDI flows, but empirical results do not show a drastic impact. Fears in this respect have been exaggerated, especially the off-shoring or outsourcing of intermediate input production – sometimes referred to as 'bazaar economy' developments – does not seem to be quantitatively very important. In Austria, with its high shares of FDI flows to CEECs, FDI in manufacturing industries, which are typically more likely to resort to outsourcing, only accounts for 20 per cent of total FDI. Moreover, we should not forget that the growing international division of labour benefits the home countries of FDI as well, as in some sectors they can remain competitive only if they buy cheaper intermediate inputs from abroad. Therefore, economic policy in the investors' home countries should abstain from protectionist moves.

The implications of outward investment for investors' home countries are not only an issue in developed countries; outward investment is also gaining importance in Central and Eastern European countries – classical FDI host countries, which are increasingly emerging as active investors. Currently FDI outflows from these countries are still low, but they show relatively high growth rates in recent years. For the moment the major destinations of FDI from the EU's new member states are locations in other new member states, mainly because of the narrow technological and cultural gap. But this will change in the near future as they will climb up on the technological ladder and will widen their radius of activities. Nevertheless the net investment position of the new member states will remain negative over the medium term.

Besides these many global issues, the book also covers two specific regions that may serve as a benchmark for CEECs. On the one hand, Ireland's success story and on the other hand, the newly arrived competitor, China.

The fact that Ireland has attracted substantial FDI inflows since the mid-1980s has been a key factor behind its outstanding growth performance. At the time of writing, Ireland's FDI per capita is as much as six times higher than the European average. Half of employment in manufacturing and a quarter of employment in services are in multinational firms. The absence of a language barrier and the large Irish community in the US are only two of the explanatory factors. Several other factors are equally or even more important: the favourable investment climate (since fiscal imbalances and labour market problems were sorted out in the 1980s); the low corporate taxes; institutions that provide young people with the necessary science and engineering training; the powerful influence of the Industrial Development Agency on government decisions; and the meritocratic orientation of public services.

Concerning Asia, the key question is whether recent and increasing FDI flows to China are complementary to FDI in other countries or are rather crowding them out. Empirical results suggest that FDI flows to China did not significantly influence FDI to other countries. The CEECs in particular seem to be quite resilient in this respect, as their geographical location, their still cheap but highly qualified labour, and the uniqueness of their catching-up process – which has put them into nearly the economic position they had before the Iron Curtain was built – make them attractive for FDI.

Due to its geographical location and its historical links with the CEECs, Austria has a special role in the changing landscape of FDI. Starting with the fall of the Iron Curtain and spurred by Austria's application for EU membership in 1989, Austrian companies were among the first ones to invest in the CEECs in the 1990s. As a result of this Austria became one of the leading investors in the region, rising to number one in several country rankings. As the markets and investments in the EU's new member states are maturing, Austrian companies increasingly invest in countries in South-Eastern Europe and in the CIS (Commonwealth of Independent States). In parallel, Austria became a 'bridgehead' for multinational enterprises, providing the home for many multinational companies that are active investors in Central, Eastern and South-Eastern Europe, and therefore headquartered in Austria. For them Central, Eastern and South-Eastern European countries are important markets at their doorstep as they provide excellent opportunities to expand a company's market share. This argument often dominates even the common offshoring objective of cost reduction. In some cases companies also follow their major customers or business partners already active in that region.

Overall FDI is seen as a win–win situation for both home and host countries, as Austrian firms and multinational enterprises contribute significantly to the economic development of the Central and Eastern European region. Like the earlier conference on which this book is based, this publication is meant to honour all those who have been involved in the changing landscape of FDI.

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