



2nd GLOBAL CONFERENCE on BUSINESS, ECONOMICS, MANAGEMENT and
TOURISM, 30-31 October 2014, Prague, Czech Republic

Relationship between Foreign Direct Investment and Domestic Investment in Selected Countries of Central and Eastern Europe

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Abstract

Effects of foreign direct investment on domestic countries have been one of the most discussed topics in post-communist countries. Privatisation started in the 90s in countries of Central and Eastern Europe. From this point of view the foreign direct investments played an important role in region. Foreign direct investments are generally considered as one of the factors with positive influence on the economic development of countries in which this investments flow. In evaluating the impact of foreign direct investment on development, however, a key question is whether foreign direct investment crowd in domestic investment, or foreign direct investment crowd out domestic investment. This paper focuses on research of foreign direct investment effects in Central and Eastern Europe. The aim of the paper is to examine the effect of crowding in or crowding out of the domestic investments by foreign investors in host countries. Annual data were tested with panel regression for the period 1993 – 2012. Detected results indicate that in specified areas, the effect of extrusion of domestic investments prevails.

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Selection and/ peer-review under responsibility of Academic World Research and Education Center

Keywords: Foreign direct investment, domestic investment, crowding in effect, crowding out effect ;

1. Introduction

Foreign direct investment (hereinafter FDI) are debated on scientific, empirical, political and others levels. Generally we speak about positive and negative effects of FDI that might be expressed indirectly or directly. Geršl et al., 2007 pointed to the fact that attracting foreign direct investment brings benefits to the host economy in terms of higher investment, employment and output of these firms, with a resulting effect on overall GDP growth – the so-called direct effects. Mišun and Tomšík, (2002) highlight that the main positive direct effects are impact of foreign direct investment on economic growth of host country, availability of modern technology, managerial know how or better access to financial fund. Foreign direct investment implement on green field are the ones that create new work opportunities. Considering transitive economy, an important role plays fiscal income from foreign direct investment

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performed by method of privatization. In addition, Mišun and Tomšík, (2002) point out negative direct effects of foreign direct investment. It involves basically pressure on appreciation of domestic currency, enforced increase of money supply and related inflation pressure increase of foreign trade deficit in the area of new technologies import and increase of deficit of current account payment balance as a consequence of profit repatriation by multinational companies. According to Blomström and Kokko, (1998) next to these direct effects, FDI can have indirect effects on the host economy, mainly through technology or productivity spillovers from foreign-owned firms to domestic firms. More than 30 years ago was published the first paper on productivity spillovers to host country firms from multinational companies. The author of this paper was Richard Caves. According to Caves, (1974) foreign investment may also impel higher technical efficiency in competing domestic firms and speed the transfer of new technology to them. Mišun and Tomšík, (2002) refer to positive indirect effect of foreign direct investment on domestic companies when positive effects from foreign companies transfer on domestic market and increase competition on market due to fact that they become business partners of foreign companies. Reverse effect, it means negative indirect effect of foreign direct investment on domestic market id dual economy, the situation when on the one hand there are foreign companies operating in domestic economy with prospect and on the other hand there are domestic companies with inefficient economy and consequently are pushed out from the market by stronger foreign companies.

Foreign direct investment is generally considered to be an instrument how to stimulate economic growth of any country. For this purpose governments of countries try to encourage the inflow of foreign direct investment by various measures. The volume of inflow foreign direct investment in Central and Eastern Europe countries has been increasing during last twenty years. Tyttell et al., (2007) highlight the fact that FDI is widely considered an important catalyst of economic development. Economist and policy makers believe that FDI can improve host countries` technological capacities and managerial style, both at companies receiving FDI (through direct effects and at companies working in the same industry (through indirect spillover effects) or in upstream industries (through backward linkages). Christl, (2007) pointed to the fact that transition economies might benefit from FDI when innovative technologies or, in general, knowledge introduced by a foreign investor spill over to the domestic firms.

The main aim of this paper is to examine effects of foreign direct investment on domestic investment in selected countries of Central and Eastern Europe; and specifically, the effects of crowding in domestic investment and crowding out domestic investment by FDI. Countries of Central and Eastern Europe are selected according to the highest value of foreign direct investment per capita. The selected countries are Czech Republic, Estonia, Hungary and Slovakia. These countries are close not only from the geographical point of view but also from the pint of the development of economic situation after the totalitarian regime disintegration. This paper is divided into five parts, two of which are the introduction and conclusion. Second part deals with literature overview dealing with this issue. Third part pays attention to model specification and data. Fourth part deals with testing the effects of crowding in and crowding out of domestic investment by foreign direct investment.

2. Literature overview

There is a series of empirical studies examining foreign direct investment effects on domestic investment in host countries. Such effects are examined by various approaches. The results of individual studies vary, which depends on the period selected, data processed, other variables included in the model or it depends on the econometric methods. A model, used to perform research in this paper, is formulated by Agosin and Mayer. Agosin and Mayer, 2000 examined effects of crowding in and crowding out of domestic investment in three regions, including Africa, Asia and Latin America. They performed research with 32 countries for the period 1970 – 1966. In this period they proved effect of crowding in of domestic investment in Asia, effect of crowding out of domestic investment in Latin America and neutral effect of foreign direct investment on domestic investment in Africa. Time period subsequently divided two sections, from 1976 – 1985 and 1986 – 1996. In these periods authors confirmed results reported for the whole time period in Asia and Latin America region. Africa, in both periods showed effect of crowding in of domestic investment by foreign direct investment. Mišun and Tomšík, (2002) performed similar research. They examined crowding in effect in Poland, Hungary and Czech Republic for time period 1990 – 2000 (Poland and Hungary) and period 1993 – 2000 (Czech Republic). Results of their research proved the effect of crowding in of domestic investment by foreign direct investment in the Czech Republic and Hungary and the effect of crowding out of domestic investment by foreign direct investment in Poland. Backer and Sleuwaegen, (2003) researched the

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