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FOREIGN DIRECT INVESTMENT AND ECONOMIC DEVELOPMENT OF EU7 COUNTRIES

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Abstract. One of the main reasons why Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland and Slovak Republic (hereafter – EU7 countries) joined to European Union was expectation to receive foreign direct investment from the old Member States of European Union (hereafter – EU15 countries).
As foreign direct investor promotes the economic activity in the investment recipient country, foreign direct investment is perceived as a tool to enhance economic growth.
The purpose of this paper is to research the effect of foreign direct investment on the economy of EU7 countries. In the paper relationship between economic structure of EU7 countries and foreign direct investment flow in particular sectors is examined. Results show that there is a positive interaction of developmed manufacturing sector in EU7 countries and foreign direct investment flow in the sector. As EU7 countries mainly have developed low value added manufacturing those sectors receive major part of foreign direct investment.

Keywords: foreign direct investment, EU7 countries, value added, economic development, European Union.

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1. Introduction

The term „capital" is one of the most frequently used economic terms. Many economists had tried to explain its content. For example, John Stuart Mill (1980) had indicated that "people who had not used to think about capital consider that capital is a synonym to the term money". Adam Smith (1993) characterized capital as a stock of different commodities that are necessary for the worker's existence and supplementation with equipment that is necessary for production.

However Alfred Marshall (1993) was of opinion that the capital has to be analyzed only as monetary value of all other things. In his point of view the capital is a propriety from which a man plans to receive profits. John Bates Clark (2000) had concluded that capital is a production tool that is always material and concrete. Joseph Schumpeter (2007) had noted hat capital is a lever that allows an entrepreneur gain concrete benefits; it is an instrument that allows using these benefits as well as directing the production in a new way. Schumpeter objected the statements that capital is a monetary value of property. He argumented that the property cannot be used to buy production tools – capital is a sum of money and other means of payment that can be used in any time.

Paul Anthony Samuelson (1989) separated capital from the money – he had a view that industrial economy has three features – specialization, money and capital.

Although previously quoted economists were of different points of view about content of the term "capital" they had concluded that the main task of capital is to be used to gain profits. The owner of capital always looks for opportunities to invest to get more profit. Globalization has facilitated capital flows around the world. Free movement of capital allows to invest not only in the residence country of the investor but to invest in a country where can get the biggest profit.

As regards capital flow capital is mainly divided in portfolio investment, foreign direct investment and other investment.

According to definition of International Monetary Fund (2005) foreign direct investment refers to an investment made to acquire lasting interest in enterprises operating outside of the economy of the investor. In cases of foreign direct investment, the investor´s purpose is to gain an effective voice in the management of the enterprise - a threshold of 10 per cent of equity ownership to qualify an investor as a foreign direct investor. Direct investment includes equity capital, reinvested earnings, other capital and financial derivatives associated with various intercompany

transactions between affiliated enterprises. Portfolio investment includes transactions with nonresidents in financial securities of any maturity (such as corporate securities bonds, notes, and money market instruments) other than those included in direct investment, exceptional financing and reserve assets. Other investment includes all financial transactions not covered by foreign direct investment and portfolio investment. Major categories of are transactions in currency and deposits, loans, and trade credits.

If investor has portfolio investment or other liabilities, he can not influence the use of capital and accordingly – profits. The owner of the capital can influence the use of capital and profits in the case of foreign direct investment. To get more profits direct investor can invest different kind of assets - money, equipment, technologies etc.

The host country of capital also benefits more if it receives foreign direct investment because foreign investment is made by enterprises (hereafter – multinational enterprises) that are more competitive than enterprises that operate only in a domestic market. As foreign direct investment contains technologies, knowledge and skills and management, it is perceived as a tool to promote host country's economy by providing more advanced facilities of production, management and technologies.

2. Foreign direct investment flows to EU7 countries

On the 1st of May 2004 EU7 countries joined to the European Union. Before that date EU7 countries had to fulfill all necessary requirements for accession – one of them was to implement acquis communautaire and ensure basic principles necessary for functioning of the Single Market. Single Market is characterized by the abolition, as between Member States, of obstacles to the free movement of goods, persons, services and capital.

Expectations that entrepreneurs from the EU15 countries would invest in EU countries was one of the main reasons why EU7 became a part of the union. As EU7 countries were emerging economies, it was perceived that efficiency seeking foreign direct investment would flow to these countries instead of third countries. Before 1st of May 2004 European Commission also stressed its expectance that entrepreneurial activities of EU15 enterprises and capital would stay in Europe: "There are emerging signs of the creation of more complex EU-wide production networks that draw on complementary patterns of specialization and involve more local technological inputs and skills. These international production networks are based on the reshuffling of value chains integrating Eastern skills and capabilities in a way that truly complements those of Western producers. This second path of industrial integration allows the EU industry to fully exploit the possibilities offered by the full array of complementary competencies existing in the enlarged EU while at the same time fostering long term technological and economic catching-up in the future Member States."

After 6 years of the accession we can make conclusions about impact of foreign direct investment on the economy of EU7 countries. To analyze the flow of foreign direct investment to the EU7 countries, the data from European Union Statistic Bureau (EUROSTAT) will be examined.

Table 1. Foreign direct investment flows to EU7 countries (Source: EUROSTAT)

	2004	2005	2006	2007	2008	2009	2010
CZ	4.5	9.4	3.8	6.0	3.0	1.4	3.4
EE	8.0	20.6	10.8	12.8	7.3	8.7	8.1
LV	4.6	4.4	8.3	8.1	3.7	0.4	1.6
LT	3.4	4.0	6.0	5.2	4.3	0.5	2.1
HU	4.4	7.0	6.5	2.9	4.8	1.6	1.4
PL	5.1	3.4	5.7	5.5	2.7	3.2	1.9
SK	4.5	9.4	3.8	6.0	3.0	1.4	0.6

The inflow of foreign direct investment shown in the Table 1 is expressed as percentage of a country's GDP. It can be concluded that amount of foreign direct investment received in the EU7 countries is rather high. Explanation could be the relatively small amount of these countries' economies. In transition economies that are developing large amount of investment compared to their GDP is sizeable. Estonia, Czech Republic and Slovak Republic receive more foreign direct investment than other EU7 countries. Attractiveness of those countries to foreign investors can be explained as more developed economy and entrepreneurial environment to start and conduct business than in other EU7 countries.

As EU7 countries were emerging countries, high economic growth was one of the major reasons why multinational enterprises invested in these countries. Economic growth is conspicuous from GPD growth. In the Table 2 real GDP growth rate is calculated as percentage change on previous year.

Table 2. GDP growth in EU7 countries (Source: EUROSTAT)

	2004	2005	2006	2007	2008	2009	2010
CZ	4.7	6.8	7	5.7	3.1	-4.7	2.7
EE	6.3	8.9	10.1	7.5	-3.7	-14.3	2.3
LV	8.9	10.1	11.2	9.6	-3.3	-17.7	-0.3
LT	7.4	7.8	7.8	9.8	2.9	-14.8	1.4
HU	4.8	4	3.9	0.1	0.9	-6.8	1.3
PL	4.7	6.8	7	5.7	3.1	-4.7	2.7
SK	6.3	8.9	10.1	7.5	-3.7	-14.3	2.3

Although Estonia, Czech Republic and Slovak Republic receive foreign direct investment more than other EU7 countries, only Estonia and besides Latvia and Lithuania had very good economic performance (see Table 2). The data in the Table 1 shows that Latvia and Lithuania did not receive foreign direct investment as much as the other EU7 countries. Thus strong economic growth could be explained that in these countries is very developed domestic entrepreneurship and local entrepreneurs contribute to economic growth.

Economic development of a country and wealth of nation (that indicates also entrepreneurial development) is seen from data regarding GDP per capita in purchasing power standards, EU27 = 100.

Table 3. GDP per capita in EU7 countries (Source: EUROSTAT)

	2004	2005	2006	2007	2008	2009	2010
CZ	78	79	80	83	84	85	82
EE	57	62	66	70	69	64	64
LV	46	48	51	56	56	52	52
LT	51	53	56	59	61	55	58
HU	63	63	63	62	64	64	63
PL	78	79	80	83	84	85	82
SK	57	62	66	70	69	64	64

Comparing the data regarding foreign direct investment inflow, GDP growth and GDP per capita in EU7 countries it can be concluded that countries experiencing strong economic growth neither received enough foreign direct investment nor their residents (legal and natural persons) were rich enough to ensure strong economic growth. It means that economic growth was fostered by the third way – financial flows from abroad. GDP per capita is high in Czech Republic, Estonia, Hungary and Slovak Republic – foreign direct investment had promoted welfare of countries that are already developed.

2.2. Foreign direct investment in manufacturing in EU7 countries

GDP consists of value added produced by different sectors. The sector where technologies are used the most and that could contribute more to GDP growth is manufacturing. As mentioned previously foreign direct investment is made by superiors, thus multinational enterprises could contribute to GDP growth more than local ones.

Multinational enterprises seek for opportunities to produce more effective and invest in sectors that are competitive. As EU7 countries are small economies, multinational enterprises are seeking for already existing infrastructure and manufacturing enterprises for production. In the table 4 are seen three most developed manufacturing subsectors in EU7 countries.

Table 4. Competitive manufacturing subsectors in EU7 countries (Source: EUROSTAT)

	The largest share	The second largest share	The third largest share
CZ	Manufacture of basic metals and fabricated metal products	Manufacture of chemicals and fibers	Manufacture of transport equipment
EE	Manufacture of food, beverages and tobacco	Manufacture of wood and wood products	Manufacture of electrical and optical equipment
LV	Manufacture of food, beverages and tobacco	Manufacture of wood and wood products	Manufacture of basic metals and fabricated metal products
LT	Manufacture of food, beverages and tobacco	Manufacture of wood and wood products	Manufacture of electrical and optical equipment
HU	Manufacture of electrical and optical equipment	Manufacture of transport equipment	Manufacture of chemicals and fibers
PL	Manufacture of food, beverages and tobacco	Manufacture of basic metals and fabricated metal products	Manufacture of transport equipment
SK	Manufacture of basic metals and fabricated metal products	Manufacture of electrical and optical equipment	Manufacture of transport equipment

Majority EU7 countries have comparative advantages in manufacturing sector – high technology, medium high technology, medium low technology and low technology subsectors. It should mean that subsectors could be attractive for foreign investors. Majority of EU7 countries, notably Baltic States have developed low technology manufacturing. In the Table 5 data regarding inflow of foreign direct investment in manufacturing sector will be analyzed.

Foreign direct investment inflows in manufacturing sector differ very much amongst EU7 countries. The largest continuous shares of foreign direct investment received these EU7 countries that have the largest part of competitive advantages in manufacturing. The main reason for differences is that multinational enterprises invest in countries that already have necessary basis for production - available resources. According to World Investment Report 2010 over the past two decades has been observed a preference for mergers and acquisitions over Greenfield investment as the dominant mode

of foreign direct investments. It indicates that investors do not want to invest time and resources to develop enterprises – nowadays one of the main motives to invest in other country is that there are the necessary conditions for production – infrastructure, production precurse and skilled labor.

Table 5. Foreign direct investment flows in manufacturing and services sectors in EU7 countries (Source: EUROSTAT)

		2004	2005	2006	2007	2008	2009
Manufacturing (%)	CZ	20.32	7.92	31.04	37.01	12.59	-32.57
	EE	22.95	8.23	17.87	8.18	2.28	1.98
	LV	9.77	6.96	17.27	5.55	6.08	13.19
	LT	54.73	25.06	53.66	25.52	9.45	397.58
	HU	33.40	20.04	44.35	7.69	-50.09	:
	PL	34.33	28.16	23.95	29.00	15.27	33.53
	SK	70.55	47.95	43.30	4.27	11.86	:
Services (%)	CZ	69.27	89.00	67.16	70.63	88.38	131.60
	EE	52.92	83.14	74.37	83.12	97.97	91.23
	LV	62.86	49.91	72.44	74.71	62.30	-20.90
	LT	29.05	33.29	42.40	64.90	81.02	-358.06
	HU	47.41	68.56	76.47	17.78	81.82	130.43
	PL	55.56	63.79	66.66	59.77	65.85	48.57
	SK	23.63	47.18	29.74	87.13	83.80	:

Country has competitive advantages in manufacturing if it has a quite large share of manufacturing in economy. The share of manufacturing in EU7 countries is indicated in the Table 6.

Table 6. Share of manufacturing in EU7 countries (Source: EUROSTAT)

	2004	2005	2006	2007	2008	2009	2010
CZ	27.9	29.3	31.2	32.2	33.6	31.0	33.1
EE	29.6	29.7	30.2	31.1	29.0	28.0	27.2
LV	34.8	36.3	36.7	37.5	36.6	33.2	34.4
LT	21.6	21.8	22.1	21.1	20.8	20.7	22.1
HU	23.7	24.0	24.7	26.3	25.8	23.8	26.0
PL	18.3	17.8	18.0	18.0	17.7	18.0	16.8
SK	23.2	23.3	23.3	23.1	22.3	17.9	23.6

Data on the share of manufacturing in EU7 countries economy affirm above mentioned statement about its importance in flow of foreign direct investment in manufacturing sector. EU7 countries with developed domestic manufacturing are more attractive that those in which development of manufacturing has to be started from scratch.

3. Conclusions

After accession to European Union EU7 countries became a part of the union that previously consisted of countries that were different comparing to EU7 countries. EU7 countries were emerging economies and experienced strong economic growth because of economic expansion. Large part of capital flows to developing countries because of higher profit there can earn, so enlargement made a chance to keep the capital in European Union. As regards capital flow capital is mainly divided in portfolio investment, foreign direct investment and other investments. The owner of the capital can influence the use of it and also profits in the case of foreign direct investment. The host country of capital also benefits more if it receives foreign direct investment because foreign investment is made by enterprises that are more competitive than enterprises that operate only in a domestic market. Foreign direct investment contain technologies, knowledge and skills and management, it is perceived as a tool to promote the host country's economy by providing more advanced facilities of production, management and technologies.

Developing countries have an undeveloped securities market, thus majority of foreign capital they receive is foreign direct investment. EU7 countries also had received largest part of foreign direct investment but examining the impact of those it is important to analyze sectors in which foreign direct investment flows and the impact of these sectors to economic development of the country. EU7 countries perceive foreign direct investment as a tool that would help them to restructure state's economy.

The process of enlargement could trigger an intra European Union relocation phenomenon as European Union enterprises could take advantage of the increased choice of sites for location of production. Five years after accession it can be concluded that entrepreneurs of EU15 used the advantage to invest in EU7 countries very little. Multinational enterprises invested in sectors where they could get the highest profit. In some EU7 countries a quite large share of foreign direct investment were invested in manufacturing, even with high or medium high value added but in majority of EU7 countries foreign direct investment in manufacturing flew into labor intensive sectors.

For investors one of the main motives to invest in other country is that there has to be the necessary conditions for production – infrastructure, production precurse and skilled labor. Few EU7 countries had necessary basis for production. Although if a EU7 country did not has the entire necessary base – EU15 entrepreneurs and the whole European Union would benefit if in the periphery high technology sectors were developed.

EU7 countries had specialized in low technology, labor intensive sectors. It was and still is very important to restructure economies of those countries to enhance competitiveness of the whole European Union. EU7 countries had and still have a potential for reaping productivity gains from resources reallocation, notably from traditional heavy industries, where productivity remains low, towards modern industry and services. Investment in these sectors would be of great importance because domestic entrepreneurs did not have enough money and ethnology to do this by them.

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