Co-funded by the
Europe for Citizens Programme
of the European Union

TEPSA
Trans European Policy Studies Association

Trans European Policy Studies Association

TEPSA BRIEFS

MAY 2020

"Where does FDI Really Come From in East Central Europe?"

Magdolna Sass*

Abstract

FDI plays an important role in Central and Eastern Europe (CEE) economies. However, research is hindered by data problems. New data on FDI stocks, broken down according to the nationality of the ultimate owner company give important insights into who really invests in CEE. While there is a Western European (and within this German) dominance, outside European FDI (especially from the US) is also important.

Introduction

It is important to know who really invests in a country, and where the firms investing there really come from. Most importantly, the home country influences to a great extent the strategy the firm follows, the various characteristics of the business and regulatory environment within which it operates, its inclination to transfer technology to the host country of the investment, the mix of business and employment practices it follows and so on. As Jones (2005) noted, while changing in importance over time, in the early twenty first century, nationality of ownership, location and geography still mattered to a great extent in international business.

However, foreign direct investment (FDI) data published by national banks have not really helped us to understand and identify from where the investors who arrive in a country really come from. This has changed recently, as with the introduction of the new balance of payments methodologies and benchmark definition of FDI, FDI data according to the nationality of the ultimate investor should also be compiled and published. This new methodology tries to comply with the reality of FDI, where the ultimate controlling investor of a (foreign) investment project may differ from the direct investor. The new guidelines recommend compiling inward investment positions also according to the Ultimate Investing Country (UIC) principle, in order to identify the country of the foreign investor that ultimately controls the investments in the host country. Thus, at present, in principle, two FDI datasets should be published: one based on the nationality of the immediate investor and another one based on the nationality of the ultimate investor in a given host economy.

* *Magdolna Sass* is Director at *the Centre for Economic and Regional Studies (KRTK)*. All the opinions expressed in this briefing are the sole view of the author, and do not represent the position of KRTK nor of the Trans European Policy Studies Association (TEPSA).

This short note tries to benefit from the fact that six Central and Eastern European countries (Czechia, Estonia, Hungary, Lithuania, Poland and Slovenia) already published their FDI data according to the nationalities of the ultimate owners. In this TEPSA brief it is compared the breakdown of FDI stock for this group of six countries according to the nationalities of the direct and ultimate investors. The difference is substantial in all cases between the compositions of FDI according to the nationalities of ultimate and direct owners. While Germany is the most important home country in CEE, outside European FDI is more important than previously thought. This is especially the case for the US: it is the second most important home country. FDI among Western European home countries is more evenly distributed according to the ultimate owners than according to direct owners.

New versus old data

Multinational companies (MNCs) play an ever increasing role nowadays in the world economy: they are the leading organisers and managers of international production. Their foreign activities are connected to FDI, and thus the various characteristics of their international presence can be examined using FDI statistics andpublished as part of the balance of payments. Though there are certain investment transactions (e.g. in real estate), which do not comply fully with the definition of FDI (OECD, 2015) and FDI is considered an incomplete measure of the foreign activities of MNCs (Lipsey, 2007). Yet, this is the best available statistical dataset for trying to trace the presence and characteristics of MNCs in foreign host countries.

The analysis of FDI data has become more and more problematic over time. One reason is that, together with globalisation, MNCs have engaged to a greater and greater extent in internationally managing and reshuffling their organisation. Furthermore, they try to reduce or optimise their tax and regulatory burden by using tax havens, which offer low tax or low regulatory burden environment or beneficial incentives to foreign investors. Additionally, certain foreign investor companies wanted to conceal their real origin and/or enjoy tax benefits through transshipping (when investing in foreign countries through a third country) or roundtripping (when investing in their own countries with the intermediation of a foreign country). In addition, some multinationals use certain subsidiaries as regional "hubs" of the organisation of their activities in certain geographical areas, based on better familiarity with and geographical proximity to other countries in the region or on regulatory grounds.

The analysis of FDI data has become more and more problematic over time. One reason is that, together with globalisation, MNCs have engaged to a greater and greater extent in internationally managing and reshuffling their organisation.

Because of the above reasons, before reaching its final destination, FDI can flow through various countries in a way which does not represent a lasting interest in and significant degree of influence over the enterprises – as it is formulated by the OECD benchmark definition of FDI – involved in this "FDI chain". These activities resulted in a web of foreign direct investment flows and stocks, with double, triple or even more counting, making it increasingly difficult to map global investment relations, including according to the nationality of the investor companies. The problem is aggravated by the fact that these activities resulted in distortions not only in macro-level data, but also – understandably – at the company level data, as these also contain information on the immediate and not on the ultimate owners. Thus they are plagued with the same problems, which are listed above. This has made the results of statistical analysis of FDI using macro- and firm-level data questionable.

Due to the requirements of the new balance of payments manual, now in effect, two FDI datasets are available for each country: one based on the nationality of the immediate investor and another one based on the nationality of the ultimate investor in a given host economy. Of course, the task of tracing the ultimate investor multinational company is in certain cases problematic and requires substantial knowledge and resources, even if there are detailed guidelines published on identifying them (OECD, 2015). That may be the reason why up until now only a few national banks published two datasets. From the CEE region, there are at present six countries: Czechia, Estonia, Hungary, Lithuania, Poland and Slovenia, which published these. Here we use the data of this country group to show, who really invests in Central and Eastern Europe. The latest year, for which all six countries publish data is 2017 at present.

Who really invests in Central and Eastern Europe?

The group and ranking of top investors is different if we compare the two databases. The Netherlands is no longer the top investor. According to the nationality of the ultimate owner, it is ranked fourth. This points to its role as an intermediary country in FDI destined for the CEE region, together with Luxemburg and Cyprus (and to some extent Switzerland and Austria). Germany takes over the top position from the Netherlands, while the US is ranked second. The large difference between the US FDI stock in the six countries according to the nationalities of the immediate and ultimate owner shows that US investments prefer to arrive to the CEE region with the intermediation of another (European) country. Further important FDI home countries for the CEE region are other Western European economies (France, Austria, United Kingdom, Italy, Sweden, Spain, Belgium, Finland and Denmark). In these cases, the investing companies usually arrive directly from their home countries. Among the top ten, we can find two countries from the CEE region: Czechia and Poland. Their position is, however, greatly influenced by roundtripping, when local companies establish a company abroad and "invest back" in their home countries as foreign investors.[1] Outside Europe investors have much smaller FDI stocks in CEE (with the exception of the US). Japan, ranked 13th, stands out, mainly going to CEE countries through intermediary economies. Next is Korea, ranked 18th, FDI coming directly from Korea. Russia (20th) and China (22nd) both use intermediary countries, which is why the extent of investments coming from these countries is underestimated by data compiled on the basis of the nationality of the immediate investor firm.

Thus, new data reveal a different pattern of home countries of FDI stock in the CEE region: Germany is by far the most important investor followed by the US and other Western European economies. Outside European investments, though dwarfed by European ones, are larger than previous (immediate) data showed.

Conclusion

The group of the leading foreign investor countries in CEE differs if the nationality of the ultimate owner of the investment is taken into account. While Germany is the top investor, the United States is now ranked second. While other Western European countries are still among the top investors and dominate the FDI stock, outside European FDI

[1] Similar is the case for Estonia, but the magnitudes, given the size of the Baltic country, are of course smaller.

is considerably larger than data according to the nationality of the immediate owner showed. Especially Asian investors (Japan, Korea, China) stand out.

The nationality of the ultimate investor matters: it influences the operation, practices, business strategy and behaviour of the subsidiary. It impacts upon its engagement in global value chains, reactions to crisis developments and business cycles. It may be important from the point of view of FDI promotion as well. Thus it is important to know, who really invests in your country.

The data about FDI composition according to the nationality of the ultimate owner provides more accurate information for economic research as well. It performs better, for example, when analysing the main drivers of bilateral FDI data (Fertő – Sass, 2020). Thus relying on it in research may provide more accurate insight into how FDI relations evolve between countries.

References

Fertő, I. and Sass, M. (2020): FDI according to ultimate versus immediate investor countries: which dataset performs better?, Applied Economics Letters, *forthcoming.*

IMF (2009): Balance of Payments and International Investment Position Manual. Sixth Edition (BPM6). International Monetary Fund, Washington DC.

Jones, G.G. (2005): Nationality and Multinationals in Historical Perspective. Harvard Business School 06-052 Working Paper. http://www.hbs.edu/faculty/Publication%20Files/06-052.pdf, last accessed 05 April, 2020.

Lipsey, R. E. (2007): Defining and Measuring the Location of FDI Output. NBER Working Paper, No. 12996., March.

OECD (2015): Measuring International Investment by Multinational Enterprises. Implementation of the OECD's Benchmark Definition of Foreign Direct Investment, 4th edition. OECD, Paris.

* Research for this brief was supported by the Hungarian research fund NKFIH (no. 132442).

Trans European Policy Studies Association

Rue d'Egmont 11, B-1000

Brussels, Belgium

To know more about TEPSA visit:
www.tepsa.eu

Follow TEPSA on:

@tepsaeu

@tepsa.eu

TEPSA – Trans European Policy Studies Association

Institute of World Economics, Centre for Economic and Regional Studies (IWE CERS)

4 Tóth Kálmán Street,

1097 Budapest, Hungary

To know more about IWE CERS visit:
www.vki.hu

Follow IWE CERS on:

Facebook

Co-funded by the Europe for Citizens Programme of the European Union