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Interaction between foreign financial services and foreign direct investment in Transition Economies: An empirical analysis with focus on the manufacturing sector

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ABSTRACT

This paper studies the nexus between financial and non-financial foreign direct investment in Transition Economies, which are members of the EU. Three questions, which are pointed out in the theoretical literature, are discussed in the paper. We use a dataset for nine Transition Economies over the period 1996–2007, for most regressions we apply GMM and for one regression 2SLS. The empirical results lead to three important statements: non-financial FDI is positively affected by financial services FDI and by market potential. Foreign banks in the EU Transition Economies are mainly driven by non-financial FDI and the capital intensity of a country. FDI crowds out domestic investment in the manufacturing sector.

1. Introduction

Foreign direct investment and foreign banks are considered as an important source of economic growth and as a positive factor in the development and transformation of Transition Economies. The effect of foreign direct investment (FDI) and its short-run determinants are quite well studied, both in theoretical and empirical sense. However, a few studies about foreign financial services exist. Moreover, until now there has been only little empirical work which deals with the causality issue and answers the often discussed question:

> *Do foreign banks follow their clients or do foreign banks work as a catalyst for foreign direct investment in Transition Economies?*

The theoretical as well as the empirical literature is concerned about the effects and determinants of the activity of foreign investors in Transition Economies. A positive growth effect of FDI trough backward knowledge spill-overs in Lithuanian firms was found by Smarzynska Javorcik (2004). The general effect of FDI on the whole economy is studied by Borensztein et al. (1998). They show that a sufficient high level of absorption capacity is a crucial condition for an economy to gain from the presence of FDI. The determinants of FDI in a gravity model approach are studied by Bevan and Estrin (2004) and Carstensen and Toubal (2004). Both find that market potential and risk have a strong effect on FDI. However, neither one of these two studies considers the role of foreign banks, which is a very important economic factor. A study by Mérö Valentinyi (2003) on the five largest EU Transition Economies shows the effect of foreign banks on the economy.

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Foreign banks contributed to the privatization and modernization of the banking sector. Another study on this topic, by Weill (2003) shows that foreign banks increase competition and lead to more efficiency in the banking sector. This leads to the question why foreign banks decide to enter Developing Economies. In comparison to the literature on FDI, relatively few studies exist on this topic. Goldberg and Johnson (1990) find that US banks follow their clients abroad. Contrary, Wezel (2004) does not find evidence for this hypothesis for the countries covered in our study. German banks indeed follow their clients when countries in Asia are considered. However, in Central and Eastern Europe the economic development is the main determinant for their entrance to the market. Further on, the recent empirical literature shows that foreign banks increase the efficiency of the local economy. Eller et al. (2006) use foreign banks as an important determinant of total factor productivity growth. Alfaro et al. (2004) find that the development of the local financial system crucially affects the positive effect of FDI on growth.

Data on FDI and foreign banks seems to show a pattern in Central and Eastern European Countries (CEEC): countries which have undergone a reform and allowed foreign banks to operate quite early, present also the highest FDI to GDP ratio in the past years. For example, by 2004 most of Hungarian banks were fully or partially owned by multinationals (Akbar and McBride, 2004). As reported by Buch (1997) the market share of foreign or joint-venture banks in total assets in 1995 was 22.7% in Hungary, 15.9% in Czech Republic and 4.4% in Poland. Mérö and Valentinyi (2003) report data about foreign bank assets as % of GDP. In the year 1998 and 2002 in Hungary the shares are 35.4% and 49%, 31.8% and 94.4% for the Czech Republic and 9.6% and 40.7% for Poland. In the same years the share of foreign banks in commercial bank assets was 62.5% and 90.7% for Hungary, 28.1% and 85.8% for the Czech Republic and 17.4% and 70.9% for Poland. The presence of foreign banks seems to be related to the FDI to GDP ratio in those countries. In 1995 Hungary received a considerable FDI inflow of 10% of GDP, which stayed at around 7% in the subsequent years (The World Bank, 2008). The Czech Republic received 4% and only 2% in the following years. A peak of 10% appeared in 1999 and the inflow remained quite high. Finally, Poland received around 2.6% and this number stayed constant, until it increased to 4.3% in 1999 and stayed at this level. The average FDI inflow over the period 1995–2005 was 6.57% in Hungary, 5.94% in the Czech republic and 3.42% in Poland.

Those numbers do not allow for conclusions, however they indicate that an early opening to foreign banks and their participation in the economy was followed by a significant inflow of FDI. It is possible that various economic factors have triggered both kinds of FDI with different lag. An empirical study is necessary to find the exact relationship and causality. Basing on the recent literature, we formalize the following questions, which we answer by empirical evidence:

Do foreign banks work as a catalyst for FDI?

Do foreign banks follow their clients or open new markets?

What is the effect of FDI and foreign banks on domestic investment in the manufacturing sector?

Three different but strictly connected problems are tackled in this paper. The literature review on each of the topics is presented in the corresponding section.

The data used in this paper and the time period covered is as follows. The CEEC destination countries are Bulgaria (1999–2007), Czech Republic (1997–2006), Estonia (1997–2007), Hungary (1998–2006), Latvia (1996–2007), Lithuania (1995–2007), Poland (1996–2006), Slovak Republic (1996–2005) and Slovenia (1994–2006). Data availability allows to study the period presented in brackets. Moreover, we exclude the years of the global financial crisis, because it distorted the long-run relationship between FDI, foreign banks, domestic investment and economic growth in most countries. Romania is excluded due to data availability problems. Data on bilateral FDI stocks and stocks disaggregated by sectors origins from the Vienna Institute for International Studies. The data on financial services foreign direct investment (FSFDI) is reported at the NACE level. Financial services include banking, insurance, pension funds and leasing. The fraction of banking in the FSFDI stock is at least 80% in the case of Poland and up to 95% in the case of Estonia (Eurostat, 2009). Foreign banks and other financial institutions which are usually subsidiaries[1] of the same investor offer also the remaining financial services. Thus, foreign financial services can be called foreign banking activity. However, to be precise, we use the term financial services foreign direct investment (FSFDI) through this paper.

This paper is organized as follows. Section 2 deals with the determinants of foreign direct investment from donor countries to host countries. Section 3 deals with the determinants of foreign financial services. The nexus between foreign direct investment, foreign financial services and domestic investment in the manufacturing sector is presented in Section 4. Section 5 concludes. Data sources and the construction of the time series is explained in Appendix A, while the Stata commands applied in the regressions are presented in Appendix B.

2. Determinants of bilateral FDI stocks

A large and continuously growing stock of foreign direct investment can be observed in Transition Economies. Around 70–85% of FDI in both the financial and non-financial sector origins from the following OECD countries: Austria, Belgium (and Luxembourg), Denmark, France, Germany, Italy, Japan, Korea, Netherlands, Portugal, Spain, UK and US. In order to

[1] For example, in Poland the bank Kredyt Bank and the insurance company Warta were owned by the KBC group; Allianz and ING offer banking and insurance; Moreover, PeKaO, the largest bank, offers banking and leasing. It is owned by UniCredit Banca.