The Impact of FDIs on Exports, and Export Competitiveness in Central and Eastern European Countries

Authors: Magdalena RĂDULESCU, Luminiţa ŞERBĂNESCU, Faculty of Economic Sciences, University of Pitesti, Pitesti, Romania, magdalenaradulescu@yahoo.com, luminitaserb@yahoo.com

After 1990, the Central and Eastern European (CEE) countries lowered the barriers to FDIs. Of course, many other developments were taking place at the same time: increasing openness to trade, privatization of previously government-owned production, and many other changes as these countries moved in various degrees from socialist to market economies and democratic governments. They privatized many state-owned enterprises, signed foreign trade agreements with other countries in the region, and have generally achieved a significant level of macroeconomic stability with improved growth rates. They also experienced a significant increase in FDI. As a consequence, the ratio of inward FDI to the CEE countries studied here in total world FDI inflows increased more than three-fold. Over the same period, these countries also achieved a substantial increase in their exports, especially towards Western Europe. We present in this paper the relation between the FDIs and exports in the CEE countries during 1990-2010 using statistic data analysis and literature review and underline the factors that determined an increase of exports in these countries. Despite other CEE countries that succeeded to attract many export-oriented FDIs, Romanian case is different because of many local specific factors such as an insufficient local production and a tight fiscal policy.
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Introduction

After 1990, the CEE countries lowered the barriers to FDI. Of course, many other developments were taking place at the same time: increasing openness to trade, privatization of previously government-owned production, and many other changes as these countries moved in various degrees from socialist to market economies and democratic governments.

Some of these countries became full European Union (EU) members in 2004 and in 2007. They also experienced a significant increase in FDI. As a consequence, the ratio of inward FDI to the CEE countries studied here in total world FDI inflows increased more than three-fold. Over the same period, these countries also achieved a substantial increase in their exports, especially towards Western Europe.

FDI affects the economic welfare, growth and development of host countries in a number of ways. First of all, in any host country, FDI manifests itself in the form of transnational companies (TNCs) establishing local operations, usually through one or more affiliates each. These foreign affiliates interact with the local economy by building production facilities and hiring workers, many of whom will require training. Second, since the affiliates are constituent elements of the TNCs involved, they are parts of the TNCs’ respective value chains, both within the host country and internationally. Third, the affiliates might have a variety of indirect, spillover effects on local firms, for example through the impact of competition that might spur local firms to improve their performance; or, conversely, they might induce failures because of affiliates’ greater efficiency. The extent and nature of these effects and the net outcome for a host economy depend, among other factors, on the scale of the initial FDI, the technology used, the number of people employed and the training and wages offered, the market orientation of foreign affiliates in the economy, the degree to which the
affiliates procure goods and service inputs locally, and the proportion of profits reinvested, as well as the conditions prevailing in the host economy.

The question that this paper tries to answer is whether the foreign direct investment in Central and Eastern Europe (CEE), over the period between 1990 and 2010, has improved the export performance of the host economies. A special case is represented by Romania among CEE countries.

The aim of the present paper is to investigate the relationship between FDI and exports in CEE countries. There is a dual link between trade flows and FDI in the theory. On the one hand, it is assumed that investment by multinationals in other countries would substitute for their exports, and therefore, reduce employment and economic growth in the home country in the long-term. On the other hand, trade and FDI are appointed in order to be complements to each other in turn boosting and having a positive relationship on each other.

Foreign capital investments are the most efficient and safe way to integrate into the world economy and to re-specialize the economy. Indeed, accumulated experience shows that FDI had substantially enhanced the national economies re-specialization processes all over the world. The authors share the opinion of those specialists who affirm that FDI play a determinant role in re-specializing transition economies and increasing the export potential. That happens, because, first, in the FDI drawing process, economies perfection takes place on the way of introducing and fast developing of new fields and by renovating traditional ones. Second, currently, FDI is the main and real source for economy restructuring and production modernization; third, FDI growth leads to the increase of manufactured production quantity.

Foreign investors had played an important role in economic development, contributing to the substantial growth of permanent capital and, collaterally, making the modernization of the capital assets of the companies bought, though the flux of FDI in these countries economy had been different from year to year.

The important volume of direct foreign investments contributed to the exclusion or the reduction of interior macroeconomic disproportions, and also to the improvement of the balance of payments, because FDI were auxiliary sources of foreign currency and budgetary incomings.
FDI had become the main way of modernization of the communication systems, and foreign bank capital contributed to the technical modernization of the bank field. The analysis made by foreign economists showed that the new companies, with mix capital (foreign – autochthonous), had ensured the main part of increasing the export of the region's countries and had essentially enhanced the export orientation of their economies.

In the countries that had drawn the highest FDI volumes, the companies, with foreign capital sharing, produce the largest part of the exported goods. But, step by step, was increased the share of the goods that require high capital investments and high qualified work force. This change of exports structure under the influence of direct foreign investments was also noticed in countries in transition within the Central and Eastern Europe.

Generally, E.U. expansion led to an increasing of trade within the union without affecting commercial exchanges with extra E.U. countries. The export growth rhythm extra E.U. shall overtake the one of the export to E.U. countries due to the conquest of new outlets but also due to the consolidation of exports in which Romania already activates, as a result of increasing the competitiveness of the products offer. At the same time, it is estimated the growth of imports from the E.U. over the average on country, imports represented by manufactured goods, of average and high technology. In exchange, the imports from other areas shall increase in an inferior rhythm, as a result of reducing the energetic and material degree of the national economies.

Multinational enterprises (MNEs) can use their already formed connections to import and export products from and in Romania, enhancing in this way the weight of the Romanian economy in world economy.

Section 2 presents the literature findings on the impact of FDIs on exports in the world and especially in the developing countries. In section 3, we examine the effects of sectorial distribution of FDI on the trade balance via exports and imports in CEE countries during the last two decades. In conclusions, we attempt to make policy recommendations for the host country from the viewpoint of external stability as well as competitiveness.
Literature review

The impact of FDI on host country exports is not only direct, through the exports of the foreign affiliates, but there may be important side-effects, which may influence the export performance of domestic producers indirectly.

There is a wide theoretical base which sustains the existence of a positive relation between FDI, export and economic growth. There are relevant for their theoretical role the benign model of FDI (Moran, 2005), but especially the models of endogenous economic growth that belong to Barro in 1997, Borensztein, De Gregorio&Lee, 1998, Graham (2001), or Aitken and Harrison (1999). Between the empirical studies that confirm this hypothesis we present those of Krkoska (2001), Borensztein, De Gregorio&Lee (1998).

One specific channel through which domestic firms may increase their productivity and export competitiveness in tradable goods and services industries is simply by copying the operations of the foreign producer. This may be facilitated by the mobility of workers previously trained in the MNE’s affiliate. Some of the other potential channels of MNE’s influence on domestic companies have been analyzed theoretically, but not in the specific context of exporting domestic companies. One of the potentially important indirect MNE’s effects on domestic producers is the competition effect. The entry of an MNE in one sector of the host economy increases the intensity of competition in this sector, which may force some domestic companies to leave the market (Markusen and Venables 1999; Barrios et al. 2005). Such an effect is less pronounced with export-oriented MNEs and domestic producers, but, in the case of exporting domestic companies, this may lead to negative effects of inward FDI if the loss of exports by domestic companies is not compensated for by new exports of the MNE’s local affiliate. However, MNE entry may also have positive indirect effects on the export performance of domestic companies. For example, an additional channel through which productivity of local firms may be increased is the so-called forward linkages, which occur when foreign affiliates sell goods or services to domestic firms. Improved products and services (and/or lower prices) in the downstream sector of a domestic firm may improve the domestic firm’s own productivity and competitiveness as well.
This implies that FDI inflows into a non-exporting sector may improve performance of domestic exporters. Another type of linkage between foreign and domestic producers consists of backward linkages to the suppliers. If the presence of foreign producer creates additional demand for local inputs, then the supply industries may be strengthened. Markusen and Venables (1999) show that strengthening the supply industries may benefit the domestic producers in the MNE’s industry, through the mechanism of forward linkages, and that this positive side-effect can be stronger than the competition effect in the MNE’s sector.

The theory of internalization suggests that FDI substitute for exports are supported and there are sufficient costs for external transactions such as exporting and licensing. Furthermore, Brainard (1997) states that the “proximity-concentration trade off”, which was determined by the firm’s fixed costs, transportation costs, and trade barriers, is the explanation for the substitutive link between FDI and trade.

Helpman et al. (2003) show that whether the relationship is complementary or subsidiary that it is an issue that depends on the type of FDI. The FDI could be of two different types: horizontal (MNEs have a subsidiary in every country of interest because of transport costs or just to be closer to the final customer) or vertical (MNEs locate each stage of the production process in different countries according to cost advantages).

Moreover, Markusen and Venables (1999) predict a substitution relationship between horizontal FDI and exports, whereas horizontal FDI arises as a product of the interaction of plant-level activities and firm-specific activities (R&D, marketing, managerial services, etc.). Therefore, whether an MNE establishes an affiliate or tends to export depends on the trade costs (tariffs) on the one hand, and the costs of establishing a new firm near the customers on the other hand. Finally, as horizontal FDI tends to take place between countries that are similar in terms of factor endowment, income, and technologies, the model predicts a negative link between skill differences and horizontal FDI.

Clasning (2000) investigates the operations of US MNEs in 29 host countries from 1977-1994 and finds a strong positive influence of FDI on exports. This relation becomes even more pronounced when multinational activity and intra-firm trade are considered. In the analysis of FDI and exports, Pfaffermayr (1994) employs the Granger-causality procedure and
obtains a significant positive causation in both directions. Eaton and Tamura (1994) also analyze the relationship. They thereby control for the country determinants such as income per capita, population and the endowment of human capital of the partner country and find a strong complementary relationship. In contrast, Andersen and Hainaut (1998) find a complementary relationship for the USA, Japan, and Germany but not for the United Kingdom.

The empirical studies on the industry level have mixed results. Lipsey (2002) show a positive relationship between US exports and FDI for 40 countries in 1970. Furthermore, Brainard (1997) finds a strong confirmation for the “proximity-concentration trade-off” on the industry level for 27 US markets and identifies that when the income per capita of the partner country catches up to the US level, FDI tends to substitute for exports. Fontagné and Pajot (2002) find complementary effects between FDI flows and trade on the sectoral level. Furthermore, they appoint an even a larger impact of FDI on exports when the spillovers between sectors are taken into account. At the same time, Blonigen (2001) detects a substitution effect between the production of Japanese automobile parts in the US and the Japanese exports of automobile parts to the USA. Further, the relation between the production of Japanese automobiles (final goods) in the USA and Japanese exports of automobile parts turns out to be complementary. Türkan (2006) also identifies a strong complementary relation between US trade and FDI stocks of intermediate goods exports, whereas there is a slight negative relation between FDI and trade in final goods.

The investigation of the relation between FDI and trade that is diversified by destination country or region is an under-researched issue in the empirical literature. Some studies investigating the relationship between FDI and exports from developed to developing countries find them to be complementary. Furthermore, the same relation is found to be substitutive between developed countries. Nevertheless, the net empirical outcome shows, to a large extent, a complementary relation rather than a substitution effect. A small number of studies also analyze the issue of the relationship between FDI and trade considering various destination countries or regions.

For developing countries, strong export orientation can be a powerful engine of economic growth as demonstrated by some East Asian
economies in the second half of the 20th century or Ireland over the last two decades. Medina-Smith (2001) gives an extensive overview of the exports growth. Although he finds evidence in favor of the export led growth hypotheses for this particular case, from the literature review he concludes that empirical evidence on the positive relationship between exports and growth may not always be very robust.

Although the global as well as country specific circumstances are very different for the countries in Central and Eastern Europe, there are at least some positive lessons from the Asian and Irish experiences about what should be done in order to improve export performance (Kokko, 2002). One of them is that foreign direct investment may help in promoting exports. This export-promoting strategy becomes relatively more important due to the narrowed choice of other export promoting instruments as a consequence of international trade agreements, or because some of them have been shown to be ineffective in many cases (UNCTAD 2002). This was especially important for those CEE countries whose goal was to join the EU and which were therefore, or are about to become, subject to even more restrictive regulations. One could say that it might be easier to attract an exporter, than to create one.

Basically, there are two ways in which FDI inflows, the increasing FDI stock, may be export-promoting: either directly, through exports of the multinational’s subsidiaries, or indirectly, by affecting the domestically-owned firms in a number of ways, such as knowledge spillovers or improved access to world markets, and thus increasing the overall international competitiveness of the host economy. But the actual effects of FDI on the host economy and possibly on its exports depend on the type of the investment as well as on the specific host-country initial economic conditions.

Different theoretical approaches give different predictions about the relationship between FDI and exports, or more generally, on the relationship between international factor movements and international trade in goods. It is reasonable to expect that firms can do business in foreign countries only at a higher cost than domestic firms. Without specific advantages capable of compensating for this inferior position, their foreign operations would not be sustainable.
If FDI is market-seeking, it would have positive influence on imports into host economy, and no effect on exports. For resource-seeking FDI, the situation is just the opposite: there is an increase of exports, while imports are unaffected. For strategic asset-seeking FDI, there are no unambiguous predictions. In order to predict the macroeconomic effect of FDI on exports, one needs to know the type of the majority of foreign investment projects, whether they are market- or resource-seeking. But even if one knew that most of the FDI in some host economy were market-seeking, there still might be some positive effects of FDI on exports through different channels of indirect influence.

There is a same bi-directional argument in the case of FDI and the export. Then there are other concerns regarding market seeking (substitute) FDI or efficiency seeking (complement) FDI. Furthermore, Vernon (1979) explores whether FDI is at the early product life cycle stage (substitute) or at the mature stage (complement) and asserts that exports increase FDI by paving the way for FDI by gathering information of the host country that helps to reduce investors’ transaction costs. Also FDI may reduce exports by serving foreign markets through establishment of production facilities there.

To illustrate the causal relationship, several studies (UNCTAD 2001) suggest that manufacturing firms first service the foreign markets by trading because trade is easier and less risky than FDI. Then gaining knowledge about foreign countries economies, political and social conditions, the home country firms establish subsidiaries in foreign markets and then subsidiary exports. Thus, the FDI-export relation is as complicated as the other bi-variate causal discussion.

Some studies analyze the dynamic relationship between export, FDI and GDP for six emerging countries of Chile, India, Mexico, Malaysia, Pakistan and Thailand. The results suggest that in South Asia, there is evidence of an export led growth hypothesis. However, in the long run, we identify GDP growth as the common factor that drives growth in other variables such as exports in the case of Pakistan and FDI in the case of India.

The Latin American countries of Mexico and Chile show a different of relationship in the short run but in the long run, exports affect the growth of FDI and output. In the short run, GDP is more important in the case of Mexico, while FDI is more important in the case of Chile In the case of East Asian countries; we find bi-directional long run relationship among
exports, FDI and GDP in Malaysia, while we find a long run uni-directional relationship from GDP to export for Thailand.

There are differences between the competitive advantages and market conditions of multinationals from different economies, and it is probably not safe to generalize the results from the US. The most comprehensive econometric analyses of the Swedish FDI-trade relationship are presented in Swedenborg (2001), Blomström, Lipsey, and Kulchycky (1988), and Svensson (1996). The studies are all based on a detailed data set on Swedish multinationals collected by the Industrial Research Institute in Stockholm, but there are significant differences regarding the specific time period and the methodology used. Yet, most of these studies conclude that there is no relation, or a small positive relation, between FDI and home exports. The exception is Svensson (1996), who focuses on the developments during the late 1980s and early 1990s. In particular, he argues that it is necessary to account for the foreign affiliates’ exports to third countries, because they are likely to substitute directly for parent exports. Doing this, he finds substitution between Swedish investment abroad and exports from Sweden. However, the quantitative impact is relatively small. Another possible explanation for divergence between Svensson (1996) and earlier authors could be that Swedish MNCs have increasingly relied on mergers and acquisitions rather than Greenfield investments as their mode of foreign market entry. Since acquired affiliates already have local suppliers and subcontractors, they are less likely to need inputs from the home country, at least in the short run. Hence, the complementarity between Swedish exports and FDI may have declined over time.

Moreover, it is important to note that all of the evidence discussed above is drawn from studies focusing on manufacturing. Services have emerged as the leading industry for new FDI, but there are very few studies exploring to what extent outward investment substitutes or complements home country activities. Given the importance of market presence and proximity to customers in most services industries, it can be hypothesized that the substitution effects of FDI are rather small: the initial export potential is often small relative to the volume of operations that can be generated though FDI.

From the discussion above, it should be clear that there are positive as well as negative effects of FDI in the home countries of multinational
The impact of FDI varies depending on the type of investment (acquisition or greenfield), industry (manufacturing or services), time perspective (short or long run effects), and various home and host country characteristics. Among the positive effects identified in the empirical literature, the most important one is probably the favorable impact on the investing firm’s size and competitiveness. In the developed country case, it was noted that there is a potential for complementarity both for horizontal and vertical FDI. With horizontal FDI, it is likely that the host country market share grows sufficiently to stimulate home country production of intermediates; in case of vertical FDI, the competitiveness of the MNC may grow sufficiently to take market shares from foreign firms, either in the home country market or in export markets. In either case, total home country production may grow following FDI. In developing countries, it is possible that the production linkages between parents and affiliates are weaker.

The impact of FDI on host country exports is not only direct, through the exports of the foreign affiliates. This upgrading of technical and managerial skills, provided by the multinationals may spillover to domestic producers (for example, through mobility of trained human resources), enhancing their productivity and helping them to improve their competitiveness on the export markets. Locally owned firms might increase their efficiency by copying the operations of the foreign producers or may be forced to do so by the foreign competition (Lipsey 2002).

It must however be noted that the extent of the spillovers and indirect effects of FDI on exports may depend on the initial technological and human capital level of the domestic producers, on the intensity of competition in domestic markets, as well as on the government policies promoting linkages between domestic and foreign firms. Moreover, there are also potential negative effects of MNEs on domestic producers. MNEs can capture domestic firms’ market share and reduce the latters’ profits.

Thanks to the detailed data on bilateral capital and trade flows between the U.S. and host countries in Latin America, they are also able to address the inter-sectorial spillovers in a more explicit way. The results vary across sectors and host countries, reflecting the importance of the specific conditions in individual countries and industries. Still, US investments in
CEE region were a few, mostly located in Poland, Czech Republic and Hungary.

Many studies on FDI spillovers in transition countries find some evidence of negative spillovers. The evidence of positive horizontal, intra-industry spillovers is even weaker if one considers some methodological drawbacks such as potential bias of the cross-section estimates used in many of the reviewed studies. The evidence on positive FDI productivity spillovers on forwardly and backwardly linked industries is somewhat more convincing than for the horizontal effects. The same is true for the papers dealing with the export spillovers.

Zhang and Song (2000) address the same research question for China at the provincial level. They also find that higher levels of FDI are consistent with higher provincial exports. It is worth noting that the positive effect of FDI on exports in China has mostly been due to the fact that China has largely been used as an export platform by MNEs. Goldberg and Klein (2000), on the other hand, analyze the impact of FDI from the United States in the manufacturing sectors of individual Latin American countries on the net exports of those and other sectors. The results vary across sectors and host countries, reflecting the importance of the specific conditions in individual countries and industries. The fact that the results are mixed makes it impossible for the authors to draw a strong and clear conclusion on the relationship between the FDI flows and trade.

In addition to directly increasing the size of domestic exports, and increasing the probability of domestic firms becoming exporters through spillover effects, FDI can affect the structure and direction of a host country’s exports. As for the studies concerning transition countries, Jensen (2002) investigates the impact of FDI on the structure of Polish exports and finds that inward FDI in Poland positively affected the technology intensity of exports. Djankov and Hoekman (1996) analyze the changes in the structure and destinations of exports of CEE countries. According to their findings, the Czech and Slovak Republics have experienced the greatest redirection of trade as well as the fastest growth of exports. On the other hand, the change of the composition of exports in these two countries has been relatively slow. In general, they find that the FDI inflows were strongly correlated with export performance and intra-industry trade levels.
Barrios et al. 2005 explicitly test the effect of inward FDI on the productivity of exporters in the UK that have been acquired by the foreign companies.

This is important since much of the FDI inflow in the transition countries was for the acquisition of existing companies (mostly through privatization). This study shows that FDI affects the productivity of acquired firms; however, the magnitude and significance of this impact depends on the time elapsed since acquisition, nor was it even for companies with different productivity levels prior to acquisition. He finds that, one year after acquisition, FDI has had significant and positive influence on average productivity growth of acquired companies (no significant effect was found in the year of acquisition). The companies with lower initial productivity, on the other hand, benefited more from FDI two years after acquisition. This shows that it takes time for the acquired firms to benefit from FDI, especially for the domestic firms with lower initial productivity. Since NEU countries are, on average, more developed than the Southeast European countries, they are expected to have relatively more productive companies. Also, they have received more FDI, which can additionally explain why such effects are significant only for this group (new-EU) of countries.

FDIs and exports in CEE countries

Some countries in Central and Eastern Europe that had large current account deficits prior to the global financial crisis of 2008–09 were also those that received large FDI inflows in the non-tradable sectors. FDI in the non-tradable sectors had boosted current account deficits without contributing to an expansion of export earning capacity. FDI was generally the largest component of capital inflows in the region. Within the region, Bulgaria and Romania (EU Balkans) recorded the largest inflows of FDI relative to GDP lately. The Baltic States (Estonia, Latvia, and Lithuania) also picked up the momentum upon their EU accession in 2004. Albania, Bosnia & Herzegovina, Croatia, Macedonia, and Serbia (Non-EU Balkans) experienced an increasing trend since 2005 mainly due to large-scale privatization. In contrast, the CEE countries (the Czech Republic, the Slovak Republic, Hungary, Poland, and Slovenia) saw a more moderate increase in FDI after 2003, when privatization came to an end. The sectoral composition of FDI inflows has been very different among the CEE
countries. In South-Eastern countries, FDI in the non-tradable sectors dominated with the exceptions of Macedonia and Romania. A similar pattern is seen in two of the Baltic States (Estonia and Latvia) in Figure 2 in Appendix. These two groups of countries received sizable FDI in the financial sector by Western European banks. On the other hand, the CEE countries have more balanced distribution between the tradable and non-tradable sectors (Figure 3, Appendix). Determinants of FDIs in the tradable sectors are: market size, infrastructure, distance, trade openness, wage and education.

Further, we shall examine some structural changes, which had been made, under the influence of FDI, in the CEE economies, drawing attention also upon the changes in the export potential of that country. In the beginning of transition, these countries were specialized in traditional industries with a low degree of transformation (textiles, clothing, furniture, footwear), in intensive resource branches (metallurgy of iron, metal working, base chemistry, wood and paper industry) and in agriculture. This specialization had been formed since the socialist time and reflected “work social international division” from the Mutual Economic Help Council (C.A.E.R.). In 1994 – 1995, after the countries within this region got European Union associated countries statute, a large flux of FDI, mainly, from Western Europe, step by step changed the type of international specialization of this country category.

In the beginning of the 1990s, in this category of countries, FDI were drawn especially in processing industry. Comparing to other branches, here, the buy-out was made earlier, and the efficiency of investments was high. In the second half of the ’90s, the highest rhythms of FDI flux growth had already been registered in the services field. The cause of this change was the shift of the buy-out center. In this way, in 2000, in the services field, had been concentrated ca. half of the foreign investments. In some countries, like Czech Republic, foreign companies had started to control the telecommunications, financial and transportation systems. There had also been made considerable investments in real estate and trade. In the first years of the 3rd millennium, the most attractive investment domain for foreign investors was, again, the processing industry. In processing industry, it is noticed a FDI structure change process. Regarding the rise of work force
cost in CEE countries, foreign companies had started to move the activities that require a large work volume in other world regions.

In such conditions, moving the industries that require a large work volume in countries with lower incomes, foreign investors, in the case of the new European countries (Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Slovakia and Slovenia), had started to already invest in more advanced technologies fields, that require a more qualified work force and in which labor productivity was higher. In this way, important investment resources had been oriented to automobile production industry. So, according to UNCTAD, Czech Republic was first worldwide, and Hungary and Poland on the 3rd place. In this way, with the help of FDI, the international specialization of these countries began to change.

It is easy to notice that the amount of FDI stock has almost constantly increased in all countries, over the period considered. At the same time, exports have mostly been stagnating in all countries except for the five Central European economies. Also, there has been an upward trend in Romanian exports for the second half of the observed period.

It is plausible that the sectorial composition of FDI matters for the trade deficit. FDI in the tradable sector is likely to increase exports over time, while no such effect exists for FDI in the non-tradable sector. FDI in the non-tradable sector may fuel domestic demand booms and boost imports, while FDI in the tradable sector only boosts imports in the short run. This suggests that countries where FDI predominantly flows to the non-tradable sector will have a higher trade deficit than countries where it flows to the tradable sector.

The countries where FDI in the non-tradable sectors dominated also had the largest current account deficits. FDI in the tradable sector is associated with higher exports. There is a positive correlation between the stock of FDI in the tradable sector (measured as a percent of GDP) and the export to GDP ratio (Figure 4, Appendix). The export to GDP ratio is the highest in the Slovak Republic, the Czech Republic, and Hungary—countries that also record a high stock of tradable FDI.

FDI in the non-tradable sector is associated with higher imports. The stock of FDI in the non-tradable sector and the import to GDP ratio are also positively correlated (Figure 4, Appendix). Bulgaria and Estonia have the highest stock of non-tradable FDI and they also have a high import to
GDP ratio. One reason for the strong link between FDI in the non-tradable sector and high imports may be that FDI in the non-tradable sector fueled credit booms. The link between non-tradable FDI and credit growth is indeed positive as a large share of non-tradable FDI is often financial intermediaries.

The negative correlation between share of tradable FDI and trade account balance is seen for the three New Member States (Baltics, Bulgaria, and Romania) in Figure 4 in Appendix. In Bulgaria, Romania and Latvia, we observe a sharp increase in trade deficits that coincide with a declining share of tradable FDI. Three of the CEE countries—Czech Republic, Hungary, and Slovak Republic—have a high share of tradable FDI and improving trade balance (Figure 4, Appendix). In two of the CEE countries—Poland and Slovenia—the trade balance is worsening as FDI is increasingly going toward the non-tradable sectors (Figure 4, Appendix).

The time-series evidence shows that more FDI in the tradable sectors seems to improve the trade balance in the medium-run. Thus, the sectorial composition of FDI seems to matter a great deal to the evolution of external balance via export and import performance.

There is a widely shared view that FDI promotes a host country’s export performance by augmenting domestic capital, helping transfer of technology and new products, and providing training for the local workforce and upgrading technical and managerial skills. This potential linkage between inward FDI and export performance is one of the reasons why developing countries compete to attract more FDI.

There are notable examples among developing countries in which FDI contributed significantly to rapid economic growth through enhancing export performance. China is considered to be one of the most successful examples of export-led economic growth, aided by substantial FDI inflows. The role of FDI in China’s export performance was studied in numerous studies in the past. However, there are few studies that report the contribution of FDI in the tradable sector. For example, the study by Zhang and Song (2000) reports that one dollar of FDI stock raises exports by about 70 cents, using the disaggregate industry level data.

For the CEE countries, the estimate for the link between tradable FDI and exports is substantially higher than those found in the Chinese studies, although it is not directly comparable due to a different unit of
aggregation. A cross-country correlation coefficient shows that one dollar of FDI in the tradable sector leads to an increase in exports by about 3.5 in the CEE region. A one percentage point of GDP increase in tradable FDI leads to about three times as much increases in exports. This is in part due to the self-reinforcing effect that countries with a profitable exporting sector are more likely to attract more FDI in the tradable sector. When we use aggregate FDI including non-tradable FDI, the positive relation between FDI and exports still exists but to a lesser extent (1.8 dollar as opposed to 3.5).

This is because the role of FDI in the non-tradable sector in supporting export activities is rather limited. There is a positive link between export performance and FDI in the tradable sector after controlling for real exchange rates and market size. Between 2000 and 2008, there was generally an increase in export propensity in the region.

However, there is a large variation across countries in the export-to-GDP ratio. The top three exporters in 2007 are the CEE countries that embarked on transition process early. Exports of CEE countries (except Poland) account for about 70 percent of GDP. FDI stock in the tradable sector is also high in these countries, accounting for over 15 percent of GDP. Countries that saw little or no increase in the export-to-GDP ratio are Albania, Croatia, Latvia, Lithuania, Romania, and Serbia, in which FDI stock in the tradable sectors is lower than in other countries. Notably, the two countries—Macedonia and Bosnia & Herzegovina—saw a significant improvement in export performance and also a high share of tradable FDI.

From the table 1 and 2 we can stress that Poland, Czech Republic and Hungary are in the top list of CEE countries as exports volume is concerned. These are the CEE countries that are in the top for attracting FDIs in the last two decades. Slovakia and Romania follows them, but we have to consider the size of the Romanian economy that places on the second position in the CEE region. So, its performance is not as notable as exports are concerned. Bulgaria represents a special issue in the CEE region because it managed to attract many FDI inflows after 2005, but its exports couldn’t follow such a significant rising trend. Both Romania and Bulgaria based on low labor-cost unit and had a low capacity to absorb FDIs in the high-skilled labor sectors with high added value. These markets faced a low purchasing power of the population and the domestic suppliers couldn’t
fulfill the internal demand, so they didn’t represent an export platform such as Asian emerging countries. In those two countries, the economic restructuring and privatization process were postponed for some time.

There seems to be a relatively clear division between investment policies of the CEE countries and of the Western European Countries of EU.

***Table 1:*** Exports evolution in CEE countries during 1990-1999 (mil. USD)

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*Source: UNCTAD, Statistics on Trade-exports and imports of merchandise and services, annual, 1990-2010*
Table 2: Exports evolution in CEE countries during 2003-2010 (mil. USD)

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Source: UNCTAD, Statistics on Trade-exports and imports of merchandise and services, annual, 1990-2010

While the former may gain most by focusing on infrastructure and R&D policies, in the latter group policies to reduce the share of low-skilled workers, for example by encouraging firms to restructure production and increase capital intensity and through a reduction of labor costs via a decrease in non-wage-labor costs, would attract most FDI. Slovenia has the lowest penetration of FDI among the observed countries. Here the privatization policy was more cautious towards foreign owners. But only in Slovenia and Czech Republic we can see that in 2010 the FDI decreasing trend reversed.
In CEE countries there was implemented a lax fiscal policy at the beginning of the last decade that widened the external imbalances in the region. The fiscal policy tightened after 2005, once the consumption tax increased in the region and generated a rise of prices. Romanian income policy was lax for a long time and there was granted fiscal facilities for imports to fulfill the internal demand. Moreover, the national currency significantly appreciated at the end of the ‘90s and in the last decade, before the crisis period and that discouraged the Romanian exports. At the beginning of the last decade, the CEE countries’ exports increased significantly due to a rise of external demand of Western Europe and they were less sensitive to the exchange rates fluctuations. Exports were stimulated by the decrease of the raw materials and oil prices. CEE countries with a traditional export structure (low manufacturing level of products) faced high growth ratios. In Poland, Hungary and Czech Republic, the export was supported by the FDIs of the TNCs from EU and US in car, equipment and transport means sectors. Poland and Slovakia attracted large FDI inflows due to the important privatization programs, just like Czech Republic and Hungary did in the ‘90s. Poland, Hungary and Czech Republic (that account more than half of the total FDIs in the CEE region) and even Slovakia benefited more of the TNCs support and of their better capacity to absorb external shocks due to their complex export structure.

Romania and Bulgaria suffered from their export structure and their weak presence on the international markets and on Community of Independent States’ market (CIS). Moreover, Bulgaria was affected by the situation in the former Yugoslavia and by the Turkish crisis during that period. In 2001-2004, CEE countries exports increased more than the world exports due to the appreciation of the euro against US dollar and to the low labor-unit cost. Hungary supported FDIs in new sectors and mergers and acquisitions. The sustained economic growth worldwide and the increase of the external demand supported the exports increase in the CEE region before crisis erupted in 2007-2008. Moreover, in the first half of the last decade, the CEE countries’ exports oriented to developing countries outside the EU area. Starting with 2003, Romania and Bulgaria managed an internalization of some TNCs’ activities from EU.

Bulgaria, Romania and Slovenia depend on imports of raw materials (for exports) and of capital goods and that situation determined an increase
of their external imbalances supported also by their national currencies' appreciation in the first half of the last decade. After 2003, FDIs decreased in Czech Republic, Poland, Slovakia and Slovenia because of the privatization process that came to an end and in Hungary because of its foreign investments abroad. Bulgaria and Romania continued to attract FDIs as a result of the postponed privatization process. With the first wave of EU accession in 2004, the new EU member states benefits of the total trade liberalization and of the EU commercial relations with different world countries. The industrial sectors of the new EU member states integrated in the TNCs’ production networks.

The exports of the new EU member states were supported by the demand of intermediary goods of the Western Europe (Germany, mainly) and by the intra-company trade in Czech Republic and Hungary. The exports of capital goods outside EU increased in Czech Republic, Hungary, Slovakia and even in Slovenia. Poland, Czech Republic, Hungary and Slovakia started to invest abroad, but only Hungary made significant investments abroad. FDIs attracted in the CEE region came mostly from EU and after EU accession the reinvested earnings began to play an important role in this region. In the Baltic States, Hungary and Slovakia, the investments and the low interest rates supported domestic demand. The exports represented a real engine for the economic growth in the Baltic States, Poland, Hungary and Czech Republic.

The external imbalances widened after 2005, as a result of economic gaps between the new EU member states and the former member states and as a result of reinvested earnings from FDIs (especially in Poland, Hungary, Czech Republic and Slovakia). After 2007-2008, once crisis erupted worldwide, the external imbalances decreased in the CEE region as a result of the contraction of the domestic demand (except the advanced CEE countries such as Poland, Hungary, Czech Republic and Slovakia due to the reinvested earnings). In the entire CEE region, FDIs decreased, except Romania. In 2009-2010, Latvia, Hungary and Romania adopted restrictive fiscal measures for financial stabilization, Bulgaria, Estonia and Lithuania adopted fiscal consolidation measures, while Poland and Czech Republic afford not to intervene. The external debt increased significantly in Hungary (over 60 percent of GDP). In 2009, the Baltic States and Hungary reached a positive external balance due to the domestic demand contraction and the
decrease of capital inflows. Romania and Bulgaria also reduced their external imbalances. FDIs and portfolio flows decreased in the CEE region. Net inflows turned up negative in Czech Republic, Bulgaria, Latvia and Lithuania and they decreased significantly in Estonia, Hungary, Poland and Romania. Romania, Latvia and Hungary claimed international support for financial assistance (Table 3 and 4).

The crisis effects were felt in 2009 and even later. FDI reacted later and to less extent. The decrease of FDI has been mainly felt in certain branches such as the automotive industries, which suffered from the structural crisis. In the CEE countries automotive industry is important as a consequence of the significant export platforms created by foreign capital in the last twenty years. The declining demand hit this industry in Hungary, Slovakia and Czech Republic. In Hungary inward FDI decreased significantly in 2009. In the Czech Republic the inflow of EU funds helped to maintain the external balance and the banking sector behave relatively well. The fiscal deficit increased but the adequate policy measures helped to stimulate the economy. Slovakia was in the recent years eminent in the CEE region, with growth rates of 10 per cent in 2007 and 7 per cent even in 2008, and introducing the euro in 2009. However, Slovakia’s reliance on the car industry (which accounts for 20 per cent of GDP) means that exports suffered a lot in 2009 and FDI decreased drastically.

Polish inward FDI did not decrease significantly in 2009. Poland’s strength is the size of its domestic market, which makes it a lot less dependent on exports than the smaller countries. Also, its industrial base is more diversified and less dependent on a single (like car) industry. Perhaps more than other new member-states, Poland could benefit from the return of highly skilled workers and from infrastructure investments co-financed by structural funds.

Bulgaria was severely hit by the crisis, GDP decreased by 5% in 2009. Inward foreign direct investment also decreased to around half of the sum in the previous year. Exports, imports and manufacturing production also declined.

In Romania besides the crisis, general economic background worsened. Despite other advanced CEE countries, Romania has only one big foreign investor in car industry, Renault that bought Dacia. Car industry and textile help Romanian exports to recover during the crisis. Foreign investors
were attracted so far by relatively low unit labor cost, proximity to the euro area, sound macroeconomic fundamentals (successful disinflation, high growth) and by domestic market potential. However, the boom of privatization-led FDI, which represented about half of the FDI inflows in the past years, is now largely over. Furthermore, Romania’s low-cost advantage is gradually eroding in certain sectors. Only at the beginning of 2011, when we achieved economic growth again, the Romanian economy has again become attractive for the foreign investors.

The export/import activity of FDI enterprises exerted a positive impact on Romania’s foreign trade. Contribution of foreign enterprises to exports was around 70%-73% in the last three years, a larger contribution against the imports that represent around 60-62% of the total Romanian imports. The largest contribution of the foreign investors to exports comes from industry, namely manufacturing: transport means, computer and electrical equipment, oil processing, textiles and trade.

Greenfield enterprises are important for exports in manufacturing, trade and real estate sector. For imports, trade is the main contributor followed by transport means, oil processing, machinery and equipment and textiles. But, if we consider the export structure, we can see that there are differences between sectors where FDIs are largely involved and the sectors that are the main contributors to Romanian exports.

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**Source:** UNCTAD, FDI database, annual data, 1990-2010
### The Impact of FDI on Exports, and Export Competitiveness in Central and Eastern European Countries

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<tr>
<td>Flow</td>
<td>1.07</td>
<td>2.49</td>
<td>1.67</td>
<td>1.69</td>
<td>3.2</td>
<td>3.56</td>
<td>-1.18</td>
<td>1.75</td>
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<tr>
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<td>22.87</td>
<td>20.6</td>
<td>23.52</td>
<td>30.38</td>
<td>28.62</td>
<td>30.77</td>
<td>31.47</td>
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So, the manufacturing sectors represent almost 92% of the total exports, but the main contributors are the car and equipment sector, the metallurgic sector and the textile sector (that is dominated by the low production), chemical and mineral sectors, rubber and plastic sector and agriculture and food sector. And more important, the intermediary goods represent half of the total Romanian exports. The consumption and capital goods represent almost 20% of the total exports. In 2010, the Romanian export recovered a little bit, as a result of a rise of the external demand, but the structure didn’t change significantly (Figure 1).

As developing countries expand beyond their traditional involvement in international production as recipients of FDI to that of rising sources of FDI, the impact of their outward FDI on the home countries as well as on host countries, especially host developing countries, assumes increasing significance. For the home countries, questions arise as to whether the exports of capital, technology and other resources by their TNCs bring benefits to the firms undertaking them.

The trade effects of outward FDI on host economies depend considerably on the motivations and type of investments abroad, and this applies to developing-country FDI as well. To the extent that market-seeking motivations drive the greater part of FDI from developing countries, and such FDI has been found to be generally complementary to host-
country exports (excepting where host countries pursue import-substitution policies), a positive impact on host-country exports may be expected. Results of our study suggest a positive relationship that confirms complementary between outward FDI and host-country exports.

From quantitative analysis realized in a previous paper by Rădulescu and Pelinescu in 2010, we can conclude that for Romania, exports growth depends largely and positively on the real exchange rate the depreciation and the monthly imports because our economy depends deeply on imports (raw materials and energetic products). The other factor that influences export is FDI that need more time (three period lag) to induce exports growth, but its influence is still very small. The real monetary base and the inflation determine the decrease of exports because of the rise of the domestic prices that affect the exports competitiveness in the external market.

A great focus is on improving the export competitiveness for the policy decreedents when they promote growth. Competitiveness starts with a rising international control of the market, but it implies more than that. It implies a diversification of the export basket, long-run sustainable path of exports growth, renewing the technologies in the export activities and a rise of the domestic firms capable to compete internationally for a lasting and sustainable competitiveness with rising incomes.

Competing exports allows the countries to import products, services and technologies for a rising productivity and the living standards. An increased competitiveness allows the countries to move forward away from the exports of some primary merchandise and improve their technologies, which represents an essential element for rising the domestic added value and wages. Exports is based on the capacities that underline competitiveness: they determine enterprises to adopt higher standards, insure opportunities for an easier access to information, put some pressure for a higher competitiveness and encourage the domestic firms to acquire new capabilities.

TNCs can help the developing and transition countries to improve their competitiveness, but raising their potential isn’t easy. TNCs have a high share in the exports of large added-value products in the developing countries. Firms of the developed countries invest in countries with low unit labor costs to export starting on new basis and they have substantial scale
economies as labor force is concerned. In these countries there is also important the promoted policy for attracting investors: they created free trade zones or they offered many fiscal incentives and not only. TNCs aren’t focus only on selling their products to the consumers outside their system, but they also insure the products circulation between their branches, especially as intermediary goods are concerned, and these flows turn into imports and exports. Of course, these phenomena don’t affect all the sectors in the same way. They are more obvious in electronic parts sector, car sector, namely in the sectors where the world trade rises the most quickly.

Attracting TNCs export oriented is an activity intense competitive and proves to be difficult to be sustained when the wages increase and the market conditions change. Coherent and consistent support from the policies implemented is essential in attracting the TNCs export oriented and it is essential that this support to be included in a national developing strategy. Export competitiveness is important and challenging, but it is important to be used as a mean that targets a final scope – development.

That raises questions about the resulted benefits of the TNCs’ transactions, starting with improving the commercial balance situation and ending with the modernization and sustainability of the export operations. Although the FDIs support the rising of exports, foreign investors also import products. In some cases, the net benefits generated by the foreign exchange rates can be small and the exports value can coexist with low levels of added value. In each case, the problem is represented by the way that the host countries can benefit the most by the TNCs’ assets. All depends on the implemented strategies of the TNCs, on one hand, and on the other hand on the capabilities and policies of the host countries.

The success of the national industrialization strategies of some countries (especially the Asian ones) that combined the efforts to attract TNCs export oriented with the development of the national capabilities could be a model to follow. There are many channels through the TNCs can support the export competitiveness of one country. But the challenge is to activate the TNCs for this objective. For attracting FDIs export oriented and for achieving certain gains as development is concerned, the countries have to find the most efficient ways to exploit their geographical positions that could support their exports. Even the countries that traditionally received significant FDIs, export oriented, must modernize to sustain wages increase
and to keep their competitiveness as an export basis. Indeed, some of the most successful countries as export competitiveness is concerned and in attracting FDIs export oriented had promoted alternative strategies based on the development of the domestic capabilities, but targeting foreign assets and resources, in the same time.

Conclusions

Studies estimated the impact of FDI inflows on export performance in transition economies, including new member states of the European Union. Foreign direct investment can contribute to higher exports by increasing supply capacity and/or through FDI-specific effects as multinational enterprises may have better knowledge about foreign markets, superior technology, lower production costs, and better ties to the supply chain of the parent firm than do local firms.

We find that, FDI inflows contributed to higher supply capacity in all those countries, leading to more exports. On the other hand, evidence for FDI-specific effects is mixed. The results suggest that this effect has been present mainly for the new EU member states, reflecting, among other things, the higher amount of FDI inflows received by these countries relative to Southeast European countries, as well as the potentially higher initial productivity of domestic companies acquired by MNEs.

Our results have important implications for policymakers and other transition economies. First, our results support the notion that the MNE has important advantage over local firms that it brings to the host economy. Hence, policymakers need to support FDI inflows by designing appropriate polices and reforms. However, it seems that the amount of FDI stock accumulated over time matters for the positive FDI-effects on exports. In the new EU countries, we showed that they received the larger amount of FDI relative to other transition economies and hence have been able to better take advantage of the FDI-specific effects than the rest of the countries, leading to more exports.

This paper argues that the composition of FDI matters: too much FDI in the non-tradable sector can exacerbate external imbalances. From 2003 onwards, FDI flows in many countries largely went to the non-tradable sectors rather than the tradable sectors and fueled domestic demand rather
than supply. This led to a surge in imports and large current account deficits. These large current account imbalances turned out to be dangerous. The countries with large external imbalances were hit hardest during the global financial crisis. In this paper, we relate the sectorial composition of the FDI stock to export performance. The cross-country evidence shows that FDI in the tradable sector is positively related to exports. The effect of FDI in the tradable sector on imports is not clear-cut perhaps because part of imports is also used as intermediate input for exportable. Thus, we conclude that FDI in the tradable sector affects external balance mainly by the export channel.

Large domestic size, good infrastructure, educated labor force, and deeper trade integration are conducive to attracting FDI in the tradable sector. The initial conditions and fiscal policy generally do not affect the composition of FDI, though the countries physically close to Western Europe have an advantage of having a lower transportation cost to attract export-platform FDI. In the countries that received much FDI in the non-tradable sector before the crisis, a shift towards the tradable sector is helpful for more sustainable path of external balance. In the short run, this entails a further progress toward greater trade integration. In the medium to long term, a country also needs to address bottlenecks in infrastructure and upgrade human capital to tilt a level-playing field towards the tradable sector.

Literature review indicates that FDI had a positive and significant impact on the exports of these countries, new EU member states. It is found that the positive impact of FDI on exports was strong, possibly reflecting the fact that these countries have managed to attract more export-oriented FDI. Other highly significant determinants were real effective exchange rates and the development on export markets. These results were confirmed after controlling for the effects of domestic investment (except for the export markets variable for the second subsample) as well as for the trade liberalization. The findings on these last two variables are mixed for different samples and specifications.

Attracting FDI can have powerful export-promoting effects. It is becoming relatively more important as the choice of other export-promoting instruments narrows down, as a consequence of international trade agreements, or because some of them, such as direct export subsidies
to specific industries, turned out to be ineffective in many cases. This is especially important for those CEE countries, whose goal was to join the EU, and were subject to even more restrictive regulations.

Government agencies can still target the potential exporters, but without being able to actually condition their incentives. It can therefore be expected that the policy measures will be shifting more and more toward exploiting potential indirect effects targeting “better” FDI and/or promoting linkages between foreign and domestic firms. It is also possible to target export oriented FDI indirectly by means other than incentives, by providing specific services, infrastructure or human resources that are possibly required by the export oriented firms. Such policy would simultaneously lower the costs for the domestic firms to become exporters.

One could argue that measures of this kind should be enough, i.e. that a country can create an exporter-friendly environment by itself, and thus, increase the export competitiveness of domestic firms without (1) attracting FDI at all, or (2) without investing additional efforts and resources (in form of incentives) in order to attract export oriented foreign investors. While it is likely that a country can succeed in promoting its exports without attracting FDI, the latter can obviously help speeding up the process and magnifying the impact and should be considered at least as a supplementary measure. This is probably more important in less developed host countries, lacking the resources, institutions and possibly also knowledge in providing important services for potential domestic exporters. In addition, only to create an exporter-friendly environment is in most cases not enough to attract a foreign investor. This may at best be supported by the empirical fact that even the rich industrialized countries offer special conditions for some foreign investors (UNCTAD 2002). It should be mentioned in the context of EU accession that, as shown by Breuss et al (2003), the redistribution of structural and cohesion funds due to enlargement determined the re-distribution of FDI within the enlarged European Union. Since more funds were redirected to new member states, they were able to use those in order to reduce the fixed costs of investment and to affect the location decisions of foreign investors.

Policy makers attach very high value to export promotion, regardless of the mixed evidence in the literature (UNCTAD 2002). So potentially, FDI might have been promoting the growth of the CEE
countries by promoting exports. But, Mencinger (2003) states that this has not been the case and that FDI did not lower current account restrictions for these economies. He argues that MNEs contributed more to imports than to exports, and that, therefore, there was no positive indirect impact of FDI on growth via exports. This, however, is a superficial argument at least.

If MNEs' imports contained a significant portion of the capital goods and machinery used for later production, and/or enabled faster enterprise restructuring (in the case of acquired domestic firms) allowing the firms to take advantage of the market access to EU, than this may have enhanced growth. Exactly the latter is found to be the case for some CEE countries in the study by Repkine and Walsh (1998), meaning that outward FDI and trade tend to be complements rather than substitutes. We also find a significant one directional causality from exports to outward FDI for the CEE countries. In contrast, there is no significant relationship between exports and FDI for the destination region Asia and Latin America.

Future work should explore whether the relationship remains robust when further determinants such as GDP and country size are included. Another interesting issue is whether the relation remains the same when we compare R&D-intensive industries and non-R&D-intensive industries. And it should be studied the impact of FDIs on imports.

Acknowledgement

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References


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Appendix

Figure 2. CESEE Composition of FDI Stock, 2007/11 (Percent of GDP)

Figure 3. CESEE Shares of FDI stock in the Tradable and Nontradable Sectors, 2007/11 (Percent of Total FDI)

Source: WDI Database on Foreign Direct Investment.

Note: Data for the Slovak Republic are from 2003.
**Figure 4:** Share of tradable FDI and trade account balance 2000-2007
(Percent of GDP, percent of total FDI)

Columns show the share of tradable FDI of total FDI (right axis) and lines show the share of trade account balance to GDP (left axis)