

# **OUTWARD FDI FROM NEW EUROPEAN UNION MEMBER STATES**

(first draft)

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**November 15, 2006**

## **1. Introduction**

One of the main characteristics of transition economies (TEs) was their modest integration with the world economy. The deregulation, privatisation and liberalisation that accompanied transition have sped up the internationalisation process, with the initial wave of inward internationalisation being faster and greater in volume than outward internationalisation. In spite of the rapid development of outward investing at the end of the 1990s the process led to large differences among transition countries and in many of them the potential of internationalisation has not yet been fully exploited.<sup>1</sup> The new transition EU members are, apart from Russia, the main outward investors among TEs.

Outward foreign direct investment (FDI) from TEs has, with few exceptions,<sup>2</sup> for a long time been a totally ignored topic partly because it is marginal in terms of its share in world outward FDI or even at the EU level. However, the growth rates clearly indicate that the internationalisation of new European member states (NMSs) is developing very fast. The growth rates of outward FDI made by these countries are the fastest, even when compared to those made by emerging economies.

The objective of this paper is to fill in some gaps in the literature in this area by updating some previous research in the field and introducing some new aspects. It overviews the development of outward FDI in NMSs, particularly those from TEs, and their major characteristics and implications. In most of the analytical parts evaluating the motives and effects we mostly concentrate on just 5 TE NMSs due to a lack of data on Latvia, Lithuania and Slovakia. Up-to-date macro data will be evaluated, while analytical data based on questionnaires stems from research conducted in 2001.

The paper is organised as follows. The next section evaluates the relative importance of outward FDI from NMSs and the geographical allocation. Section 3 concentrates on trends including the evaluation of the IDP pattern of outward FDI. Section 4 moves on to identify the major competitive advantages and investors' strategies. In Section 5 we provide an evaluation of outward FDI performance. Section 6 discusses specific issues like the role of SMEs in internationalisation, indirect investment and compares the results of investors with those of exporters and non-investors. The paper concludes with some general conclusions and policy recommendations.

## **2. Relative importance of outward FDI from NMSs**

The shares of FDI from NMSs are gradually rising but are still marginal compared to incumbent EU members. The share of NMSs in the outward FDI stock of the EU-25 increased from 0.1% in 1990 to 0.19% in 2004. The outward FDI stock of NMSs grew 21-fold in the

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<sup>1</sup> See WIR estimations on potential and actual/real FDI indexes (UNCTAD, 2003-2006).

<sup>2</sup> See, for instance, Macmillan, 1987; Hamilton, 1986, Jaklič and Svetličič, 2003 and Svetličič and Rojec 2003.

1990-2004 period, and 3.3-fold since 2000. The relative importance of Cyprus and Malta in such inward and outward FDI stock within the group of NMSs is smaller when it comes to inward FDI and quite important in the case of outward FDI. In the case of inward FDI flows account for 0.8% and 5% in terms of inward stocks. The role is much greater when it comes to outward FDI (mostly financial investment) where shares within NMSs are 18.2% (flows) and 16.6% in the case of stock (2004). NMSs have a determining influence on the overall performance of both inward and outward FDI positions but exert less of an influence when it comes to outward FDI.

## 2.1. Major FDI indicators

In the pre-transition period and even upon starting the transition in 1990 NMSs were almost not present on the map of FDI. Today they constitute a modest part of global trends. Inward FDI, as theory predicts, are much more important (12.4 times) compared to outward FDI stock. However, their growth rates are very high, in some of them even higher than inward FDI, which indicates that some balancing in the long term can happen. The higher growth rates of the outward FDI of NMSs seems to be a manifestation of the stronger impact of external globalisation factors (this is not the case for the early comers to internationalisation from OECD countries but it is for emerging countries) and small-market push factors. Namely, with the exception of Poland, all NMSs are small countries. Internal push factors also included a quite sudden change to the system and consequently opened doors for outward FDI which was previously mostly not allowed at all. In the case of the OECD, investors foreign developments have been much more gradual.

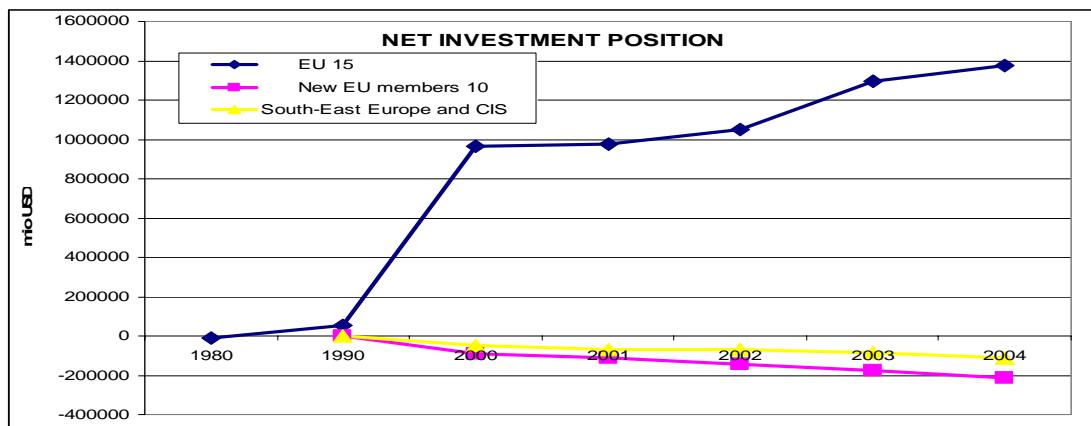
Table 1: NMSs' FDI stocks and flows compared to the EU-15 (USD million)

		1980	1990	2000	2001	2002	2003	2004
EU-25	FDI inflows	21,484.7	97,758.9	696,294.9	382,620.3	420433	338678.3	216439.5
	FDI inward stock	223941.6	753706.6	2174834	2379225	2811543	3606924	4023935
	FDI outflows	23874.9	130746.7	813413.3	433927.3	384549.2	372400.2	279829.8
	FDI outward stock	212572	805851.5	3046301	3245550	3715099	4726873	5189738
EU-15	FDI inflows	21362.1	96709.2	674484.8	363051.1	397144.8	326611.3	196098.7
	FDI inward stock	225272.9	751255.6	2077108	2261471	2657380	3416864	3794201
	FDI outflows	23853.9	130701	812370.2	432807.3	383071.6	369098.9	276330
	FDI outward stock	212260.3	804980.5	3040879	3238648	3705674	4712965	5171384
New EU members 10	FDI inflows	122.6	1049.8	21810.1	19569.2	23288.2	12067	20340.8
	FDI inward stock	***	2450.9	97725.9	117753.5	154163.4	190059.4	229733.6
	FDI outflows	21	45,6	1043,2	1120,1	1477,6	3301,3	3499,8
	FDI outward stock	311.6	870.9	5422.1	6902.2	9425.2	13908.6	18353.9

Source: based on UNCTAD 2006.

In spite of the relatively rapid growth of outward FDI by firms from NMSs and the relatively higher importance of inward FDI, their net investment position is still moving downwards while incumbent members of the EU are investing abroad much more than they are hosting foreign investment at home.

Figure 1: Net investment position



Source: UNCTAD 2006, own calculations.

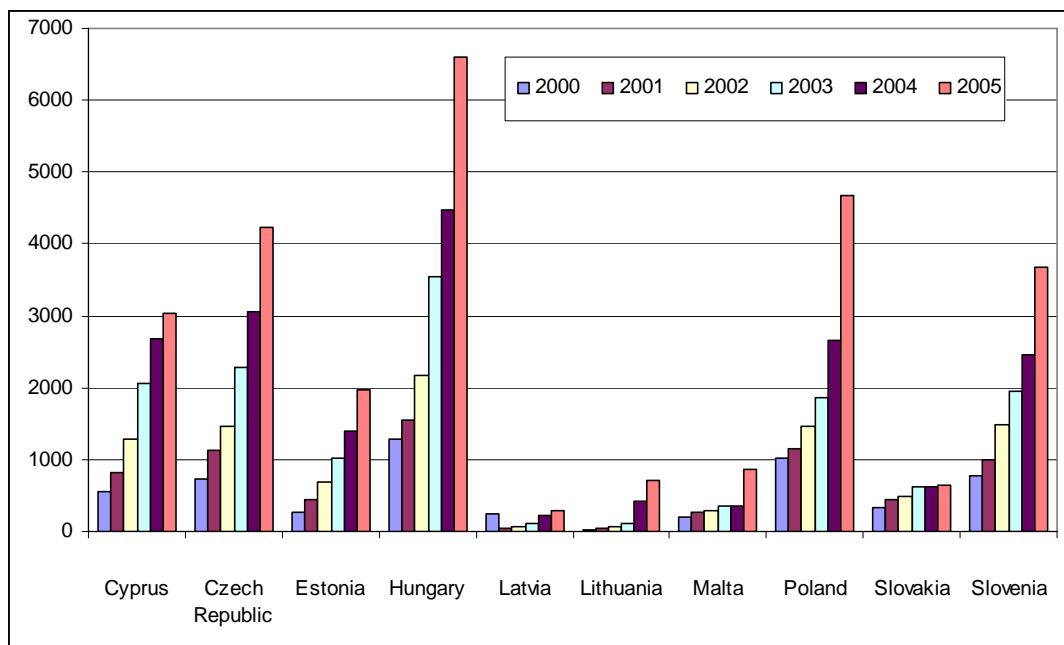
Table 2: Growth rates of outward FDI stock in percent

	2001	2002	2003	2004	2005
EU-15	6.5	14.4	27.2	9.7	
New EU members 10	27.3	36.6	47.6	32.0	
South-east Europe and CIS	55.9	69.2	31.4	12.8	
Cyprus	44.5	57.9	60.7	30.7	13.2
Czech Republic	53.9	29.7	55.0	34.0	38.5
Estonia	70.5	53.0	51.0	36.9	40.8
Hungary	21.6	39.2	63.3	26.4	47.7
Latvia	-81.8	45.5	65.6	113.2	30.1
Lithuania	63.3	24.3	101.1	253.4	67.4
Malta	28.6	6.8	26.5	2.5	137.6
Poland	13.6	26.0	27.3	43.5	75.5
Slovakia	37.1	8.9	29.2	-1.5	3.2
Slovenia	30.7	48.0	31.4	25.5	49.8

Source: own calculations, based on UNCTAD 2006.

Four trends are obvious. The first is that the growth rates of NMSs are on average more than 3 times greater than those of the EU-15. The second is that small NMSs are moving faster. Poland as the only large country among them has recently been catching up. The fourth is that outward FDI flows are still oscillating but stock is constantly growing as is their role as a share of GDP.

Figure 2: Outward FDI stocks by NMSS in EUR million



Source: UNCTAD 2006, own calculations.

Outward FDI flows have only really picked up in the last 2-3 years in almost all countries, particularly Poland and Lithuania (from very low levels) and the Czech Rep. while in Hungary they have been oscillating up and down in the last 3 years. The least developed among them – Lithuania and Latvia – are the only ones to substantially lag behind in terms of growth and volume but less so in terms of the share of outward FDI in GDP. With the exception of Latvia and Slovakia, the importance of outward FDI in GDP is growing substantially, particularly in non-transition NMSs, Cyprus and Malta but also Estonia, Slovenia and Hungary. The top three ranking countries mainly invest abroad in financial services<sup>3</sup> and therefore do not have such a strong real-sector restructuring impact. Second, small countries are investing abroad more than larger members.

Table 3: Outward FDI stocks as a percentage of GDP

	2000	2001	2002	2003	2004	2005
Cyprus	6.4	8.9	12.7	16.0	17.4	18.2
Czech Republic	1.3	1.9	2.0	2.5	2.9	3.4
Estonia	5.0	7.9	10.4	12.4	12.5	15.0
Hungary	2.7	3.0	3.3	4.3	4.5	6.0
Latvia	3.4	0.6	0.8	1.0	1.7	1.8
Lithuania	0.3	0.4	0.4	0.7	1.9	2.8
Malta	5.7	7.2	7.2	7.6	6.7	15.8
Poland	0.6	0.6	0.8	0.9	1.1	1.6
Slovakia	1.6	2.1	2.0	1.9	1.5	1.2
Slovenia	4.0	5.1	6.8	7.1	7.5	10.6

<sup>3</sup> In Estonia outflows are (similarly as inflows) concentrated in the tertiary sector, particularly in finance, transport, storage and communications. These two industries account for 61% of outward stock (and 47% of FDI inward stock). Foreign banks are the most important investors abroad.

Source: based on UNCTAD 2006.

Although outward FDI is still relatively modest it is nevertheless also playing an increasingly important role in gross fixed capital formation (GFCF); Malta is the only exception here although it experiences strong oscillations. However, their role is still lagging well behind their role in GFCF in the case of the EU-15.

Table 4: FDI outflows as a percentage of GFCF

	1990	2000	2001	2002	2003	2004	2005
Cyprus	0.3	11.0	15.9	24.7	24.3	49.8	31.0
Czech Republic		0.3	1.0	1.1	0.9	3.5	2.7
Estonia		4.8	13.5	7.1	5.9	8.4	16.7
Hungary	0.2	5.5	3.0	1.9	8.9	4.9	5.3
Latvia		0.2	5.5	3.0	1.9	2.7	3.0
Lithuania		0.2	0.3	0.6	0.9	5.4	5.8
Malta		2.8	2.6	-1.1	56.6	n.a.	-2.2
Poland	0.0	0.0	-0.2	0.6	0.8	1.8	2.7
Slovakia		0.4	0.6	0.1	0.3	-1.4	1.3
Slovenia		1.3	3.1	3.1	7.2	7.0	6.7
EU-25	8.2	47.5	25.7	21.8	25.3		
EU-15	8.4	49.9	27.0	22.9	26.2		
New EU members 10	0.13	1.25	1.29	1.61	3.00		

Source: based on UNCTAD 2006.

The underlying issue when looking at the role of FDI outflows in GFCF is the concern as to whether outward FDI is a substitute for local investment and/or it enhances the investment base of the home country by improving productivity and consequently increasing GDP. Globerman and Shapiro (2006) found no evidence that outward FDI and GFCF are substitutes. Outward FDI is unlikely to be a significant constraint on domestic capital formation. They claim (2006; 37) it is even more plausible that such capital formation is mildly encouraged.

The results of our empirical research (survey) lead us to assess that outward FDI has not acted a substitute for local investment. Outward FDI has, for instance, not crowded out domestic investment in Slovenia: regression analysis shows a positive and statistically significant correlation between outward FDI and investment in a parent firm (Jaklič, 2001). However, there is always a danger that a certain part of outward FDI would qualify as speculative investment, making candidates for a substitution effect. This may be stronger when compared to similarly developed industrial countries. Some financial investment may fly abroad just to seek tax havens or to avoid paying taxes on the personal incomes of owners<sup>4</sup> (a new wave of system/tax-evading outward FDI).

## 2.2. Geographical allocation of outward FDI from NMSs

Geographical orientation is an important aspect of outward FDI in terms of two aspects; first, to indirectly indicate the type of firm specific advantages (FSA) of these countries' firms and,

<sup>4</sup> See the large and growing share of outward FDI by a Slovenian firm in the Netherlands particularly following changes in tax legislation in 2004.

second, to be a basis for the evaluation of the potential restructuring impact of such investment on the EU. The assumption is that the domination of outward FDI in countries at a similar or lower development level would indicate the relatively weaker competitive position of investing firms. A low share of such investment in EU members would also be an indication that such investment can only have a very modest impact on restructuring processes within the EU-25.

Following the argument that market-seeking investments usually dominate the FDI stage one would expect most of the FDI of NMSs in major partner countries, i.e. in the EU. Yet this is not the case. The geographical spread of outward investment shows a strong regional concentration in countries at a lower or similar development level, with a similar history (socialist countries even being part of the same countries) with the presence of strong national minorities (like the strong role of the Chinese population abroad in the case of China's investment abroad) and similar economic structures and traditions. Our survey<sup>5</sup> revealed that most affiliations have been established in neighbouring countries, mostly other TEs (54 percent): Estonian banks in neighbouring countries, Czech investments in Slovakia, and Slovenian investments in the successor states of former Yugoslavia. The number of affiliations established in EU countries was much lower (21 percent of all foreign affiliations in our survey).

The domination of other Central European Economies (CEEs) as host countries can be explained by two factors: previous export experience and historical and cultural proximity. Countries such as the Czech Republic and Slovenia previously formed part of larger countries, i.e. Czechoslovakia and Yugoslavia, which gives them certain advantages in these markets as investment locations. These location-specific factors are complemented by the ownership-specific advantages of the investing firms (strongly home-country-location-based) which reinforce such a regional orientation of outward FDI. The reason is that the FSA are just not of the kind or strong enough to make outward FDI in the OECD possible.

On the other hand, asset-augmenting outward FDI in order to complement an investing firm's skills with those available in the EU are still not developed at this historical stage of outward FDI. Keeping market shares, outward FDI as a trade-support mechanism, following the customers, clients in standardised products/services (customisation) have dominated among the drivers of outward FDI. Only lately have cost considerations been gaining in importance parallel with the erosion of the competitive/comparative advantages of firms/countries (knowing how to do business is a perishable factor). Other underlying factors were the enhancing of scale and scope economies in more standardised products/activities.

The main locational advantages of target markets are therefore:

- similar tastes and markets in general;
- knowing and understanding the consumer, distribution channels, the ability to adjust, to communicate;
- established business ties, networks;
- less foreign competition; while foreign (developed economy) MNEs serve a narrow top market segment, regional MNEs (those originating from TEs are more capable of adjusting);

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<sup>5</sup> A sample of 180 outward investors from the Czech Republic, Estonia, Hungary, Poland and Slovenia were evaluated. It was made in 2001 (also see Footnote 11).

- knowing informal institutions, overcoming institutional gaps is easier than for foreign competitors; and
- poor enforcement of contracts and intellectual property right protection which may be an invitation to invest abroad to protect market position or prevent imitation by local firms.

### 3. Outward FDI trends and developments

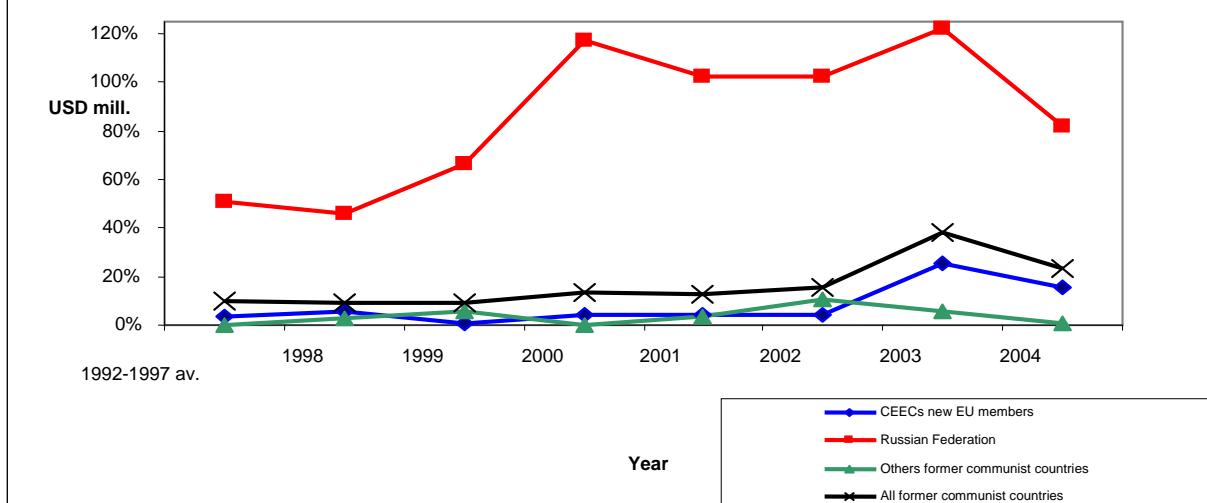
When analysing outward FDI by NMSs we must take into consideration that they are very heterogeneous as regards economic development, the advancement of economic and political reforms, openness, or the choice of economic model. Another important source of differences might be the size of the economy. A small domestic market might have sped up the initial stages of outward internationalisation but results more in the creation of regional MNEs, while large domestic markets more frequently offer opportunities for new global players.

#### 3.1. Trends

The real take up of outward FDI from NMSs began at the end of the 1990s and sped up after 2000 (see the Appendix). Two drivers were decisive; transition as an internal one and enhancing globalisation as an external one. Nevertheless, outward FDI from NMSs is in spite of the rapid recent growth still very modest on the global scale. There is not a single enterprise from the NEUM among the world's top 50 financial or 100 non-financial MNCs (UNCTAD, 2006). Between 1990-2004 their global share of outward FDI stock increased 19-fold, from almost nothing (0.001%/0.09% in 2000) to a still marginal 0.19% of total world outward FDI stock in 2004. The share of inward stock grew from 0.14% in 1990 to 2.6% in 2004. The comparison of outward FDI, diversity of MNEs and their characteristics reveal at least three different clusters: Russia, NMSs and South-east European countries (SEE).

The comparative analysis of NMSs shows that their net investment position has been slowly deteriorating but recently improving. Russia is the closest to a balance while other TEs are gradually deepening their net investment position. Such trends are more the result of higher inward than lower outward FDI from the NMSs. The rate of FDI inflow is gradually decreasing while the rate of FDI outflow is gradually beginning to grow.

**Figure 5: OFDI/FDI ratio in former transition countries, 1992-2004 (%)**



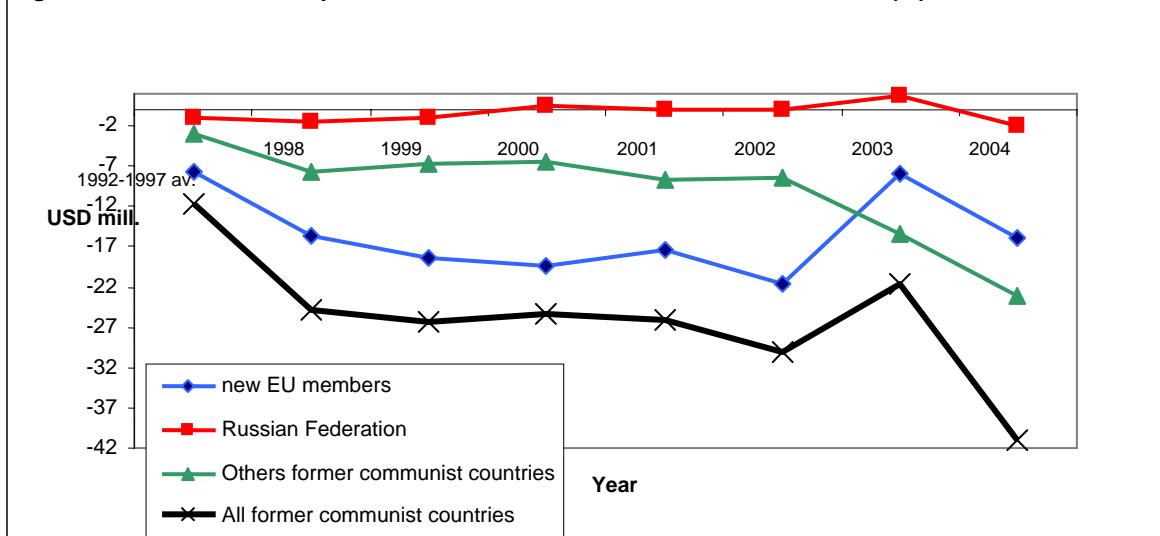
Source: UNCTAD (2005).

### 3.2. Outward internationalisation as an evolutionary process

Dynamic models of internationalisation such as the Uppsala model and investment development path/IDP predict that outward FDI is a function of the development level of the country whose net investment position depends on the GDP per capita. An updated version of IDP (Dunning and Narula, 1998) claims that, although the general trend still holds, the stages and amplitudes are shrinking due to country-specific factors such as the quality of institutions, its economic structure, its openness to international trade and government policy towards FDI (see Dunning et al., 2006: 7). The link between inward/outward FDI is however not causal, as emphasised by Lipsey. There is more of a co-evolution involved (Globerman and Shapiro, 2006: 10).

Rosati and Wilinski conclude that generally the variable outward/inward FDI and outward FDI/per capita explain generally about half of the variability of the dependant variable, with the other half related to other variables such as policy variables, geographical location and integration links with other countries (Rosati and Wilinski, 2003: 180, 181).

**Figure 6: Net Outward FDI position in former transition countries, 1992-2004 (%)**



Source: UNCTAD, 2005.

TEs NMSs are on average still between the second and third stage<sup>6</sup> although the positive net investment flow position of Slovenia in 2003 and 2005 may indicate that Slovenia is more advanced. However, due to the much more modest share of inward FDI in Slovenia and the expected increasing flows in the next few years due to foreseen foreign acquisitions/investment, inward FDI will increase substantially in the next few years.

It can be expected that transition- and globalisation-specific factors will speed up the IDP of the NMSs. Policies which might even stimulate outward internationalisation in order to enhance the restructuring of local industrial structures could work in the same direction. Geographical allocation based on the strong indebtedness of the FSA in the policy environment of such an investment is another speeding up factor promoting taking advantage of first-movers in the markets of other TEs. Bilateral IDPs are therefore more advanced (see

<sup>6</sup> Similar is the conclusion of Gorynia et al. 2006 and Filippaio and Papanastassiou 2004.

Gorynia et al. 2006). The most important explanatory variable for differences between transition and non-transition countries, or more generally between highly and medium-developed countries, may be the different weight attributed to the ownership advantages of firms and the location advantages of countries.

In spite of the strong idiosyncratic nature of such investment, although it may be for different reasons<sup>7</sup> it seems that at least small NMSs hold certain common characteristics which make their potential IDP path similar (small markets, similar economic structure, same timing and character of reforms, governance, similar foreign trade structure...). The fast growth of outward FDI but still deepening of the net investment position does lead to an assessment that NMSs will remain at this stage for some time to come, although with a much faster growth of outward than inward FDI on average.

#### **4. Strategies and competitive advantages**

MNEs from developed economies are for several reasons much stronger in terms of FSAs compared to firms from TEs. Yet the evolution of MNEs from TEs in the last decade shows that they are able to go international as well. Therefore, they have to possess certain although obviously different competitive advantages and employ specific strategies to realise them by investing abroad.

##### **4.1. Strategies**

With the exception of Poland, all other NMSs are relatively small countries with mostly smaller firms compared to the leading investors in the world: large multinationals. They therefore have to find specific strategies of internationalisation closer to those of smaller firms, following niche strategies or following so-called pulled internationalisation driven by their customers such as large multinationals. MNEs from TE NMSs have mostly chosen one or a combination of the following strategies:

- becoming a domestic/regional market leader, after gaining a strong position and economics of scale in the domestic market;
- exploiting a first-mover advantage in other TEs;
- a niche strategy, specialised product, intermediary product specialisation;
- becoming a supplier to a global company;
- follow the leader and follow the customer; and
- change the image as not originating from TEs (IT firms, services firms in general).

##### **4.2. Competitive advantages**

FSAs are according to the eclectic theory a precondition for outward investment in combination with location-specific advantages and, finally, the way they can be most efficiently materialised (internalisation).

Our survey indicates that among the relatively equally weighted technological, marketing and organisational FSA of investing companies, technological advantages are the most important followed by marketing knowledge. Differences among investors from different countries in this regard are in general very small and statistically non-significant. Interviews and case

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<sup>7</sup> Like in the case of Austria and Slovenia. In Slovenia the reasons are mostly transition- and history-specific while in Austria they are EU integration- and enlargement-specific (see Bellak and Svetličić, 2003: 26).

studies have shown that the technological advantages of investing companies from CEEs are not based so much on new products and processes but more on appropriate technology and cheaper, although branded products. In terms of R&D expenditures, the surveyed firms still lag behind internationalised firms from developed industrial countries. The share of R&D expenditures in sales revenues of our sample investing firms on average increased from 2.2 percent in 1997 to 3.3 percent in 2000. The next source of FSAs of the surveyed investing companies is a stronger human capital base compared to non-investing companies. The share of employees with a university education in the sample firms was 24.3 percent in 2000 (an increase from 21.6 percent in 1997, see Svetličić and Jaklič, 2003: 64).

Our empirical research has demonstrated some unique advantages of firms from CEEs, like:

- marketing know-how (brands, good products, knowing how to do business) has proved to be the most important, followed by technological and organisational advantages;
- innovativeness;
- human capital (good knowledge of foreign languages, education, flexibility);
- early internationalisation;
- adapted technology (branded generic drugs...);
- management knowledge/style (intangible assets);
- speed of decisions, risk taking, first-mover advantage (types of advantages that can vanish); and
- failures (in the past) can be productive if lessons were taken on board.

Type of competitive advantages may also determine some of the effects of such investment. From a more macroeconomic perspective such investment may be regarded by host countries/investors as:

- weaker and less dangerous foreign partners (less fear of domination);
- providing more appropriate technology, organisation and management styles;
- being more knowledgeable regarding resources, capabilities and consumer needs in host countries due to smaller development and cultural gaps; and
- being more sensitive to social responsibility (see Hall 2006), when looking at this as a strategic asset in view of other weaknesses compared to big MNCs.

## **5. Performance (and importance) of outward investors**

In the absence of appropriate statistics (company data) almost the only way for assessing the impact of outward FDI in these countries at least on investors was to see how they themselves assess such investment by applying a survey technique. More robust techniques are just not yet possible due to the very short time lag from a major investment taking place to get a macroeconomic assessment of such an investment. Secondly, this enabled us to evaluate the restructuring role of inward FDI and thereby indirectly assess the role of indirect investment abroad.

### **5.1. Results of the survey**

Our survey of 5 CEECs demonstrated that the success of outward FDI of the sample companies has on average been good; investors have mostly realised what they planned at the start of the project. Very few investing firms have really failed and very few have achieved

more than they expected. There may be a bias in answers as far as success is concerned; still the results are surprisingly good given the early stage of internationalisation.

The most important effect of outward FDI for investing firms has been to gain additional market shares. The majority of sample companies introduced new products, adaptations or a wider range of products while improving their quality. Many firms increased investments in R&D. International competition thus motivated the sample companies to strengthen their firm-specific advantages by investing abroad. Outward FDI proved to be instrumental in strengthening competitiveness, stimulating transition and facilitating EU accession to a degree of the quantitative importance of outward FDI in the economies of investing countries. It has been an efficient instrument of the investing company's restructuring, although not the main instrument. Companies have restructured their production programmes and even their organisation as a result of investing abroad. Investing abroad has improved a range of products, feedback with customers and in this way provided access to new knowledge clusters. By investing abroad, firms have also succeeded in keeping some jobs, which would have been lost otherwise. Very few companies started to relocate production abroad because of rising wages at home. Prevailing market-seeking investments resulted in additional market shares abroad, the growth of exports and domestic production levels. Consequently, outward FDI enhances efficiency and restructuring. A direct presence in foreign markets has helped investing companies respond to customers' needs more rapidly. Investors have improved their image and enhanced and broadened their marketing, management and organisational skills. Outward FDI mostly complements exports. It has not crowded out domestic investment. Investing firms have on average higher growth potential than other home-country firms; exposure to foreign competition forces them to pursue high quality, adaptations and innovations which are also introduced in the home economy. Outward FDI enables firms to exploit the advantages of globalisation and to draw on factor endowments abroad. All these changes influence the industrial structure of the home economy and help bring about changes, which better reflect what the international division of labour under globalisation pressures shows to be the optimal allocation of resources. Companies that invested abroad did indeed increase the average value added per employee. Outward FDI is therefore growth-instrumental, although limited to a group of investors.<sup>8</sup>

The internationalisation of companies from transition economies has enhanced the restructuring and transformation of the investing companies and hence stimulated the transition process. Investing abroad might be treated as a catching-up tool since it helps to narrow the gap in productivity, efficiency and knowledge (above all, in marketing, organisation and management). For many firms from small countries or for those that reached the upper limit of market concentration allowed in the home economy, investing abroad has become the most promising or only way to grow.

Direct investment abroad in most cases seems sustainable and is not a whim provided that the resulting profits are used creatively to strengthen one's own capabilities and not only to defend achieved market positions. Above-average R&D expenditures promise that the prevailing home country location-driven advantages thus far will gradually be replaced by firm-specific advantage-driven internationalisation.

## **5.2. Transition and integration (enlargement) specific effects**

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<sup>8</sup> Based on (Svetličić and Jaklič, 2003: 71-75).

Since we are evaluating outward FDI by NMSs it is important to see what role the transition has played. Secondly, what was the impact of EU membership and thirdly what role was played by foreign firms? Have these factors sped up investment abroad and, if yes how, in which directions, and if not, why not? In other words, to what extent is outward FDI at this stage transition- or even integration-specific?

Historically systemic factors in fact triggered off outward FDI. Investors abroad tried to evade the limitations of restricted socialist systems (system escape investment; see Svetličić et al., 1994). In most countries it was tolerated or even part of the policy (see MacMillan 1987) like it is now in some emerging economies.<sup>9</sup>

Although we cannot robustly assess the role of transition, anecdotal evidence, cases and macro trends do indicate that the transition has played an important yet also a mixed role. Initially destimulating outward FDI, policy later started to tolerate it and finally modestly stimulated it. Outward FDI was forbidden almost until the end of the 1990s. Membership in the EU and OECD for some countries finally brought these countries in line with the OECD/EU regulations. The fast change from a socialist protected economy to an open market economy also enhanced competition in the local market and consequently pushed companies to look for all available means to enhance their competitiveness, including by engaging economies of size by outward FDI and, later, looking for lower cost production (efficiency investment). Firms just have to start developing their FSAs in open markets with tough competition starting already at home. A very specific but relatively important factor in view of the regional allocation of the outward FDI of these countries was expertise in privatisation by more advanced TEs which NMSs held. They are therefore able to get involved in privatisation in other TEs faster and more efficiently than Western companies also due to the narrower institutional/cultural gap. One of the key advantages proved to be knowing how to do business there.

The time for evaluating the effects of EU membership is certainly too short. Secondly, EU-membership-specific factors are strongly intertwined with some of the above transition-specific factors. They have probably worked in the same direction (EU regulation), stimulating outward FDI. Theory suggests that integration can stimulate intra trade (static effects) as well as intra FDI in the custom union or internal market. We can even speak of the dynamic effect of investment creation after membership. More important for our analysis are dynamic investment creation integration effects. The creation of a large internal market, facilitating technology/knowledge flows, a positive impact on productivity has been creating good conditions in which firms were forced to strengthen their competitiveness in order to survive and thereby also to enhance the general macroeconomic restructuring process (better allocation of resources).

The types of FSAs have nevertheless made potential static investment creation effects rather modest and in the initial periods even negative. There was no longer any reason for system-escape type or tariff factories within EU markets. Therefore, some of such investment created before EU membership has been abandoned, including trade facilitating affiliations. Enlargement has, on the other hand, stronger investment creation effects since most of outward FDI is in fact directed to other TEs (still) not EU members. The effects have therefore been mixed. The new EU borders have in a way destimulated intra FDI flows to

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<sup>9</sup> The going global Chinese strategy for instance or in the case of state-owned companies in Singapore. However, this argument that such outward FDI is because of the »states behind them« is generally overstressed since basically they mostly behave as market actors and are only new wine in old bottles (see Dunning et al., 2006).

countries with previous free-trade arrangements and stimulated them from another perspective (tariff factories). Some previously local investment now became foreign (inherited outward FDI). One could expect an increasing share of outward FDI in other new EU members, therefore implying more intra new members' FDI only in the long run. Now investment among NMSs is not so important. In a very few cases are the NMSs among the first 5 outward FDI partner countries. Gorynia et al. even conclude that 'there was a counter effect of Poland's integration in EU which in a short run indicated a tendency to prolong the stay in the stage 2 but which is estimated to be counterbalanced in the medium term by firms increasing their FDI outflows from Poland into EU' (2006; 9).

We can only hypothesise that other factors presently outperform the enlargement effects. The regional orientation of outward investment in mostly other former socialist countries outside the EU provides the main illustration. It is also in line with other studies claiming that integration investment creation effects happened in many countries before integration occurred (Svetličić and Rojec, 2002). Transition, general liberalisation and privatisation certainly outperformed integration-specific factors although already an EU association agreement and later membership certainly created the infrastructural stimulating climate for FDI.

With the transformation from more relationship-based societies/systems to more rule-based ones parallel to the advancement of the transition in the major host countries, firms FSA of investors from NMSs will obviously evaporate compared to their OECD competitors since their competitive advantage is relationship management, knowing how to do business in similar business and political environments.

The role of transition-specific factors is, along with the advancing transition, gradually evaporating while EU integration-specific factors will be gradually enhancing its impact. Transition was an initial push factor triggering off such investment before the normal development level argument would predict such investments. The same applied to systemic factors like the system-escape type of outward FDI which ceased to exist in these countries together with most of tariff factories (no tariffs in the EU any more). Therefore, one can expect a certain 'calming' down of the initial rapid growth of such investment from the initially very low levels due to systemic factors (transition, EU membership) parallel with the strengthening pushing role of enhancing FSAs. With the changing and enhancing of FSA more outward FDI in the EU may be expected as the asset-augmenting type of outward FDI as is already happening in the case of emerging economies' outward FDI. More outward FDI in the EU is expected particularly in the service sector as a consequence of the liberalisation of it in the EU and the competitive advantages of firms from NMSs in some service activities (construction, engineering and design).

Yet the balance between the role of systemic vis-à-vis EU integration/enlargement factors can only be determined empirically. We can only hypostatise that the initial push of systemic factors was relatively stronger than will be the more gradual enhancing role of the strengthening of FSA as a dynamic integration effect. This is namely a much longer process by definition. Weaker FSA coupled with historical path dependence factors like strong links with a previous country or the ethnic ties of NMSs will for a longer time determine the specific geographical allocation of outward FDI.

To the extent that foreign-owned firms are also outward investors one also has to look at the restructuring role of inward FDI. In all selected NMSs manufacturing activity has shifted

away from low-technology industries towards either medium-low or medium-high technology industries. Restructuring processes have been much more intensive in a foreign investor's enterprises (FIEs) than in domestic enterprises (DEs).

Table 5: Changes in the distribution of manufacturing value added\* by technology intensity in individual Central European countries\*\*: For all enterprises and FIEs in 1993-2001\*\*\*; in percentage points

	All enterprises						FIEs					
	CZ	ES	HU	PL	SI	SK	CZ	ES	HU	PL	SI	SK
High tech	1.1	2.7	11.8	1.7	0.7	-0.3	2.6	14.2	16.3	0.0	1.7	0.2
Medium high tech	2.7	-12.1	8.2	1.5	1.3	-1.2	3.1	-17.5	11.6	3.1	-12.7	0.6
Medium low tech	-0.9	8.0	-5.1	-3.1	3.4	8.0	1.5	3.3	-11.5	11.2	6.8	14.5
Low tech	-2.9	1.5	-14.9	-0.1	-5.4	-6.5	-7.3	0.0	-16.4	-14.4	4.2	-15.2
Absolute change	7.6	24.2	40.0	6.3	10.9	15.9	14.5	35.0	55.8	28.8	25.3	30.5
Weighted change	2.6	-2.7	15.6	1.6	2.7	1.6	5.2	3.6	20.2	5.9	-4.5	5.4

Source: Damijan and Rojec, 2004.

\* For Hungary and Poland sales data have been used.

\*\* CZ – Czech Republic, ES – Estonia, HU – Hungary, PL – Poland, SL – Slovenia, SK – Slovakia.

\*\*\* Czech Republic, Hungary and Slovakia for 1993-2001, Estonia for 1995-2001, and Slovenia for 1994-2001.

Dynamically the impact on productivity is what matters the most. Table 7 shows that in high-tech industries FIEs outperformed DEs 2.34 times and in low-tech industries 1.46 times, while in medium-high-tech industries and in medium-low-tech industries DEs slightly outperformed FIEs (1.133 and 1.02, respectively). The very high labour productivity growth of FIEs in high-tech industries is to a great extent influenced by the outlying situation in Hungary (Damijan and Rojec, 2004).

Table 6: Cumulative changes in labour productivity (value added per employee\*) by the technology intensity of industries in FIEs and DEs in 6 CECs in 1995-2001; in %

	High-tech FIEs		Med.-high-tech FIEs		Medium-low-tech FIEs		Low-tech FIEs	
	FIEs	DEs	FIEs	DEs	FIEs	DEs	FIEs	DEs
Czech Republic	46	99	77	92	95	64	97	106
Estonia		166	95	118	239	133	341	141
Hungary	422	60	136	103	147	63	125	140
Poland	270	180	174	141	374	126	240	138
Slovenia	330	141	130	147	125	127	177	121
Slovakia	120	122	173	102	138	86	167	97
<b>Average</b>	<b>238</b>	<b>128</b>	<b>131</b>	<b>117</b>	<b>186</b>	<b>100</b>	<b>191</b>	<b>124</b>

Source: Damijan and Rojec, 2004.

\* Average cumulative growth rates of individual sectors within respective technology sectors. In the cases of Hungary and Poland sales instead of value added data have been used.

It is therefore safe to assume that the outward FDI of FIEs has also contributed to such restructuring effects in the proportion of their role in outward FDI (see Chapter 6.2.).

## **6. Selected issues & recent developments**

We will only concentrate on three issues here; the role of SMEs, investment abroad by foreign owned firms (so-called indirect investors), and partly a comparison of the performance of investors and non-investors/exporters.

### **6.1. Small and medium-sized firms as investors abroad**

The UNCTAD's latest list of the top 50 MNEs from emerging markets indicates a relatively poor correlation between the size and degree of globalisation of business (as measured by market value), with a value of 0.4. SMEs therefore seem to have opportunities to internationalise in spite of the many limitations they face in terms of capabilities. Not surprisingly they constitute in some NMSs the majority of investors abroad in terms of numbers<sup>10</sup> although by volume large firms prevail. Internationalisation is obviously not the domain of large firms only. Smaller ones may be even pushed more to go international following the philosophy that the smaller the niche the more international firm must be to gain economies of scale and scope. In spite of many limitations SMEs have some advantages like flexibility, appropriate technology/management and networking potential. The internationalisation of SMEs can enhance their domestic and global position.

Like in other countries major investors abroad from 5 CEECs are larger firms but not in terms of the number of investors. Smaller ones constituted from 10% in Hungary to 79% of all investors in Slovenia. The role of SMEs in outward investing is strongest in the smallest countries: Estonia and Slovenia. Specialised SMEs in these national markets are often too limited in scale to survive, and international expansion is a means of their survival.

The survey<sup>11</sup> evaluation indicates more similarities than differences in internationalisation patterns. SMEs' investment abroad is market-seeking. Both groups of firms identified similar barriers yet SMEs face larger financial and capacity problems whereas their larger counterparts enjoy superiority in marketing and production capabilities but, on average, lack the agility needed for swift and efficient market entry. As they frequently target specialised niches, the main competitive advantage of SMEs is technological know-how, combined with organisational flexibility and a closer relationship with their customers, while larger

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<sup>10</sup> According to the EU's methodology, SMEs are those employing less than 250 employees. In addition, a company's annual turnover must not exceed € 40 million and/or its annual balance sheet must be lower than € 27 million (OECD, 2002: 7).

<sup>11</sup> A sample of 180 companies from Estonia, Czech Republic, Hungary, Poland and Slovenia were used to test the hypothesis on differences between large firms and SMEs' internationalisation. Data were collected by a fully structured questionnaire in 2001. Large firms, although being in the minority in the total sample, strongly influenced the descriptive statistics. The average firm had 1,213 employees, although the majority of sample companies had less than 250 employees. SMEs altogether represented 53% of the sample. Companies with up to 50 employees constituted 33% of the sample, medium-sized firms with 51-250 employees another 20%, and large ones over 250 employees the remaining 47%. The average age of an investing company was 28 years; large firms were statistically significantly older than SMEs (29 years versus 17 years on average). This chapter is based on Svetličić et al., 2007.

competitors benefit from scale economies and marketing. Home-country employment effects of SMEs are positive and larger than for large firms.

Apart from competitive advantages no differences are found in the ranking of particular motives and barriers. Market motives proved to be by far the most important, with almost no differences between SMEs and large firms. Regardless of size, all firms usually enter foreign markets firstly by trade units while cost efficiency comes in the second step. Large firms are stronger in their capabilities to exploit cost differences while SMEs are, due to their specialisation, very strongly pushed to get close to their customers to satisfy their needs, not just selling products to adapt products and services and establish closer relationships. This is particularly true for specific highly specialised service companies (consultancy and similar) or intermediary products sold mostly B2B. The only significant difference between large and SMEs was cost competitiveness although this motive is the least important reason for firms investing abroad regardless of size. Closer (or neighbouring) locations that are most frequently target host countries for their direct investment do not offer sizable differences in labour costs.

The highest barriers to the outward investing of SMEs are host-country related factors like high political risks, an unstable investment climate, or no systemic transparency. The largest difference in the relevance of barriers was access to financial resources where SMEs turned out to be more vulnerable than large firms.

## **6.2. The role of indirect investors**

Frequently it is claimed that it is not really indigenous firms which invest abroad from TEs but affiliations of foreign investors (we call them indirect investors) using TEs as a springboard. Therefore, it is important to see the relationship between inward and outward FDI the differences between direct and indirect investors.

There is no reason to believe that the effects should be any different when we evaluate the relationship between inward-outward FDI in the case of developed and with the NMSs. The co-evolution of inward and outward FDI holds, however this does not imply causality between the two. But to the relatively stronger role of inward FDI compared to industrial countries may imply that the link in the case of NMSs could be stronger. The second country-specific factor making the pattern of the link different in the case of NEUM countries is the type of governance involved. Firms from NMSs may also invest abroad because external markets are less efficient, less transparent (weak protection of property rights for instance), and more corrupt. They use outward FDI as an instrument for overcoming such difficulties (see more on these effects, see Globerman and Shapiro, 2006: 13). One case in point is an investment of Perutnina Ptuj in Croatia for instance<sup>12</sup>. It seems that companies have an easier time controlling their intellectual property and defending their original products against imitations when they have a direct presence. They invested abroad in order to reduce the possibility of imitation by local producers by establishing production in the local market themselves and in such a way creating higher entry barriers to new entrants.

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<sup>12</sup> Investor firms have been producing poultry salami under the brand name Poli. The local fake product was named Doli and completely imitated the Slovenian (the same packaging, promotion tools, and distribution channels) and caused a substantial loss in sales for the Slovenian producer.

The more important aspect is the potential differences between the two in terms of the performance and host-country effects. They may be based on a different organisation of the international division of labour within firms (who makes the decision) and consequently who gains the benefits. In the case of indirect investors, Altzinger et al. 2003 claim that it is more the parent direct investor who makes the decisions, while the competencies of the affiliation within the network of MNCs are limited. Competencies acquired by the affiliation are also expected to be more intensively utilised by the parent.

The importance of indirect investors in the case of outward FDI by 5 CEECs varies depending on the definition of such investment. If we take 10% ownership as a benchmark, then based on our survey they constitute 56.7% of all outward FDI but less if 50% ownership is taken as the criterion (23.3%). Our survey clearly supported the expectations that the extent of indirect investors correlates with the level of inward FDI in the country, i.e. the higher level of inward FDI in the particular country, the higher the share of indirect investment in the total outward FDI of a respective country (see Altzinger et al. 2003: 92).

The descriptive analysis shows some statistically significant differences between direct and indirect investors, but only if 10-percent foreign equity share criteria for indirect investors are used. Indirect investors are significantly more motivated by market-related motives and, consequently, the effects on the parent company's market shares abroad and employment are significantly different and positive in the case of indirect investors. The regression analysis confirmed a significantly different and positive impact of indirect investors on changes of parent companies' market shares abroad and employment. In the case of exports, no such correlation was found. It also suggests that employment effects depend on production volume in the parent company; higher-more effects. Employment is also positively correlated with indirect investors, much more than in the case of a direct investor (Altzinger et al. 2003: 108). A similar conclusion was made by Varblane et al. (2006), indicating an overall possible positive relationship between outward FDI and employment growth in Estonia although a negative (statistically not significant) effect on the employment of indirect investors.

We expected that differences would be even more pronounced if the 50% criterion is taken as a benchmark. Surprisingly the results did not confirm this. Quite the opposite, differences were less statistically significant in the fields of motivation, competitive advantages and effects. The only significant difference was found in the difficulties they are facing (lack of financing, for instance). Compared to direct investors, indirect investors seem to have a significantly more positive influence on parent companies' market shares abroad (see Altzinger et al., 2003: 97).

### **6.3. Investors versus exporters and non-investors**

According to our 2001 survey, investing firms performed better than non-investing firms and also improved in the second half of the 1990s. The growth of investing companies was much faster than of non-investing firms. The issue is whether such a conclusion can also stand more robust tests when also taking into consideration the self-selection of exporters and investors. They may namely be better already from the beginning and do not learn by investing abroad, becoming more productive.

Investing abroad also enhances enterprise competitiveness according to a more robust econometric analysis (Jaklič et al., 2005) unfortunately undertaken only in the case of

Slovenia. Slovenian investing firms' premiums<sup>13</sup> are much higher compared to non-investors and exporters. Such premiums go up to over 100% in terms of employment and sales but not in terms of productivity. Premiums differ in terms of firms' size and other aspects. The largest are in the cases of the employment of micro and large firms, and the sales of small and large firms.

Premiums (in sales, profits, productivity) are the highest in the case of investors which started to invest between 1998 and 2000, demonstrating that at least a 2-year time lag is needed for assessing the results of such an investment.<sup>14</sup> Even more important is a dynamic evaluation demonstrating that premiums on employment, productivity, salaries per worker and capital per worker have decreased for non-investing exporters. This analysis of 634 new investors (80% started after 2000, with a 3-year time lag based on a matching technique singling out only 122 investors) revealed that firms significantly increased their sales in the second year (all firms including SMEs) due to investing abroad. They also increased their profits (only small firms in the second year) and employment for medium-sized firms (negative for large firms) (Jaklič et al., 2005: 38 and 67).<sup>15</sup>

## 6. Conclusions

Outward FDI by NMSs or by TEs basically follows the traditional theory, although their IDP stages are much shorter, and the specific weight of drivers, types of FSA and consequently types of FDI and regional orientation are somewhat different. The stronger share of inward FDI compared to industrial countries makes the role of indirect investors relatively more important although country-specific differences do exist.

The strong impact of globalisation and other external factors will speed up the IDP of NMSs. They may even jump over some stages (leapfrogging internationalisation). Some indications point to the possibility of enhanced convergence between investment behaviours of today's industrially developed countries and NMSs. New multinationals from NMSs may become competitors to small emerging economies MNCs in some niches and in some services, less so in manufacturing but not in the area of resource-seeking outward FDI where emerging economies multinationals are becoming quite strong.

Although inward FDI is still under the strong impact of the lagged privatisation processes in some of these countries (one case is Slovenia), implying 'irregularities' in FDI inflows (large privatisation-related inflows), we expect a long-term balancing of the net outward position in the medium-term future at least in smaller NMSs. They can only become net investors abroad in the long term.

The type of FSAs and path (systemic) dependency decisively determine the regional allocation of NMSs' investment abroad. They mostly invest in neighbouring and countries that had the same (socialist) system or even more importantly were part of the same country. Some outward FDI is also ethnically rooted. Some firms just inherited some previously local activities which then became international. EU membership has not had a major impact on outward FDI by NMSs. It is expected that EU membership will become more important

<sup>13</sup> Better performance in respective criteria compared to non-investors and/or only exporters expressed as the average difference (in percentage) between investing firms and control group in the same industry.

<sup>14</sup> It measures the superior performance characteristics following the Bernard, Jensen 1999 methodology.

<sup>15</sup> It may demonstrate that large firms are increasingly locating labour-intensive production abroad and consequently reducing the number of employees at home.

parallel to the growing importance of the asset-augmenting type of outward FDI and with new enlargement. Candidate countries are namely among the major destinations for some investors. We do not expect a very strong upsurge of investment among NMSs. Other candidate countries and other transition economies are expected to remain a major destination of their outward FDI. Emerging economies, especially China and India, will also increase their attractiveness as an investment location.

The restructuring potential of outward FDI is important when it comes to home countries but less so in the EU context. Quantitatively, it is relatively more important indirectly through the role of inward FDI as investors abroad. The role of SMEs as investors is growing although in terms of volume they are less important investors. They can invest abroad successfully provided they are fast and clever, have the ability to assimilate others' knowledge (free riding), are capable of successful networking and, most importantly, if they operate in niches.

Globerman and Shapiro concluded that the policy of promoting outward FDI is not likely to succeed unless accompanied by changes in the underlying governance of private and public sector activities, and unless outward FDI contribute to higher income levels in the home country more generally, also of those who are not owners of investing firms (2006: 37). Nevertheless, it seems that a certain orchestrating of outward FDI is needed in the early stages of the development of this, for most firms' new processes in NMSs. From the policy point of view, a really important barrier to internationalisation is the lack of knowledge and experience of management. This is an area where firms and respective home governments can do much in order to promote internationalisation. Education systems are not yet geared enough to educate 'ready made' global managers. Training is still functionally oriented; there remains a lack of holistic knowledge about internationalisation and outward FDI.

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## Appendix

Table 1: FDI flows and stocks by NMSS (USD, million)

ECONOMY	YEAR	1990	2000	2001	2002	2003	2004
		CATEGORY					
Cyprus	FDI inflows	126.6	854.9	944.4	1057.4	1010.8	1146.2
	FDI inward stock	***	2910.4	3854.9	4912.3	6986.2	8132.4
	FDI outflows	4.6	172.1	249.6	461.3	523.9	629.7
	FDI outward stock	8.5	560.4	809.9	1278.9	2054.6	2684.3
Czech Republic	FDI inflows	1444 <sup>16</sup>	4986.3	5641.4	8482.7	2101.4	4463.3
	FDI inward stock	19.6	21643.7	27092.2	38669.2	45286.7	56414.5
	FDI outflows	—	42.9	165.4	206.5	206	546.2
	FDI outward stock	—	737.8	1135.6	1473	2283.5	3060.6
Estonia	FDI inflows	—	386.9	542.4	284.3	890.6	926
	FDI inward stock	—	2644.7	3160	4226.4	6510.5	9529.6
	FDI outflows	—	63.4	199.7	131.8	148.1	257.4
	FDI outward stock	—	259.1	441.8	676	1020.8	1397.5
Hungary	FDI inflows	623.4	2764.1	3936	2993.5	2161.8	4166.9
	FDI inward stock	569	22869.9	27406.9	36223.9	48320.4	60328.3
	FDI outflows	16.1	620.5	368.1	278.1	1646.5	537.6
	FDI outward stock	196.8	1279.9	1556.1	2166.5	3537.2	4472.4
Latvia	FDI inflows	—	412.6	132.1	253.7	300	646.9
	FDI inward stock	—	2083.8	2328	2751	3282	4493
	FDI outflows	—	12.3	18.9	3.7	36.2	109
	FDI outward stock	—	241.4	44	64	106	226
Lithuania	FDI inflows	—	378.9	445.8	732.0	179.2	773.1
	FDI inward stock	—	2334.3	2665.5	3981.3	4959.8	6388.9
	FDI outflows	—	3.7	7.1	17.6	37.2	262.6
	FDI outward stock	—	29.3	47.9	59.5	119.7	422.8
Malta	FDI inflows	45.8	622.1	258.9	-426.3	294.4	420.9
	FDI inward stock	465.3	2385.5	2560.9	2440.6	3136.3	3557.2
	FDI outflows	..	25.9	21.8	-9.5	19.5	8.8
	FDI outward stock	..	203.1	261.2	278.9	352.7	361.5
Poland	FDI inflows	89	9343	5714	4131	4123	6159
	FDI inward stock	109	34227	41247	48320	55268	61427
	FDI outflows	5.4	16	-90	230	196	806
	FDI outward stock	408	1018	1156	1457	1855	2661
Slovakia	FDI inflows	—	1925.4	1584.1	4093.8	668.8	1122.4
	FDI inward stock	—	3732.9	4836.2	8529.8	11863.6	14500.7
	FDI outflows	—	20.9	34.9	4.92	22	-155.5
	FDI outward stock	—	325.2	445.7	485.5	627.3	617.9
Slovenia	FDI inflows	—	135.9	370	1686.1	337.0	516.1
	FDI inward stock	—	2893.7	2601.9	4108.9	4445.9	4962.1
	FDI outflows	—	65.3	144.5	153.2	465.9	497.9
	FDI outward stock	—	767.9	1003.9	1485.9	1951.9	2449.8

Source: UNCTAD 2006, own calculations.

<sup>16</sup> Czechoslovakia.

