On 25th February 2014 my friends and colleagues of the Faculty of Law and Political Sciences at Széchenyi István University humbled me with an invitation to address the audience of the Winter Seminar 2014 bearing the subtitle Law, Politics, Economy and Society of the Central and Eastern European Countries. The paper below is an epitome of my contribution on the economic trends of the CEE (Central Eastern Europe) region at the auspicious event.

1. COMMON CHARACTERISTICS OF THE CEE COUNTRIES

Prior to the crisis the CEE countries were among the fastest growing countries in the world. From 2000 to 2008 with the annual GDP growth rate of 4.8% the region was only surpassed by China and India (with 10 and 5.6 percent growth rates respectively) and it outstripped the performance of the developing Asian, Latin American and advanced Asian countries as well as that of the EU and the United States.\(^1\)

The small and open CEE economies were heavily dependent on FDI and exports, which made them highly sensitive to changes in the advanced world, primarily to those coming about in the EU. In a PWC analysis titled “Foreign Direct Investment in Central and Eastern Europe” the period 2003-2008 is described as the 21st century gold rush. FDI of the region rose from US$20 billion in 1997 to US$30 billion in 2003. From this base, however, inflows leaped more than five-fold in five years, reaching US$155 billion in 2008, which rounded up to almost ten (9.1) percent of the then global FDI inflows.\(^2\) Bulgaria, Croatia, Estonia, Latvia and Slovenia had not attracted large amounts of FDI prior to 2003 but saw inflows rise markedly from 2004. The Czech Republic, Poland and Hungary have been major regional destinations for FDI inflows since the mid-1990s. These countries also saw FDI rise from 2003, although by a proportionately smaller amount than many of the other nations in the region.\(^3\)

In an empirical analysis on FDI in the EU and the CEE countries published in 1998, Paul Brenton and Francesca Di Mauro\(^4\) observed complementarity between FDI and both exports and imports. The authors have found that FDI enhances the commercial presence of source country firms in the host country. The transfer of source country technology, the presence of source country nationals in the host country, the participation of host country nationals in training courses etc. in the source country, all serve to foster close commercial links that may affect trade in both directions.

The latter very much describes the nature of the relationship among the EU-15 and the new EU members. FDI-flows to the Central and Eastern European Countries have significantly grown in the beginning of the mid-nineties. From being “virtually residual” they reached a level of 40 % of the local GDP in Eastern Europe by 2004. Firms from the EU-15 states were main investors (77.5 % in 2004), followed by US and Swiss firms. Despite the growing FDI-flows towards the New Member States, their share of the EU-15 outflows only amounted 4 % in 2004. Thus, the EU-15 remained with a share of 53 %

from all FDI-outflows the most important destination for EU-15 FDI outflow activities, followed by the USA (12 %).5

UNCTAD’s 2004 World Investment Report predicted the new EU members, due to the combination of relatively low wages, low corporate tax rates and access to EU subsidies enhanced by a favourable investment climate, a highly skilled workforce and free access to the rest of the EU market, to be attractive locations for FDI both from other EU economies and from third countries. The same WIR issue noted however that the potential rise of CEE countries as FDI destinations did not jeopardise the position of the EU-15 as FDI hosts, in fact, eight CEE countries (the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia) saw a fall in their FDI-inflows one year prior to their EU-accession.6

WIR 2004 also expected the CEE and Asian countries, especially Poland, China, India and Thailand, to be major recipients of FDI in the following years. There is a huge difference between FDI-inflows to CEE and to ASEAN countries though. While between 1995-2005 emerging East Asian economies attracted 13.9 percent of their FDI-inflows from the United States with further 14.7% from the EU, 10.5% from Japan, 34.9% from Asian NIEs (Hong Kong, South Korea, Singapore, Taipei) and 3.1% from the ASEAN countries7, FDI source regions for the new EU countries remained extremely highly concentrated. In 2006 the EU-15 countries held the highest share of productive capacity owned by foreigners in CEE countries, whereas the USA and its many international corporations contributed a great deal of foreign stock to this region.

Thailand attracted 10.5, 10.5, 25.1, 27.6 and 0.9 percent of its foreign capital stocks from the US, EU, Japan, Asian NIEs and other ASEAN countries respectively between 1995-2005, whereas EU-15 economies held 74% of productive capacity owned by foreigners in Poland, while the USA and other international corporations contributed to further 13% and 6% to foreign stock in the Polish economy.8

The 2008 crisis and the following global economic downturn massively hit all foreign capital reliant emerging regions of the world, yet, CEE countries were double-smitten due to their asymmetric interdependence with the EU-15, which was exasperated by the sovereign debt crises of a number of European economies.

In a 2012, entry on the Visegrád countries Radomír Špok assessed the effects of the 2008 crises on the small, open, and primarily Germany-dependent economies of the Check Republic, Hungary, Poland and Slovakia. Spok shared the views in the publications of the World Bank (2009), UNCTAD (2013) and McKinsey (2013).9 He argues that the geographical composition of the foreign trade of the V4 economies clearly shows a collective dependence on Germany, as approximately one-fifth of the Slovakian, one-fourth of the Hungarian and Polish, along with one-third of the Check exports are directed to Germany. Italy, Austria and France are similarly important importers for V4 products. A decrease in the German demand automatically causes declines in the GDPs of the Central and Eastern European countries. A further common feature is a strong reliance on imports for mineral fuels, especially from Russia. The latter combined with the import of Chinese manufactured goods deteriorates the positive trade balances of the V4 countries maintained with the EU-15. Geographical proximity and the availability of arm’s-length suppliers have always played a crucial role in the internationalisation of business activities. While 80 percent of the world trade is in fact movement of goods and services within global value chains coordinated by transnational corporations10, the results of UNCTAD’s World Investment Prospects Survey (WIPS) 2007-2009 show a high concentration of TNCs in their respective home regions. For instance, companies from European countries are more present in other European countries than are other companies. Similarly, North American companies are better
represented in North America (through cross-border investments between the United States and Canada) than their European and Asian counterparts.11

In his revealing Harvard Business Review article of 2001 entitled “Distance Still Matters: The Hard Reality of Global Expansion”, Pankaj Ghemawat conceived the CAGE-theorem, which explains the relevance of cultural, administrative, geographic and administrative distances when it comes to the evaluation of foreign markets.12

The relevance of the above listed types of closeness is undeniable, yet, while in the above quoted 2007-2009 WIPS issue the new EU-12 countries are ranked as FDI host economies right after North America, the EU-15 and South, East and South-East Asia in the most recent 2013-2015 edition the new EU-12 countries are only positioned on the eighth place after East Asia, the US and Canada, the EU-15, the ASEAN (South-East Asia), other developed countries (Australia, Israel, Japan and New Zealand) and Latin America and the Caribbean.13 Whereas Asia seems to uphold and further improve its reputation regarding its foreign direct investment attractiveness both for Asian and non-Asian investors, Central and Eastern Europe is losing momentum and is for the most part merely appealing for EU-15 transnational corporations.

The asymmetric EU-15 dependency of the new EU countries is not only expressed in their trade balances and FDI figures, it is further aggravated by its sectoral composition. While the majority (60%) of the FDI targets the service sectors of the new EU countries, the bulk of the manufacturing investments (30%) land in the Central and Eastern European automobile cluster. Nearly two-thirds of automotive exports go to EU-15 markets and 60 percent of these sales are concentrated in Germany, the United Kingdom and France. A growing network of parts suppliers in the CEE also feeds Western European auto plants, particularly in Germany.14

The studies carried out by Ernst & Young (E&Y) in 2010 and 2013 reinforce the latter findings. The previous study on after-crisis performance of the automotive sector notes that Europe’s industry was less affected by the economic downturn than that of Japan or the United States. The report underlines however the differences between Western and Eastern Europe and the further dissimilarities among the second group. E&Y classifies the Eastern European car industry in accordance with the markets that the producers target. In this sense the CEE countries, especially the Czech Republic, Slovakia and Hungary share common characteristics.

The automotive plants in the Czech Republic and Slovakia operate almost entirely independently of the local market, relying on strong demand in the destination countries in Western Europe. Hungary is also becoming a significant net exporter, with production running at more than twice domestic sales, and that will increase with the Mercedes-Benz plant which came on-line in 2012. Most of the plants in these three countries have been less affected by the crisis than those in Western Europe. The vehicles produced in CEE are mainly small cars — a segment that across Europe has not shrunk in the downturn due to the high customer incentives provided by the different scrappage programs of many European Governments. Many of these plants belong to brands growing in the European market as a whole and these new plants are among the most efficient ones in Europe. Poland suffered a 21% production loss just after the crisis in 2009 as its industry is dependent on both, local demand and export markets. (Romania and Turkey share fairly similar characteristics.)15

In the European Automotive Survey 2013 E&Y interviewed 300 continental carmakers and delivered intelligence on the operation as well as the jobs creation in the region. Their major findings are as follows:

a) Auto industry managers in Eastern Europe, France, Germany and the UK in particular look to the future with optimism. In Italy, by contrast, every third respondent anticipates a deterioration in their own business situation;

b) growth in small cars segment: 52% of respondents expect healthy growth rates in the low-price segment;

c) 42% of companies plan to step up investment in Eastern Europe; in Western Europe, the corresponding figure is only 30%;

14 Labaye et al.: op. cit. 17.
in the automobile industry considerably more European companies intend to create jobs (28%) than to cut them (11%). In Europe, by contrast, employment is likely to stagnate at best: one in five companies intends to create jobs and the same number plans to reduce headcount.\textsuperscript{16}

The above quoted survey also polled the 300 car makers on their opinions about productivity in the automotive sector and found that between 2011-2013 the hubs of the Czech Republic, Poland, Slovakia and Hungary demonstrated productivity growths of 7.7 and 1.1 percent respectively but did not further search for the interconnections of FDI and productivity changes.

A 2009 study of the European Central Bank confirmed however that FDI in the CEE countries not only contributes to export, GDP and employment growth, but, especially in the above detailed manufacturing sector, it further results in massive productivity gains. “At the broad sectoral level manufacturing has been the main driver of productivity convergence, whereas gains in services have been less pronounced. Despite this catching-up process, however, a marked gap vis-à-vis the rest of the EU remains. Productivity gains have been accompanied by substantial inflows of FDI, particularly to financial and business-related services and, to a lesser extent, to industry. These general trends, however, mask important differences at the country and industry level. The empirical results point to three main conclusions which seem to be robust to a variety of tests. First, there is a strong convergence effect in productivity both at the country and at the industry level, i.e. productivity growth depends positively on its gap vis-à-vis the euro area. At the country level, this effect is highly pronounced in the Baltic region. At the industry level, the convergence effect is particularly strong in the manufacturing sector. Second, foreign capital in the form of FDI inflows plays an important role in accounting for productivity growth in the CEE region. Third, the impact of FDI on productivity critically depends on the absorptive capacity. More specifically, the effect of FDI on productivity seems to be increasing with a declining productivity differential vis-à-vis the euro area. There is also evidence that the level of human capital is positively associated with a larger impact of FDI. The former type of interaction between absorptive capacity and the beneficial impact from FDI seems to be important in manufacturing, whereas the latter one is more significant in services.\textsuperscript{17}

The latter findings on the decreasing productivity gaps and increasing levels of human capital as preconditions for productivity growth generated by FDI resonate with Pankaj Ghemawat’s theory on the importance of physical, administrative, cultural and economic closeness very well.

The employment contribution of the multinationals operating in the CEE region has to be further recognised. (In 2011, 1.6 million employees of the total Hungarian employment of 3,856,000\textsuperscript{18} filled in private sector vacancies with 413,000 jobs created by partly of fully foreign owned enterprises, thus, multinationals contribute to approximately 10 percent of the total Hungarian employment, whereas they give one-quarter of the private sector openings. It is further relevant to note that the average number of employees at nationally owned enterprises was three in 2009 as opposed to 32 at multinationals.)

The 2009 research titled “Employment impact of relocation of multinational companies across the EU” conducted by EUROFUND delivered significant lessons for the CEE countries: “Companies originating from their major source of FDI, Germany weathered the crisis reasonably successfully and maintained overall employment levels, albeit with much restructuring within countries and some shifts of activities between countries. Most of the multinational companies included in the study have shifted at least part of their production out of the EU-15 into the new Member States in order to contain or reduce production costs. European multinational companies seem reluctant to make themselves ‘stateless’ and truly ‘global’; most of these companies tend to retain both a strong presence in their ‘mother’ country, in particular in respect of design and development work, and general administration and marketing. This, however, may equally be true of Japanese or US companies, which feature in the case studies from a foreign market perspective rather than from a domestic market one. In other words, a similar study carried out, for example, in the US might come to a similar conclusion about US companies. The capacity of the new Member States to take advantage of their new competitive advantage appears to vary between them, ranging from the Czech Republic, where labour skills, discipline and the quality of infrastructure seem to be important, to Bulgaria and Romania, where low wages are currently the dominant factor. The question is whether companies in these countries which have recently

undergone a transition from centrally planned to market economies can also make the transition to locations where their competitive advantage does not reside in low costs alone.”

2. CHALLENGES TO FDI ATTRACTION AND GROWTH

The FDI contribution index, created by UNCTAD, aims to measure the development impact or the significance of FDI in a host economy. It looks at the contribution of foreign affiliates to

1. GDP (value added),
2. employment,
3. wages and salaries,
4. exports,
5. R&D expenditures,
6. capital formation and
7. tax payments, as a share of the host-country total (e.g. employment by foreign affiliates as a percentage of total employment).

These seven variables are among those recommended by the Manual on Statistics of International Trade in Services (2010) for inclusion in the collection of foreign affiliate statistics. A number of these variables are also proposed by the G-20 in its work on indicators for measuring and maximizing economic value added and job creation arising from private sector investment in value chains.

According to the World Investment Report (WIR) 2012, the significance of foreign direct investments was the highest in Hungary, followed by Belgium and the Czech Republic and in the same group with Estonia, Switzerland, Ireland, Hong Kong, Panama, Singapore and Sweden. To generate growth in these FDI-reliant countries it is crucial to identify the incentives of capital attraction. The same WIR 2012 issue sums up the most relevant FDI determinants as follows:

1. Market attractiveness (size of the market, spending power, growth potential power of the market)
2. Availability of low-cost labour and skills (unit labour cost, size of manufacturing labour force)
3. Presence of natural resources (exploitation of resources, agricultural potential)
4. Enabling infrastructure (transport, energy, telecommunication).

In the previously quoted 2013 December study of McKinsey entitled “A new dawn: Reigniting growth in Central and Eastern Europe”, the research institute suggest a growth model for the region that further capitalises on the (manufacturing) export driven capabilities and uncovers further potentials in the sectors of agriculture, construction, retail, transportation and network industries. The document acknowledges, however, that the suggested development may only take place if national investments in infrastructure policies enabling urbanisation and investments in workforce quality create a strong foundation (precondition) for the much desired economic growth.

In the research entitled “Factoral impacts on regional development in Hungary” Csaba Hahn outlines that “accessibility” of the closeness of transport infrastructure (motorways) and the presence of foreign direct investors have a major impact on the economic, social and complex development of regions. The imminence of motorways has a positive impact on the income levels of regions, the overall economic indicators are influenced positively, whereas unemployment drops. Hahn further underscores the linkage between transport infrastructure and urbanisation: motorway constructions have an even more upgrading effect on the economy in more urbanised areas.

He further notes that economic development is strongly influenced by the educational background of the inhabitants, emphasizes however that FDI is very unlikely to have a balancing effect on regional

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development as location choices (primarily in the automobile sector) have already been made and reinvested earnings contribute to the enhanced development of the regions previously preferred by foreign investors. The study also implies that public subsidies spent on regional development have a positive impact on the infrastructural improvement of regions; however, they have little or no influence on the social or economic development.

Infrastructure and skilled labour force as FDI attraction incentives thus generators of economic stimulus are by no means Hungary- or CEE-specific determinants. In a 2009 Canadian article that examined the efficiency of government spending on infrastructure, the author came up with the conclusion that shortages in skilled labour may constrain the outcomes of infrastructural investments.\(^2\)

The latter statement is confirmed by a 2013 release of the Canadian Chamber of Commerce (CCC) published on the Top 10 barriers to competitiveness, identifying inadequate infrastructure planning and a shortage of skilled labour as two of the biggest impediment to Canadian competitiveness in the global economy. In 2011, OECD called Canada the most educated country in the world. But this CCC report claims education isn’t providing the opportunities it should.\(^2\)

Further extensive literature, from Chile to Myanmar, is available on the magnitude of the absence of skilled labour force being the most immediate hurdle to industry and economic growth.

In a 2009 publication entitled “CEE’s dwindling skilled labour supply: the vagaries of unfavourable demographics”, Rohit Das and Esha Mendiratta analyse Russia, the Czech Republic, Hungary and Poland as potential offshoring locations. Due to an expected drop in skilled labour force, the authors depict a rather gloomy picture of these countries as potential FDI hosts. While skilled labour supply is calculated to grow from 33 million to 35.4 million in Russia and from 3 million to 5.8 million in Poland between 2005 and 2050, it is expected to drop from 676,000 to 633,000 in the Czech Republic and from 805,000 to 700,000 in Hungary in the same period of time.\(^2\)

The general problem of unemployment, especially that of youth joblessness and the relevance of employment creation by transnational enterprises has been addressed the author’s previous 2013 publication issued in the Jubilee Volume of the Doctoral School of Law and Political Sciences. The article focused on the importance of the growth of foreign investments, thus exports in the CEE countries as highly indebted nation states and leveraged households economic have been in desperate need for capital underpinning the economic growth and the improvement of employment levels after the 2008 and the 2010 European sovereign crisis.\(^2\)

In the aftermaths of the financial and economic downturns reluctance as common sentiment ruled both investors and analysts, and a great number of publications cautioned about the fact that cash holdings of the greatest global and European multinational enterprises would not translate into investments. The current problem seems to be aggravated by the capital attraction incapability of FDI host economies, which, as discussed above, is rooted in the insufficient supply of skilled labour force.

An EU labour force survey published in 2013 concludes that vocational education and training are able to speed up young adults’ transition from education to the world of work, relative to general education graduates students entering the labour market with vocational education and training benefit from a faster transition to work are more likely to have a permanent first job and are less likely to find a first job with a qualification mismatch.\(^2\)

It becomes more and more evident that both at the levels of secondary and higher education vocationally equipped graduates enjoy a privileged entrance to the labour market. As a result of the widely successful apprentice programmes, Germany and Austria demonstrate historically low youth unemployment levels. In other EU countries, outstandingly in the EU-15 reliant CEE economies,


vocational education and the generation of adequate skills rises the massive question of the financing of education.

According to the Central Statistical Bureau of Hungary, in 2013, the share of non-state financed secondary schools and institutions of higher learning was 48 percent, whereas only 23 percent of the teachers/instructors/professors were employed by non-state owned educational establishments. While half of the state-run educational budget is being spent on payrolls, again, it is difficult to conceive a change in the educational structure without the active involvement of private businesses.\textsuperscript{27} The main question and the topic of a future investigation is whether European companies are willing to invest in the education of employable workforce in Central and Eastern Europe or is it more likely that they are inclined to relocate their operations to places where the abundance of skilled labour is no stumbling block.

3. **SUMMARY**

The paper above on the economic trends of the CEE countries is divided into two major parts. The first section of the writing assesses the common characteristics of the CEE countries, which delivers a general positive image of the region with its open economies, FDI attraction capabilities, integration to global, or primarily European, (manufacturing) value chains, increasing productivity figures and its vital closeness to the main EU-15 investors and trade partners.

The second half of the essay concentrates on the FDI-attraction barriers. As all of the CEE countries and the majority of the emerging markets are externally capitalised economies the factors of the end use (consumption, investments, exports) or on the demand side of the economy largely depend on foreign investors or the capital attraction capability of the countries.

Admitting that the CEE region offers an optimistic overall picture, it still needs to be underlined that without further improvements in infrastructure and a profound educational reform targeting all levels of learning as well as the financial architecture of education, long term competitiveness is difficult to foresee.