

# Relocation via foreign direct investment from old to new EU member states Scale and structural dimension of the process

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Received December 2006; received in revised form November 2007; accepted November 2007

Available online 4 December 2007

## Abstract

The paper analyzes two issues related to the relocation via FDI from old to new EU member states. The first is the nature and scale of the relocation via FDI, i.e. the existing and future potential for relocations. The second is structural characteristics of the relocation process, i.e. which industries are in the heart of the process. We apply the so-called flying geese model (FGM) framework to analyze the structural trends in inward FDI to the new member states. We claim that it is mostly efficiency-seeking FDI in manufacturing, which is the bearer of the relocation process. The existing stock of efficiency-seeking FDI in the new member states is very small in terms of overall EU-15 outward FDI, but at the same time results in rather high level of foreign penetration in the new member states. These limit the existing and future scale of relocation to the new member states. In terms of the structural aspect of relocation, efficiency-seeking FDI in the new member states is increasingly in medium tech and in lower end segments of high tech industries, while the attractiveness of these countries for low tech labor intensive production is gradually vanishing. Low tech industries will be increasingly relocated outside EU-25.

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*JEL classification:* F210; F230; L600; O140

*Keywords:* Foreign direct investment (FDI); Relocation process; Low tech industries

## 1. Introduction

The issue of production relocation via foreign direct investment (FDI)<sup>1</sup> from the old (EU-15) to the new EU member states from Central Europe (NMS-8)<sup>2</sup> has attracted an increasing attention in the recent period. Although the

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<sup>1</sup> Relocation means that companies move part of their production processes and/or service functions to a subsidiary in a cheaper location. The term is usually used in the sense of international relocation (Hunya and Sass, 2005: 2), meaning that companies relocate their activities by the way of FDI. More on the definition of relocation, and similar but different concepts of outsourcing and offshoring see in Hunya and Sass (2005: 2–3).

<sup>2</sup> Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia. The paper has been written before 1 January 2007, therefore it does not include Bulgaria and Romania.

restructuring of production along the lines of integrating countries' competitive advantages is one of the main benefits of economic integration and is to be a welcomed and anticipated result of the last EU enlargement, policy makers, trade unions and public at large in EU-15 seem to be caught by a negative surprise. Three issues are particularly interesting in the context of FDI and relocation: (i) does the relocation via FDI causes the fall of home country production, exports and employment; (ii) what is the (actual and potential) scale and nature of this relocation; (iii) what are the structural characteristics of the relocation via FDI. While the first issue is of particular interest of EU-15 as investing countries, the third issue is the most important for NMS-8 as FDI recipient countries. The second issue is relevant for both.

In the existing literature, far the most attention has been devoted to the first issue, i.e. to the impact of FDI on investing countries' production, exports and employment. Although empirical studies are not of unanimous opinion, the overwhelming conclusion is that there is basically no empirical evidence, which would support the notion of decreasing exports and employment in EU-15 because of the relocation of production to NMS-8.<sup>3</sup> This is in sharp contrast with a popular view that every relocation results in the reduction of exports and employment in the investing country. Such a perception may be true for a particular production, particular industry, particular region or a particular cohort of employees, but looking the investing country as a whole, the empirical evidence says that relocation has been (more than) compensated by increased investment, production, exports and employment in other investing country industries. The relocation problem for economic policy is that those employees, which have lost jobs because of the relocation, are not the same as the employees, which have got the jobs because of the restructuring of home country economy into higher value added activities. In other words, in spite of a positive macroeconomic effect of relocation for investing economy, the fact that particular regions and/or cohorts of employees may be worse off, urges the policy makers to resolve the problems of those being worse off.

The primary aim of this paper is to shed light on the second and the third issue, i.e. firstly, on the nature and scale of the relocation via FDI, on what is the existing and future potential for relocations via EU-15 FDI to NMS-8 (Section 2), and, secondly, on what are the structural characteristics of the relocation process, which industries are in the heart of the process. Here we apply the so-called flying geese model (FGM) to analyze the structural trends in inward FDI to NMS-8 (Section 3).

## 2. Nature and scale of relocation via FDI from EU-15 to NMS-8

The lack of exact data on the relocation via FDI is probably the main problem in analyzing the phenomenon. There is no broad and accurate database, which would directly tackle the relocation aspect of FDI. Our proposition here is to grasp the nature and the overall scale of the relocation by: (i) differentiating between various types of FDI; (ii) assessing the relevance of NMS-8 in EU-15 outward FDI flows, which indicates the existing scale of relocation, and (iii) assessing the level of FDI penetration in NMS-8, which indicates the scope for further relocation in the future. We claim that it is efficiency-seeking (production cost advantages-seeking, vertical) FDI in the manufacturing sector, where the main potential for relocation lies and that the scope for relocation via EU-15 FDI to NMS-8 is limited and so is its potential for future growth. Also, relocation is accompanied by increased imports of subsidiaries from their foreign parent companies, which may more than compensate eventual initial substitution of exports by production abroad.

### 2.1. Type of FDI and relocation

In analyzing FDI as a means of relocation it is convenient to distinguish between (local) market seeking (horizontal) FDI in manufacturing, efficiency (factor cost advantages) seeking (vertical) FDI in manufacturing and FDI in the service sector.

In the case of *market-seeking FDI*, foreign investor establishes a foreign subsidiary to better serve a particular market. Here, the potential for relocation is obvious, since the investor may substitute previous exports from home country by local production in a host country. Local markets of NMS-8 have been one of the main, if not the main motive of manufacturing foreign investors. However, the issue is to what extent has local production of foreign subsidiaries substituted previous exports from foreign investor's home countries. Here, there was not much to be substituted. As

<sup>3</sup> More on that see in Lipsey (2002), Brainard (1997), Konings (2004), Konings and Murphy (2003), Braconier and Ekholm (2000), Becker et al. (2005), European Commission (2005a, 2005b), etc.

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