The european union and Central and Eastern European countries on integration, foreign direct investment and international trade

Kyrkilis D., Pantelidis P.

in

Giannias D.A. (ed.), Mergos G. (ed.).
Selected readings on economies in transition

Chania : CIHEAM
Cahiers Options Méditerranéennes; n. 44

2000
pages 183-191

THE EUROPEAN UNION AND CENTRAL AND EASTERN EUROPEAN COUNTRIES ON INTEGRATION, FOREIGN DIRECT INVESTMENT AND INTERNATIONAL TRADE

Dimitrios Kyrkilis,
University of Macedonia
Pantelis Pantelidis,
University of Piraeus

ABSTRACT

The purpose of this paper is to analyze the effects of the integration process between the European Union (EU) and the Central and Eastern European Countries (CEEC) on the latter's international trade and foreign direct investment (FDI) position. The paper also examines the type of FDI, which is directed towards CEEC in relation to its integration with the European Union and its development process. Finally a mathematical model stating the relationship between trade flows, integration, FDI and economic growth is also presented.

KEYWORDS:

FOREIGN DIRECT INVESTMENT, INTEGRATION, CEEC

1. INTRODUCTION

Central and Eastern European Countries (CEEC) is undergoing a structural transformation from a centrally planned economy to a free market economic system. The integration of CEEC into the world economy is a process that involves the expansion of international trade as well as Foreign Direct Investment (FDI).

The purpose of this paper is to analyze the effects of the integration process between the European Union (EU) and the Central and Eastern European Countries on the latter's international trade and FDI position. Two integration processes are examined:

1. The integration process within the EU, that is, the completion of the internal market, and

2. The integration between the EU and the CEEC, which is currently taking the form of trade liberalisation.

The paper also examines the type of FDI, which is directed towards CEE in relation to its integration with the European Union and its development process. Finally a mathematical model stating the relationship between trade flows, integration, FDI and economic growth is

also presented.

2. COMPLETION OF THE EU INTERNAL MARKET

The completion of the internal market in the EU includes policies concerning the total abolition of trade barriers of any type, including the and abolition of practices which lead to barriers of market entry, i.e. market segmentation. Such barriers are, for example, discrimination in public procurement, monopoly rights (especially in services like telecommunications), banking, insurance, merger legislation, state subsidies, abuse of dominant market positions, etc.

Economic integration creates static as well as dynamic effects. The static effects are of two kinds:

a. trade creation, due to the free movement of goods among the member states, and

b. trade diversion, due to the replacement of third country imports by EU production. This effect will be larger the higher the common EU external barriers to trade are.

The dynamic effects include:

a. enhanced competition which leads to more effective resource allocation,

b. enlarged markets, so that scale economies are better exploited and firms operate closer to the optimal scale, and

c. innovations and, therefore, higher productivity.

All effects increase competitiveness through cost reduction, which is more potent for the advanced industries and the service sector, for which the market fragmentation (caused by trade barriers, market protection and small market size) and the corresponding inability to take advantage of scale economies is more harmful. Traditional industries with limited scale economies will benefit to a lesser extent.

The ultimate consequence of both the static and dynamic effects is the increased intra-EU specialisation in accordance with the member states' comparative advantages, hence, the replacement of the inefficient domestic producer by suppliers from other member countries. This, in turn, will strengthen the static trade creation and trade diversion effects, especially when EU producers become more competitive compared with suppliers located outside the union. This is particularly so in the case of technologically advanced sectors, where the gains of innovation and productivity are expected to be more significant than in traditional sectors. The latter may face increased competition from suppliers with low labour cost, hence, due to the advancement of market positions brought about by the lower costs of labour, exports to the EU may decline. That, in turn, will tempt EU authorities to protect employment and production of "sensitive" sectors[1] via imposing barriers to trade and thus imports will be curtailed. However, the provisions of the Uruguay Round favour the liberalisation of international trade and form an obstacle to excessive protectionism.

On the other hand, increased efficiency and competitiveness due to the completion of the internal market constitute the source of additional growth for the EU[2]. This additional growth is expected to increase import demand, although the amount of import growth depends on income elasticities, which vary for different sectors and products according to the distribution of consumer preferences. Furthermore, they change over time according to consumer preference changes. In general, as income rises, demand is diverted from low quality

---

[1] For the significance of the so-called "sensitive" sectors, namely agriculture, ores and metals, textiles, clothing, leather, footwear, chemicals and food processing, in all EU countries, see Rollo and Smith (1993).

[2] See Commission of the European Communities (1988) and Bakhoven (1990).

products to rather sophisticated goods and consumer services, such as tourism, banking, passenger transport, etc. That, in turn, means that only countries which are able to supply such types of goods and services may potentially benefit from any growth rate in imports in the EU.

The program "Europe 1992" postulates gains through innovation, technological progress and faster growth[3]. This certainly is a rather favourable investment environment, and thus one expects that FDI flows will be increasingly attracted to the EU. Fears of protectionism and discrimination against outsiders ("Fortress Europe") would also induce foreign companies to acquire the status of an EU firm by investing locally, thus enjoying all the benefits of the internal market. Moreover, the completion of the latter will induce rationalised FDI from both EU and non-EU multinationals[4]. Rationalised FDI is attracted mainly by the availability of the appropriate human and technological skills, the necessary infrastructure, investment subsidies, good conditions for expatriate management, availability of inputs of appropriate quality other than labour and on time delivery. It is apparent that a number of countries outside the EU, especially developing ones, will be at a disadvantage in attracting FDI because the internal market will be a relatively more important location for FDI due to both market and location characteristics.

Consequently, these countries will face some difficulties in attracting FDI and thus in updating their technology and in increasing their competitiveness. Too much involvement from the suppliers' point of view will erode their export potential to the EU. On the other hand, the competition for FDI within the EU between the core countries and the less developed ones, especially in the European South, will increase the inflow of FDI in the latter. That will raise labour costs in these areas, and so it will reduce their competitiveness in labour intensive sectors. In turn, production in labour intensive industries will be relocated outside the EU in countries with relatively low labour costs. So the latter's export potential in the traditional sector goods will be enhanced.

On the basis of the above analysis it can be argued that CEEC will be able to expand their exports to EU countries. Their degree of success depends upon their competitiveness vis-a-vis EU production. Needless to note that restructuring in EU also involves the rise of the innovation process, which will accelerate labour and resource saving technological progress. So industries, which are better placed to absorb such progress, i.e. advanced sectors, will gain relatively more in productivity terms, CEEC will be less successful in penetrating those sectors than the ones of labour intensity, where they currently enjoy an advantage due to lower wages. However, even in the latter to the extent that technological progress in EU is faster than in CEEC, productivity also rises faster in the former, reducing any competitive edge of the latter.

Furthermore, the increased competitiveness of EU firms may lead to increased import penetration, especially in advanced sectors in CEEC, thus setting their balance of payments under pressure. Indeed, in 1994 the trade balance between EU and CEEC showed a surplus, with an export to import ratio equal to 119.8%. This ratio had been improved for the EU compared with the 95.2% in 1989 in all cases with the exception of Bulgaria where it was reduced. However, between 1989 and 1994, exports from CEEC to EU increased substantially, although individual countries performed unequally. Former Czechoslovakia, Poland, Hungary and Bulgaria achieved a rise in the value of their exports, in millions of ECU to EU, by 223%, 135.1%, 90.3% and 153.5% respectively, while exports from Albania increased by 27.6% only and the values of exports from Romania were reduced.

---

[3] See Cecchini et al. (1988).
[4] See Young, Mc Dermont and Dunlop (1991).

It seems though that the main motivating factors of the export boosting from CEEC were:

a. the overcapacity due to the economic depression in CEE, i.e. reduced domestic demand,

b. the reorientation of international trade of CEEC away from the former COMECON area and towards the EU, due, first to the political will and, second, to the collapse of the system of division of labour and exchange in the area, and

c. the gradual trade liberalisation between CEEC and EU.

On the contrary, there is no evidence that a relation between export growth and comparative advantages exists[5].

3. EU AND CEEC ECONOMIC INTEGRATION

The EU has put into effect a special regime[6] that regulates its relationships with the newly emerging markets of Central and Eastern Europe, namely Poland, the Czech Republic, Slovakia, Hungary, Romania, Bulgaria and Albania. This regime constitutes the basis of future entry of these countries in the EU and it consists of two actions. The first action is that of the "European Agreements", whose main provisions are:

– The gradual formation of a free trade area whose objective is its completion at the end of a ten-year period.

– The abolition of trade barriers by the EU, faster than the CEEC.

– The protection of a group of products. Agricultural products will be receiving a rather permanent protection, while for the so-called "sensitive" products, mainly ores and metals, textiles, clothing, leather, footwear and food processing products, protection will remain stable for some years[7]. Also special protection measures are allowed in cases of emergency.

– The gradual liberalisation in the services sector, the capital movement and public procurement. The CEEC are committed to adjusting their legal and institutional framework to the one that prevails in the EU.

– The development of co-operation between the two parties in a number of fields such as investment in manufacturing and agriculture, research and technology, banking, tourism etc. The EU will provide financial aid for such co-operative actions[8].

The second action is the "structural relationship" that provides a framework for discussion and exchange of ideas in a series of matters of mutual interest, specifically the common European economic policies, the common European foreign and defence policy, internal affairs and justice.

Trade liberalisation between EU and CEEC will definitely increase the volume of international trade and it will put into effect a process of specialisation according to comparative advantages that will further increase international trade. Given that EU trade barriers are being lifted more rapidly for CEEC products than those of CEEC for EU goods, exports from CEEC to EU are favoured more than exports in the opposite direction. It should be noted that the rather traditional "sensitive" sectors, where the CEEC has an overcapacity and previous

---

[5] See Hughes and Hare (1992), Rollo (1992) and Valden (1995).

[6] See Messerlin (1992), Rollo and Smith (1993) and Valden (1995).

[7] These products are here defined accordingly to the two-digit NACE classification.

[8] The PHARE project supports actions aiming at the restructuring of the economy in all sectors, the protection of employment and social security and the building of infrastructure. This project is supplemented by the JOPP project aiming at assisting the establishment of joint ventures between firms of both areas and the PHARE-INTERREG project for the development of the near border with the EU regions of CEEC.

experience in the Western market[9], with their advantage due to lower labour cost, are still protected. Furthermore, anti-dumping policies of the EU are further preventing import penetration.

4. FOREIGN DIRECT INVESTMENT (FDI) IN CEEC

Another outcome of integration between CEEC and EU is the stimulation of FDI. Such investment will aim at the establishment of export platforms both in labour intensive sectors and in industries characterised by mass production processes, taking advantage of wage differentials between the two areas, a qualified labour force and potential scale economies facilitated by the free trade between the EU and CEE. Furthermore, FDI oriented in the food industry may rise for exploiting agricultural raw products. Therefore, exports from CEE to EU will potentially grow.

However, there are certain obstacles to the rise of CEEC incoming FDI in the short and medium run period. Firstly, countries in CEEC have a weak institutional framework. As important institutions are currently being established and the political environment is still unstable, the political system cannot guarantee a predictable economic and legal framework with a strong and active role of government in guiding the economy. Besides, they experienced a major structural break and an exceptionally deep recession, so sources of supply for many goods and services complementary to final production, infrastructure and labour skills are not yet readily available and their future cost and availability is subject to high uncertainty.

Secondly, European multinational enterprises (MNEs) are competing more on the basis of superior quality and less on the basis of lower cost, so the push factors from competition for the relocation of production in low labour cost countries are weak. There is evidence that the most important incentive for investing in CEEC is the access to domestic markets and the expansion of business, with labour costs emerging as an incentive only if the host country offers an attractive local market. There are some differences in the degree of being motivated by low cost according to the nationality of the investor. German and Italian firms are more interested in low cost sourcing than others[10].

Besides, sectors like textiles, steel, chemicals, etc. are suffering from overcapacity in both EU and CEEC and they are protected. Hence, exports from CEEC are being prevented and therefore export-oriented FDI in the sectors where CEEC have current comparative advantages is discouraged.

It should also be noted that low wages per se do not present a decisive incentive even for international production intensive in unskilled labour. What really matters is the wage productivity ratio. The necessary condition for attracting low cost sourcing FDI is that productivity in CEEC would increase faster than wages, and that, in turn, is a function of the macroeconomic income and industrial policies of the host governments.

Host government policies are also related to export oriented FDI in another way. Export platform FDI is destined to countries offering local external scale economies. On the other hand, better technology and other infrastructure is associated with bigger markets and higher incomes[11]. In this way, FDI would increase along with the development process in the

---

[9] The products of the "sensitive" sectors namely iron and steel, chemicals, food and live animals, footwear, textiles and apparel accounted for 50.2% of total exports to EU countries in Bulgaria, 44.8% in former Czechoslovakia, 57.8% in Hungary, 43.8% in Poland and 32.6% in Romania in 1989. See Rollo and Smith (1993).

[10] See Meyer (1995).

[11] See Kravis and Lipsey (1982).

CEEC.

The development process has certain effects on the level and type of FDI that a country attracts. If it is accepted that development proceeds in stages[12], in the first stage a country has an advantage in agriculture and natural resources. FDI in resource exploitation is attracted. In the second stage of development, advantages are directed towards products of low cost and standardised technology. FDI is taking advantage of cheap labour in sectors of labour intensity and also in industries characterised by capital intensity, but on a rather medium scale of production, e.g. chemicals, iron and steel, shipbuilding, synthetic fibres, electrical appliances, etc. Production in these sectors is of standardised technology and the most important cost item is the labour cost. An export platform along with local market seeking FDI is expected in this stage. The third stage involves the growth of industries producing differentiated products and mass consumption durables, e.g. automobiles, electronics, etc. FDI is aiming at the establishment of a regionally integrated production and marketing network. Specific components or intermediate goods are produced in different locations according to the comparative advantages of each one. The most significant attraction for this type of FDI is an effective local infrastructure and production capability complementary to the competitive advantages exclusively possessed by MNEs. In the final stage, the country is transformed into a producer of information intensive goods and FDI is seeking local skills and technology capabilities that advance the competitive advantages of the parent companies.

In the context of the above-argued interrelationship between the development process and the FDI pattern, governments have to play an active role in pursuing certain aims and objectives. The types of activity that a country attracts depend on the specific indigenous capabilities and institutions it develops, and these in turn are partly affected by its national policies.

No doubt, though, can be cast upon the interaction between location advantages of individual countries and ownership advantages of MNEs[13]. The latter strengthen their specific advantages through strategies of international integration, and by drawing upon differentiated technological capabilities in a variety of countries. In turn, MNEs assign to their subsidiaries the role of World Product Mandate Subsidiaries[14]. The latter would allow much more entrepreneurial scope for management to work with local marketing, engineering and technological personnel for developing distinctive and innovative new products that can be sold throughout the MNEs' world-wide network.

From that point of view, host country governments should focus on the long-term environment rather than on short-term policy measures attracting and regulating FDI. That means that coherent development strategies are required, aiming at economic restructuring and at promoting activities in fields where the country enjoys its greatest technological and organisational innovative potential.

The CEEC are currently in the second stage of development and are about to enter the third one[15]. Initially, the FDI aims to seek low labour costs. Regional integrated FDI will come at a future phase. These types of FDI have certain implications for international trade. The fact that FDI is seeking low costs, as well as its promoting of exports, might also increase imports in two ways:

1. The parent company may export intermediate products to its subsidiary for further

---

[12] For a presentation on this argument, see Rostow (1959), Porter (1990) and Ozawa (1992).
[13] See Dunning (1988).
[14] See Bonin and Perron (1986).
[15] See Ozawa (1994).

processing.

2. The subsidiary may function as a sales agent for other products supplied by the parent company or other subsidiaries. Intra-firm trade and hence imports may be encouraged by the trade liberalisation between the EU and CEE. Besides, imports of capital goods and technology, as part of the FDI package, should also be taken into account.

Regionally integrated FDI, aiming at producing as effectively and competitively as possible a product or a component of a product or undertaking a production stage, promotes exports and imports in both home and host countries, so the net trade effect is difficult to be determined. Subsidiaries operating within a vertically integrated MNE are involved in intra-firm trade importing components produced in previous stages of production by other subsidiaries and exporting to another subsidiary which undertakes the next production stage or assembles and markets the final product. Subsidiaries, which are part of a horizontally integrated MNE, are specialised in some products within the industry exporting them, while some other varieties are imported, i.e. intra-industry trade. Nevertheless, the size of the host market influences the volume of subsidiary exports, since part of its output may be oriented towards the local market. The integration between the EU and CEE will further favour this type of investment and therefore the intra-firm and intra-industry trade will grow.

5. THE MODEL

We consider that FDI, as the vehicle of MNEs' international operations affects, among other factors the international trade position of host countries. Different types of FDI have different implications for import substitution and exports. So, FDI may be used as an independent variable in a model explaining the trade flows of host countries. The proposed model takes the form of the following three equations:

$$X= X(P, F, I) \hspace{4cm} \textbf{1}$$

$$M= M(P, F, I) \hspace{4cm} \textbf{2}$$

$$Y= Y(F, I) \hspace{4cm} \textbf{3}$$

where X= CEEC exports to the EU,

M= CEEC imports from the EU,

P= Relative price level, i.e. CEEC prices over EU prices (P is a proxy for relative competitiveness and includes exchange rate effects),

F= Foreign Direct Investment,

Y= Growth level of CEEC, and

I= Integration process between the EU and the CEEC. Tariffs and other non-tariff barriers are included.

Equations (1) and (2), apart from describing relations stated by traditional international trade theory, include as explanatory variables, integration and FDI, with the assumption of trade creation. Equation (3) represents the dynamic interaction between economic growth, FDI and integration.

By differentiating (1), (2) and (3), the following relations are reached:

$$Dx = X_P dP + X_F dF + X_I dI \hspace{3cm} \textbf{4}$$

$$dM = M_P dP + M_F dF + M_I dI \hspace{3cm} \textbf{5}$$

$$dY = Y_F dF + Y_I dI \hspace{3.5cm} \textbf{6}$$

By solving this system with respect to dI and dF, and then calculating DX/Di, dM/dI, dX/dF

and dM/dF, we have:

$$dX/dI = -A /(M_P Y_F) \qquad \textbf{7}$$

$$dM/dI = A /(X_P Y_F) \qquad \textbf{8}$$

$$dX/dF = -A /(M_P Y_I) \qquad \textbf{9}$$

$$dM/dF = A /(X_P Y_I) \qquad \textbf{10}$$

$$\text{where } A = X_P(M_F Y_I - Y_F M_I) - M_P(X_F Y_I - X_I Y_F) \qquad \textbf{11}$$

From trade theory it is known that $X_P < 0$ and $M_P > 0$.

In order for the integration process to achieve export and import creating effects, i.e. $dX/dI > 0$ and $dM/dI > 0$, the following necessary conditions, which also represent three possible alternative scenarios, are required:

a. $Y_F > 0$, $Y_I < 0$, $M_F > 0$, $X_F > 0$. Growth is positively related with FDI and negatively with integration. FDI is both export and import creating.

or

b. $Y_F < 0$, $Y_I > 0$, $X_F > 0$, $M_F > 0$. Growth is negatively related with FDI and positively with the integration process. FDI is again both export and import creating.

or

c. $Y_F > 0$, $Y_I > 0$, $X_F < 0$, $M_F < 0$. Growth is positively related with both FDI and integration. FDI is import-substituting but export-reducing.

From the above scenarios, we note that the opportunity cost of having a trade-creating integration process and a trade-creating FDI has some adverse effects on growth, either by FDI or integration. On the other hand, if we accept a trade creating integration process together with a trade reducing FDI, then growth is positively affected by both FDI and integration.

6. CONCLUSION

The international trade between the CEEC and the EU is expected to grow in volume due to the process of integration between the two areas. Exports from CEEC will face some difficulties, partly because of enhanced competitiveness of EU firms, as a result of further European integration, and partly because of the preservation of protection in the so-called "sensitive" sectors and agriculture. Exports, though, will receive support from export platform FDI that is anticipated to be located in CEEC, subject to lower labour costs and the gradual liberalisation of trade between the latter and the EU. Such exports are more plausibly expected in labour intensive and scale intensive industries, but of standardised technology. On the other hand, imports will be encouraged from the heavy requirements in capital goods and technology because of the restructuring process underway in CEEC and the expected rise in FDI.

The restructuring of the economy will certainly widen the productive base of CEE economies and enhance their competitiveness, so eventually exports will be favoured. But incomes will also rise, driving up real wages. Hence, imports will increase and low labor costs as well as comparative advantages will deteriorate. That will reduce the incentive for export platform FDI and therefore exports.

To the extent that economic and development policies will succeed in creating infrastructure, labour and technology skills, supply sources of adequate quantity and quality (at reasonable

cost) and regionally integrated FDI will take place, encouraged also by further integration between the EU and CEE and the proximity of the markets. Such types of investment will give rise to intra-firm and intra-industry international trade. In this context the trade balance is difficult to be predicted.

REFERENCES

BAKHOVEN A.F., "An Alternative Assessment of Macroeconomic Effects of "Europe 1992", in H. Siebert, (ed.), *The Completion of the Internal Market. Symposium 1989,* Tubingen: Mohr, 1990, 24-44.

BONIN B. and PERRON B., "World Products Mandates and Firms Operating In Quebec", in H. Etemad and L. Seguin Dulude, (eds.), *Managing the Multinational Subsidiary,* London: Groomhelm, 1986.

CECCHINI P. et al., *The European Challenge 1992-The Benefits of a Single Market,* Aldershot: Wildwood House, 1988.

COMMISSION OF THE EUROPEAN COMMUNITIES, "The Economics of 1992. An Assessment of the Potential Economic Effects of Completing the Internal Market of the European Community", *European Economy, 35,* March 1988.

DUNNING J.H., "The Eclectic Paradigm of International Production: an Update and Some Possible Extensions", *Journal of International Business Studies,* 19, 1988, 1-31.

HUGHES G. and HARE P., "Trade Policy and Restructuring in Eastern Europe", in J. Flemming and J. Rollo, (eds.), *Trade, Payments and Adjustments in Central and Eastern Europe,* RIIA, 1992.

KRAVIS I.B. and LIPSEY R.E., "The Location of Overseas Production for Exports by US Multinational Firms", *Journal of International Economics,* 12, 1982, 201-223.

MESSERLIN P., "The Association Agreements Between The EC and Central Europe: Trade Liberalisation vs. Constitutional Failure", in J. Flemming and J. Rollo, (eds.), *Trade, Payments and Adjustments in Central and Eastern Europe,* RIIA, 1992.

MEYER K., "Factor Cost Oriented Direct Foreign Investment: East Asia Versus Eastern Europe", in R. Schiattarela, (ed.), *New Challenges for European and International Business,* ROME: European International Business Academy, 21st Annual Conference Proceedings, 1995.

OZAWA T., "Foreign Direct Investment and Economic Development", *Transnational Corporations*, vol. 1, no. 1, 1992, 27-54.

OZAWA T., "Japanese MNCs as Potential Partners in Eastern Europe's Economic Reconstruction", in P. Buckley and P. Ghauri, (eds.), *The Economics of Change in East and Central Europe,* New York: Academic Press, 1994.

PORTER M., *The Competitive Advantage of Nations,* New York: Free Press, 1990.

ROLLO J., *The Association Agreements Between The EC and Central Europe: A Half Empty Glass?,* mimeo, RIIA, 1992.

ROLLO J. and SMITH A., "The Political Economy of Eastern European Trade with the European Community: Why so Sensitive?", *Economic Policy: A European Forum,* 8(1), April 1993, 139-181.

ROSTOW W., *The Stages of Economic Growth,* London: McMillan, 1959.

VALDEN S., "The European Union and Central and Eastern Europe", in N. Maraveyas and M. Tsinissiselis, (eds.), *The Integration of the European Union,* Athens: Themelio, 1995, 567-615.

YOUNG S., MC DERMOT M. and DUNLOP S., "The Challenge of the Single Market", in B. Burgenmeier and J. Mucchielli, (eds.), *Multinationals and Europe: Strategies for Future,* London: Routledge, 1991, 3-21.