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# The European flying geese New FDI patterns for the old continent?

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## Abstract

This article attempts to apply the flying geese metaphor to emerging foreign direct investment (FDI) patterns in Europe and the Mediterranean. Such a division of labour is at best at a nascent stage, given the overwhelming share of Western Europe in both inward and outward foreign direct investment flows. Because of these imbalances, special attention is to be paid to Central and Eastern Europe's (CEE) potential, both in the group joining the European Union (EU) in 2004 and the rest of the subregion. For the former, middle-income countries, risks in investment promotion are related to uncertainty brought about by the transition to European Union's *acquis* and an eventually too fast increase in production costs. Policy response to that requires a modernisation of both general and specific investment promotion policies, adjusted to the rules of the Union. For the rest of Central and Eastern Europe, the challenge is to adjust to the enlarged European Union and to improve the business and investment environment, in order to capture the foreign direct investment outflows of other European countries searching for optimum labour costs.

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## 1. The changing face of Europe

Over the 1990s, the face of Europe underwent major changes, mostly as a result of the end of the cold war and the pulling down of the Iron Curtain. The Eastern part of the continent rejoined the Western part. The distribution of income level, too, underwent major changes. A bird's eye view of the old continent and its Mediterranean neighbourhood in 1992 resulted in a patchwork of income levels. Most of the European Union (EU) member countries were either in a clearly high-income bracket (Table 1), or—in the case of countries such as Spain, Portugal and Greece—in a second group in its way toward becoming full-fledged high-income countries. Then there was a middle-income group consisting of the natural-resource-rich Russian Federation, Turkey, as well as most of the countries that later on, in 2004, would join the EU to form a new group of 25 countries. The rest of Europe and the Mediterranean—including two of the three Baltic States—were low-income.

By 2001 (the latest year for which comprehensive gross domestic product (GDP) data are available) the fortunes of countries turned around significantly. On average, the GDP per capita of Europe and the Mediterranean remain practically unchanged: it increased by 0.3 percent. But within that average, there were strong fluctuations.

Most of the EU-15 countries kept their ranking, although some of them, as well as non-EU Switzerland, saw their nominal GDP per capita shrink over that period. In turn, GDP per capita increase very fast in all the countries joining the EU in 2004. Their number in the second layer of high-income countries increased from one to three. With the arrival of the two Baltic States, and the departure of the Russian Federation and Turkey to the low-income group, they also became dominant in the middle-income group. The Russian Federation and Turkey were washed back to a very heterogeneous low-income group, in which some countries (Serbia and Montenegro, Georgia, Azerbaijan) experienced major declines, others including second-wave accession Bulgaria and Romania experienced major increases.

What has emerged from these changes is an increasingly clear-cut division of the continent into three distinct income blocs. Of the close to 900 million people populating Europe and the Mediterranean, close to 400 million, mostly on the Western side, are enjoying relatively high-income. About 80 million, in the middle, can increasingly enjoy middle-income. However, because of the large differences with the rich part, despite a fast increase in GDP, this group is to be expected to remain behind the first two layers. The remaining more than 400 million are expected to stay at low-income levels.

This geography should have major implications for the organization of production in the old continent. In principle, the three major groups should specialize on the relative advantages: the rich countries on high functions, the middle-income ones on middle-level coordinating and knowledge-intensive production, while low-income countries on labour-intensive manufacturing.

In principle, the division of labour, especially in efficiency-seeking activities, should follow unit labour costs. In high-income countries, wages are high but so is productivity in high value added activities. And in certain cases, other locations simply miss the necessary skills, or the economic, legal, political stability, or both, required for such activities. Middle-income countries, with their lower wages but also lower productivity, should specialize in the middle range. Finally, low-income countries, on condition that a basic level of stability is there, may be prepared to attract unskilled labour-intensive activities. All this

Table 1  
The changing face of Europe and the Mediterranean, 1992–2001

Income group	Country	GDP per capita 1992 (US\$)	Country	GDP per capita 2001 (US\$)	+/- (%)	EU
High income (first group)	Switzerland	34,964	Luxembourg	42,017	21.8	EU-15
	Luxembourg	34,505	Norway	36,974	25.5	
	Norway	29,466	Switzerland	34,449	-1.5	EU-15
	Sweden	29,386	Denmark	30,265	6.4	
	Denmark	28,452	Iceland	27,032	0.9	EU-15
	Iceland	26,790	Ireland	26,725	76.0	
	Germany	25,127	United Kingdom	24,186	28.9	EU-15
	Austria	24,190	The Netherlands	23,785	7.8	EU-15
	France	23,485	Sweden	23,680	-19.4	EU-15
	Belgium	22,654	Finland	23,297	7.9	EU-15
	The Netherlands	22,064	Austria	23,260	-3.8	EU-15
	Italy	21,630	Germany	22,418	-10.8	EU-15
	Finland	21,592	Belgium	22,351	-1.3	EU-15
				France	21,990	-6.4
High income (second group)	United Kingdom	18,769	Italy	18,928	-12.5	EU-15
	Spain	15,235	Israel	17,547	28.6	EU-15
	Ireland	15,182	Spain	14,234	-6.6	
	Israel	13,640	Cyprus	11,566	18.3	EU-25
	Portugal	9,882	Portugal	10,944	10.7	EU-15
	Cyprus	9,780	Greece	10,703	10.0	EU-15
	Greece	9,730	Slovenia	9,463	47.2	EU-25
			Malta	9,267	24.1	EU-25
Middle income	Malta	7,468	Czech Republic	5,536	91.7	EU-25
	Slovenia	6,429	Hungary	5,209	44.0	EU-25
	Hungary	3,617	Lebanon	4,724	143.7	EU-25
	Russian Federation	2,971	Poland	4,560	107.3	
	Czech Republic	2,888	Croatia	4,558	111.6	EU-25
	Estonia	2,741	Estonia	4,084	49.0	
	Turkey	2,679	Slovakia	3,793	71.1	

Table 1 (Continued)

Income group	Country	GDP per capita 1992 (US\$)	Country	GDP per capita 2001 (US\$)	+/- (%)	EU
Low income (first group)	Slovakia	2,217	Lithuania	3,442	561.6	EU-25
	Poland	2,199	Latvia	3,211	524.3	EU-25
	Croatia	2,154				
	Lebanon	1,938				
	Algeria	1,831	Russian Federation	2,139	-28.0	Candidate
	Tunisia	1,819	Turkey	2,131	-20.5	
	Serbia and Montenegro	1,810	Tunisia	2,077	14.2	
	Bulgaria	1,207	Algeria	1,778	-2.9	
	Macedonia, TFYR	1,198	Romania	1,726	58.6	Accession
	Morocco	1,116	Bulgaria	1,687	39.8	Accession
	Romania	1,088	Macedonia, TFYR	1,684	40.5	
			Albania	1,318	509.6	
			Belarus	1,224	165.4	
			Bosnia and Herzegovina	1,173	236.6	
		Morocco	1,157	3.7		
		Serbia and Montenegro	1,030	-43.1		
Low income (second group)	Georgia	832	Ukraine	763	88.9	
	Azerbaijan	787	Armenia	686	111.6	
	Lithuania	520	Azerbaijan	679	-13.7	
	Latvia	514	Georgia	601	-27.8	
	Belarus	461	Republic of Moldova	346	226.4	
	Ukraine	404				
	Bosnia and Herzegovina	348				
	Armenia	324				
	Albania	216				
	Republic of Moldova	106				

Source: Author's calculations, based on UNCTAD's Handbook of Statistics 2003 on-line, <http://stats.unctad.org/>, accessed on 12 December 2003.

presupposes that wages are rightly priced, more or less at an “equilibrium” level. In other words, they are not excessively low, nor are they too high. In the latter case, a location would price itself out from the division of labour.

It may be argued, however, that this type of division of labour is far from being accomplished for two major reasons: because of the inherited structures of the past, and because of policy-related reasons. As for the first factor, until the 1990s, most of the current EU-accession countries slated to join in 2004 were not on the production map. Middle-income functions were undertaken in some of the relatively lower-income members of the EU (e.g. Spain, Portugal, Greece), and most of the labour-intensive production in Turkey or in the Southern Mediterranean. With the changes during the 1990s, and for that reason, the Central and Eastern European (CEE) accession countries of 2004 increasingly started attracting first, labour-intensive, then middle-income functions. Low-income CEE was originally a latecomer but became a magnet for labour-intensive production in the late 1990s. One may argue that most of the CEE countries are in this sense in a catch-up phase.

As for policy obstacles to a new geography, one may mention protectionist pressures in the incumbent EU members, calling for the retention of departing production (e.g. textile and footwear). However, with enlargement in 2004, that pressure towards middle-income new members should lessen. What is gaining importance is the quality of the business environment in CEE. In this sense, the main challenge for policy makers there—both in the countries joining the EU in 2004 and the others, is how to improve the business environment fast enough to capture the activities leaving the richest EU members. This is less serious a problem in the accession countries which are undergoing a forced march towards applying the *acquis communautaire* than for the rest of the region.

## 2. FDI trends in Europe and the Mediterranean

Looking back to the decade of 1992–2002, the foreign direct investment (FDI) trends of Europe and the Mediterranean have reflected rather imperfectly the emerging trends in the standards of living. It may be so because of the mutual relationship between GDP growth and FDI, the first direction (the impact of GDP on FDI) may have been weaker than the second one (the impact of FDI on GDP). What emerged over the decade is an overwhelming dominance of the richest countries (with 2001 GDP over US\$ 20,000) in both FDI inflows and outflows (Table 2). As expected, these countries turned out to be net capital exporters (with their cumulative FDI outflows exceeding their cumulative inflows by more than US\$ 1 trillion). Moreover, these rich countries performed better than any other group in relative terms, too (when FDI inflows and outflows compared to population or gross fixed capital formation).

Quite strikingly, the second group of rich countries (Italy, Israel, Spain, Cyprus, Portugal, Greece, Slovenia, Malta) followed quite distantly, and performed badly when FDI inflows were compared to population and gross fixed capital formation (GFCF). It seems that this group was much less attractive than the middle-income—mostly accession—countries (Czech Republic, Hungary, Poland, Estonia, Slovakia, Lithuania, Latvia, plus Croatia and Lebanon). It may well be that the former locations could not compete with the latter ones for medium-technology activities, which in the previous decades used to be the backbone

Table 2  
Indicators of FDI in Europe and the Mediterranean, by income group, 1992–2002

Group	Cumulative FDI inflows (US\$ billion), 1992–2002	FDI inflows per capita (US\$), average for 1992–2002	Inflows as a percentage of GFCF, weighted average for 1992–2001	Cumulative FDI outflows (US\$ billion), 1992–2002	FDI outflows per capita (US\$), average for 1992–2002	Outflows as a percentage of GFCF, weighted average for 1992–2001
High income, first group (Belgium, Luxembourg, Norway, Switzerland, Denmark, Iceland, Ireland, United Kingdom, The Netherlands, Sweden, Finland, Austria, Germany, France)	2 577	870	17.4	3 584	1 212	25.3
High income, second group (Italy, Israel, Spain, Cyprus, Portugal, Greece, Slovenia, Malta)	311	22	6.6	359	255	6.6
Middle income (Czech Republic, Hungary, Lebanon, Poland, Croatia, Estonia, Slovakia, Lithuania, Latvia)	140	160	16.0	6	7	0.5
Low income, first group (Russian Federation, Turkey, Tunisia, Algeria, Romania, Bulgaria, TFYR Macedonia, Albania, Belarus, Bosnia-Herzegovina, Morocco, Serbia-Montenegro)	76	20	5.7	21	6	1.5
Low income, second group (Ukraine, Armenia, Azerbaijan, Georgia, Republic of Moldova)	13	16	12.3	1	1	0.7

Source: Author's calculations, based on UNCTAD's FDI/TNC database and Handbook of Statistics 2003 on-line, <http://stats.unctad.org/>, accessed on 12 December 2003.

of their economies. Mirroring this fact, the second group of high-income countries was also a net capital exporter.

The middle-income group was clearly the magnet of inward FDI over the past decade, at least if relative measures are considered. It attracted eight times more FDI per capita than the second layer of the rich-country group, and more than twice in terms of FDI per GFCF. In turn, it was a source of very low levels of FDI.

Finally, the share of low-income groups in both FDI inflows and outflows, as expected, turned out to be low. In general, the poorer countries are, the less inward FDI they attract and the less outward FDI they export. The only exception to this rule is the first group of low-income countries. It includes two recently major sources of outward FDI: the Russian Federation and Turkey (which became “forced” capital exporters due to the problems of the domestic business environment). As a result, compared to GFCF; this group is a more important source of outward FDI than middle-income countries.

### 3. The flying geese metaphor

What could in the future become a new division of labour in Europe and the Mediterranean would be possible to predict by the “flying geese” metaphor of FDI, borrowed from the Japanese/Asian context. It is however, a metaphor, and not a full parallel. It is also to be taken into account that such a division of labour is not a “fatality”. Whether it emerges or not, for the mutual interest of most of the countries involved, will depend on the interaction between corporate and government decision makers in the future.

The flying-geese paradigm was originated in Japan (and first in Japanese language only) by Kaname Akamatsu in the 1930s. He presented them in English in the 1960s (Akamatsu, 1961). This theorem was expanded and applied to FDI and transnational corporation (TNC)-led growth by Kojima (1973, 2000). This expanded flying geese paradigm states that, as host countries industrialize and go through industrial upgrading and learning in an open-economy context, the type of FDI flowing from home countries changes in character towards higher skills; in turn, simpler activities will gradually flow out from relatively advanced host countries to newcomer host countries. This process reinforces the basis for, and the benefits from, trade (UNCTAD, 1995, pp. 258–260).

The flying geese theorem is to be applied and interpreted here in conjunction with other basic theories of FDI. There is indeed a close relationship between them. This relationship is particularly patent when, for example, the flying geese paradigm is compared with Raymond Vernon’s (1966) product cycle theory. The main difference between the two is a relatively macro-level and development-oriented approach of the former and a relatively more micro and firm-oriented approach of the latter. The flying geese are also closely related to the investment development path (IDP) (Dunning, 1981, 1986) under which the international investment position of countries fluctuates according to the level of GDP per capita. The investment development path offers a new approach to one of the oldest theoretical constructs of development, viz. development through stages. The stages of IDP are: stage 1: low inward and outward FDI, net inward investment position; stage 2: high inward and low outward FDI, increasingly net inward investment position; stage 3: outward investment catches up with inward investment; stage 4: outward FDI exceeds inward FDI; stage 5: net

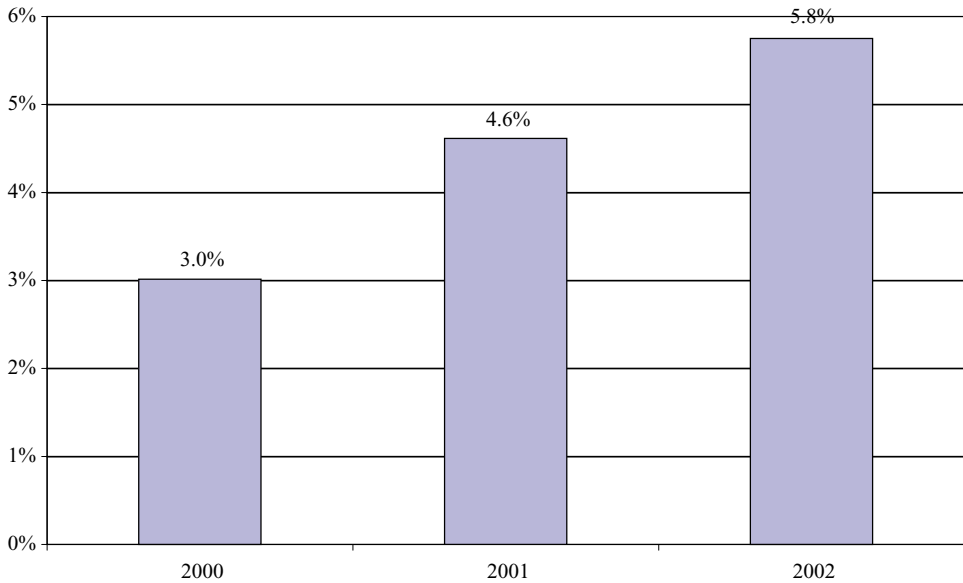


Fig. 1. Do candidates divert FDI from the EU-15? FDI inflows of 10 accession countries (2004) as percentage of EU-15, 2000–2002. *Source: Kalotay, 2003.*

outward position fall again and fluctuates around zero. The main difference of this stages approach with the flying geese paradigm that it treats countries in themselves, without going into the details of their international (regional and global context). Finally, all these theories can be interpreted in the envelope of the eclectic paradigm (Dunning, 2000), which offers a framework for organizing theories rather than a theory per se (it is more a meta-theory).

This article focuses on the flying geese metaphor because in the current quest for a mutually beneficial new division of labour in Europe and the Mediterranean, it offers the ideal theoretical construct to suggest ways for reshaping current FDI trends.

Current FDI trends, as seen from the statistics, do not necessarily follow the flying geese shape. The flying geese are at best in an embryonic stage. Most of the inward FDI of the continent FDI is still blocked in the first group of high-income countries (Fig. 1). There is a need for increasing the share of all the other countries in inward FDI flows. Another bottleneck is at the level of the middle-income countries. Their outward FDI until recently has been too low to support a flying geese movement. The structure of FDI, too, needs to reflect better the relative advantages of different locations. Middle-income countries have to increase the share of knowledge-intensive FDI. These requirements point at the fact that CEE—both the EU accession (middle-income) part and the low-income non-accession part—are now holding the key to future developments. This is the reason why the rest of the article will focus on recent FDI trends and policy challenges in CEE.

The enlargement of the EU is in this context a key policy variable affecting future FDI flows. Being inside the integration grouping—the fate of almost all middle-income countries after May 2004—offers some irreplaceable advantages for attracting FDI. First of all, it

offers stability and security to investors. Secondly, it provides for the free movement of persons, capital, good and services, a condition that is particularly important for efficiency and asset seeking investors—the focus of the flying geese metaphor. Thirdly, it provides opportunities for a better representation and defence of national policies and policy interests.

It does not mean, however, that EU membership would be the only factor determining future FDI flows. It acts in conjunction with other factors. And as for countries outside the integration grouping, there is always a way to negotiate some kind of economic agreement with the EU trying to obtain as much as possible from the advantages of the free movement of persons, capital, good and services, as well as security and stability. This is of particular importance for those countries of CEE and the Mediterranean that are not offered a perspective of negotiating EU accession.

#### 4. FDI patterns in Central and Eastern Europe

The reintegration of CEE into the world economy has been a long and difficult process, propelled by the crumbling of the Berlin Wall in 1989. As mentioned earlier, it will enter a new phase when eight of these countries will join the EU in 2004 (and two others, Bulgarian and Romania in 2007). Immediately after transition had started—and independence had been gained, in many cases—liberalization in trade and capital flows became the first vehicles of that reintegration. From the mid-1990s onwards, inward foreign direct investment has gained importance in an increasing number of CEE countries, reinforcing a successful reintegration of these countries into the world economy (Kalotay, 2001).

EU integration and FDI inflows indeed have been parallel and mutually reinforcing processes. In most cases, new phases of EU integration have been accompanied by surges of FDI inflows (Fig. 2). Until 1990, the FDI inflows of the region remained under US\$ 1 billion. In 1991, the year when the first Europe (association) Agreements were signed, they increased to more than US\$ 2 billion; in 1995, when most of the applications for membership were submitted, they already exceeded US\$ 14 billion. And in 2002, when in Copenhagen the conditions of accession were finalized, the inflows of CEE reached a new record of US\$ 29 billion (UNCTAD, 2003, p. 59).

The upward trend affected not just the eight CEE countries joining the EU in 2004 but the rest of the region. It seems that in an indirect manner, EU enlargement has spread its umbrella of stability to the rest of the region, too. The steady performance of CEE contrast sharply with the global downturn of FDI in 2001 and 2002 (consider that after a record of US\$ 1.4 trillion in 2000, global FDI flows plummeted to US\$ 651 by 2002. This is the sharpest decline in global FDI in 30 years—of which by and large CEE countries remained immune).

Cross-border mergers and acquisitions (M&As), both privatisation related and others, were important for CEE's inflows in 2002, with the 10 largest cross-border sales (Table 3) amounting to US\$ 12 billion in 2002 and the total reported exceeding US\$ 16 billion. These data are, however, imperfect indicators of FDI-related developments, because the values of various cross-border deals remain undisclosed and some cross-border M&A sales do not have counterparts in the FDI inflow data. This is why the cross-border M&A sales of Hungary in 2002 were significantly higher than FDI inflows (for a discussion of the

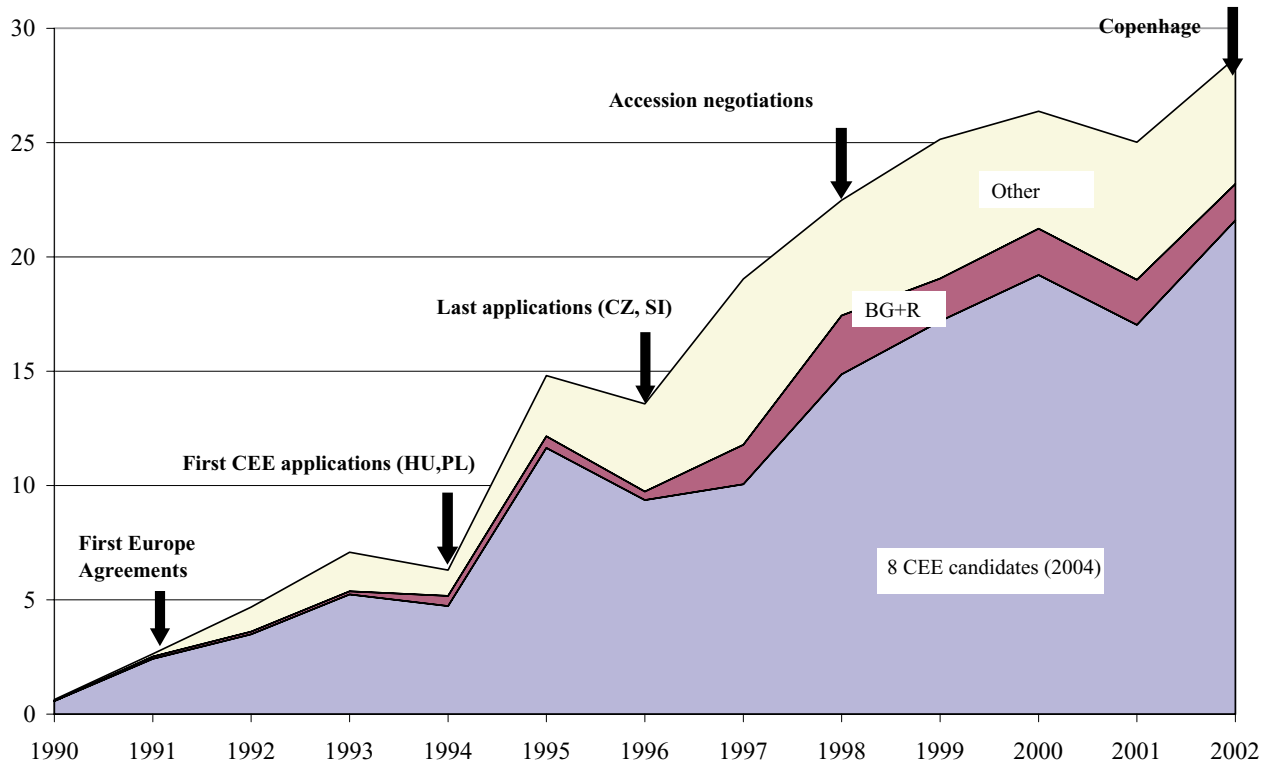


Fig. 2. EU integration process and FDI in CEE (US\$ billion), 1990–2002. Source: Kalotay, 2003.

Table 3  
Largest cross-border M&A sales in CEE, ranked by value, 2002

Firm sold	Host country	Industry	Acquirer	Home country
Transgas	Czech Republic	Gas utility	RWE	Germany
Slovensky Plynarensky Priemysel	Slovakia	Gas utility	Gazprom, Ruhrgas, Gaz de France	Russian Federation, Germany, France
Pannon GSM (KPN's (The Netherlands), Sonera's (Finland) and Tele Danmark's (Denmark) shares)	Hungary	Mobile telecom provider	Telenor	Norway
Lek	Slovenia	Pharmaceutical	Novartis	Switzerland
Ceska Sporitelna	Czech Republic	Bank	Erste Bank	Austria
GTS Central Europe	Poland	Informatics	KPN	The Netherlands
Kredyt Bank	Poland	Bank	KBC Bank	The Netherlands
Zagrebacka Banka	Croatia	Bank	UniCredito Italiano, Allianz	Italy, Germany
Bravo International	Russian Federation	Beer	Heineken	The Netherlands
Nova Ljubljanska Banka	Slovenia	Bank	KBC Bank	Belgium

Source: Based on UNCTAD, 2003, p. 79, footnote 37.

data on cross-border M&As and its correspondence with FDI flows, see UNCTAD, 2000, pp. 105–106).

Trends in individual countries are often related to the lumpiness of related-related FDI, causing large upswings or downswings. In other cases, a wait-and-see attitude by investors may explain the lower than expected level of FDI, as accession countries are adjusting their FDI regimes to the requirements of EU membership (e.g. Hungary).

As a result of the changing dynamics of FDI and the catching up of some latecomer countries, the traditional dominance of the Czech Republic, Hungary, Poland and the Russian Federation is starting to change, with only the Czech Republic still growing, while the other three countries declined. For various reasons discussed below, Hungary was only the eighth largest recipient in 2002.

The automobile industry in CEE—a major recipient of FDI—is still on a growth path. The announcement of new projects in early 2003 in Slovakia (by PSA) and the Russian Federation (by Renault) and the announcement of the expansion of existing projects (e.g. by Audi and Suzuki in Hungary) ensure that growth continues in 2003 (Table 4).

Table 4  
CEE: a car assembly bonanza, 2003

Location	Manufacturer
Czech Republic	
Mlada Boleslav	Volkswagen/Skoda
Kolin	Toyota/PSA (2005)
Hungary	
Győr	Audi Hungaria Motor
Esztergom	Suzuki (Swift, Wagon R+)
Poland	
Gliwice	General Motors/Opel (Opel Agila)
Poznan	Volkswagen (T4)
Lublin	Daewoo FSO <sup>a</sup>
Warsaw	Daewoo FSO
Zeran	Daewoo (Lanos)
Bielsko Biala	Fiat
Romania	
Pitesti	Renault (Dacia Nova)
Craiova	Daewoo (Matiz) <sup>a</sup>
Russian Federation	
Moscow	Renault (X-90) (2005)
Togliatti	GM/AvtoVAZ joint venture (Niva 4 × 4)
Slovakia	
Bratislava	Volkswagen (Tuareg, Polo, Golf 4 × 4, Variant 4 × 4, Bora 4 × 4)
Trnava	PSA/Peugeot (2006)
Slovenia	
Novo Mesto	Renault (Clio)

Source: UNCTAD, 2003, p. 61.

<sup>a</sup> Project discontinued/closed.

By contrast, the electronics industry in CEE, both local and foreign, faces global overcapacity, sluggish demand and cost competition from East Asia, especially China. Electronics firms shed activities based on unskilled cheap labour and expanded activities based on higher skills. Hungary—as the middle-income economy in the region with the “oldest” electronics foreign affiliates—is the first to face the pressure of restructuring towards higher value-added activities (Fig. 3). Flextronics, IBM and Philips are undertaking both closures and capacity expansions—but in different product segments (Table 5).

In the middle-income countries such as the Czech Republic, Hungary, Poland, Slovakia and Slovenia, inward FDI increasingly targets business services and research and development (R&D) (see Table 5 for Hungary). Indeed, the arrival of business services, first to Budapest, and to Prague, both in 2002, is the most marked change of FDI patterns in middle-income accession countries. The move to FDI based on higher labour skills makes the EU accession countries direct competitors with other emerging locations.

In Budapest, Diageo alcoholic drinks company was the first bird to set up a European business service centre, providing all-round financial process management services to all the West European markets of the firm, including the United Kingdom, where it is headquartered. On reaching full speed, the centre could operate with 400–450 employees. The decision to set up that unit in Budapest was mostly driven by “the availability of a flexible, skilled workforce, an ideal business environment and advanced infrastructure” (Benkő, 2002). In October 2002, it was followed by General Electric (GE) Capital that launched its European operation services centre in Budapest, serving the company’s clients and affiliates in Western and Central Europe. The Hungarian affiliate was modelled after GE Capital International Services, GE’s Indian affiliate offering back-office processing services to international clients since 1996. Managers from the Indian call centre were actively involved in the training of the local staff (Benkő, 2002).

GE, just like other firms such as the United States-based aluminium firm Alcoa, decided to locate business services in Hungary in addition to its existing manufacturing facilities. That in principle may provide synergies between the two, especially in terms of upgrading production. In the case of Alcoa, in 2003 a regional information technology (IT) centre was located back-to-back to production and marketing in Hungary.

In Prague, DHL, an express courier and logistics company, created as many as 500 jobs in 2003 when opening a new European IT operations centre there. It followed the footsteps of early bird Accenture, which opened its shared service centre in Prague in October 2001, providing accounting and financial services to Accenture’s European clients from the manufacturing sector in the form of outsourcing. Other examples of business services in the Czech republic include Philips’ IT services centre and Siemens’s CEE purchasing and logistics centre, Nextra’s (Telenor) subregional headquarters for CEE and Genesys’s (Alcatel) subregional contact centre.

The emergence of foreign affiliates in some knowledge-intensive corporate services, however, has not necessarily increased the volume of FDI inflows because they can be established with small capital investments.

Preliminary projections (United Nations, 2004) show the FDI inflows of CEE remain in 2003 at the same level as in the previous year. Within that, however, there may be important differences. FDI inflows into the eight CEE countries joining the EU in 2004 dropped (from

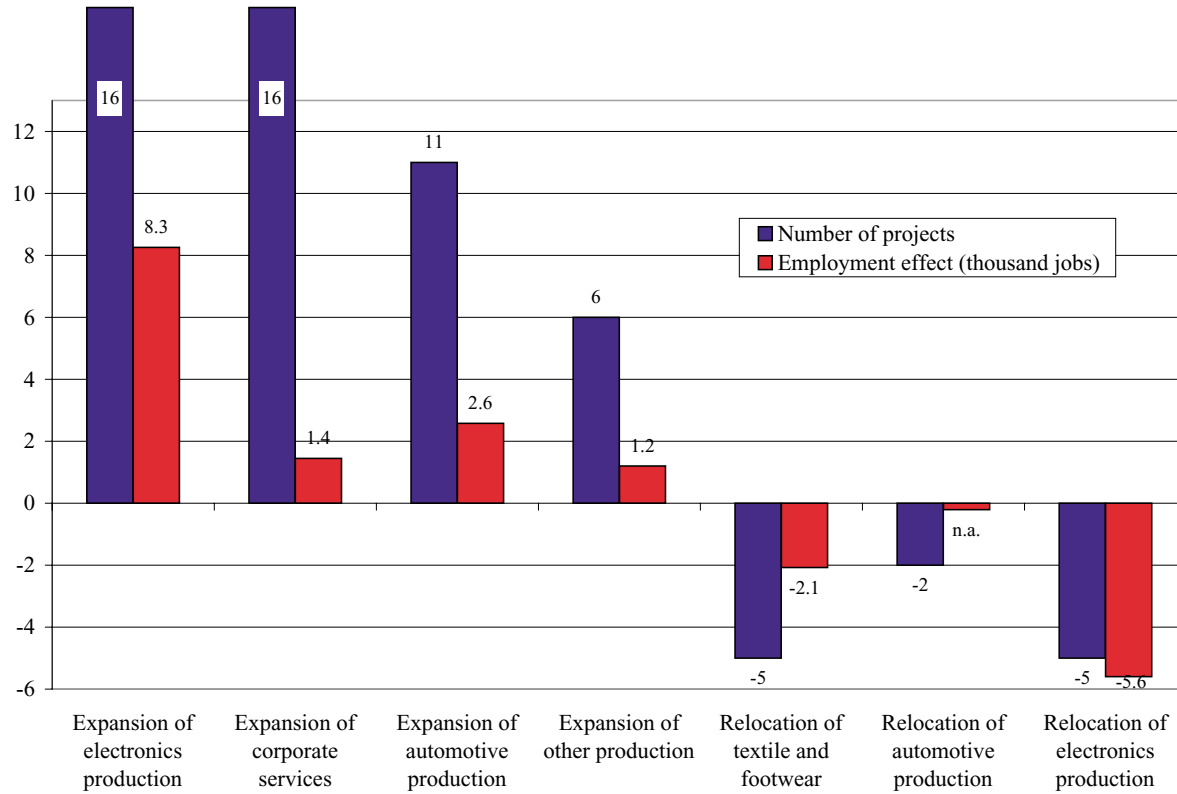


Fig. 3. Expansion and reduction of capacity by affiliates in Hungary—the “ins” and the “outs”, 2002–2003. *Source:* Author’s collection of information, in part presented in UNCTAD, 2003, p. 62.

Table 5  
Selected cases of expansion and reduction of production capacities by foreign affiliates in Hungary, 2002–2003

Foreign affiliate	Industry	Type of action	Activity concerned	Other location involved	Estimated employment effect in Hungary
<b>Alcoa-Köfém Kft.</b>	<b>Aluminium</b>	<b>Relocation to Hungary</b>	<b>European regional computer centre</b>	<b>Thirty-eight other European countries</b>	<b>+150</b>
Artesyn Kft.	Electronics	Relocation to Hungary	Power supplies manufacturing for telecoms and wireless technology	Austria	+50–100
Audi Hungária Motor Kft. <b>Audi Hungária Motor Kft.</b>	Automotive <b>Automotive</b>	Expansion of capacities <b>Expansion of capacities</b>	Eight-cylinder engine <b>Technology development centre</b>	n.a. <b>n.a.</b>	+330 <b>n.a.</b>
Robert Bosch Kft.	Electronics	Relocation to Hungary	Car electronics	Germany	+500
Robert Bosch Elektronika Kft.	Electronics	Relocation to Hungary	Car electronics	Austria, Germany	+250
Bosch Rexroth Kft.	Electronics	New capacity	Car electronics	n.a.	+400
Elcoteq Magyarország Kft.	Electronics	Expansion of capacities	n.a.	n.a.	+250
Electrolux Lehel Kft.	White goods	Relocation to Hungary	Refrigerator production	Spain	+400
Electrolux Lehel Kft.	White goods	New capacity	Refrigerator production	n.a.	+600
<b>Electronic Data Systems (EDS)</b>	<b>Electronics</b>	<b>New capacity</b>	<b>Regional service centre</b>	<b>n.a.</b>	<b>+110</b>
<b>ExxonMobil</b>	<b>Oil and gas</b>	<b>Business support centre</b>	<b>Business support centre</b>	<b>n.a.</b>	<b>n.a.</b>
Flextronics International Kft.	Electronics	Expansion of capacities	In part, mobile phone production	n.a.	+2100
Flextronics International Kft.	Electronics	Relocation from Hungary	X-box production	China	–1000
<b>Flextronics International Kft.</b>	<b>Electronics</b>	<b>Regional HQ</b>	<b>Treasury</b>	<b>n.a.</b>	<b>n.a.</b>
Foxconn Hon Hai	Electronics	New capacity	Spare parts for computers, mobile phones and other consumer electronics	n.a.	+1600 (by 2006)
<b>GE Capital Kft.</b>	<b>Financial services</b>	<b>Relocation to Hungary</b>	<b>Regional call centre</b>	<b>other European countries</b>	<b>+400–450</b>
GE Hungary Rt.	Electronics	Expansion of capacities	Lighting bulb production	n.a.	+100
<b>GE Hungary Rt.</b>	<b>Electronics</b>	<b>New capacity</b>	<b>Logistical centre</b>	<b>n.a.</b>	<b>n.a.</b>
<b>GE Hungary Rt.</b>	<b>Electronics</b>	<b>n.a.</b>	<b>GE Lighting's regional headquarters</b>	<b>n.a.</b>	<b>+500 (2004)</b>
GFP Mezőgépgyár Kft.	Machinery	Relocation from Hungary	Grass cutter and plough production	Latvia	–150
GlaxoSmithKline Biologicals Kft.	Pharmaceuticals	New capacity	Vaccine production	n.a.	n.a.
<b>Opel Southeast Európa Kft./ GM Daewoo Central and Eastern Europe Kft.</b>	<b>Automotive</b>	<b>Regional headquarters</b>	<b>GM's/Daewoo's regional headquarter for CEE</b>	<b>n.a.</b>	<b>+60–80</b>

Table 5 (Continued)

Foreign affiliate	Industry	Type of action	Activity concerned	Other location involved	Estimated employment effect in Hungary
IBM Storage Products Kft.	Electronics	Relocation from Hungary	Hard disk drive	China	–3,700
IBM Magyarországi Kft.	Electronics	n.a.	n.a.	n.a.	+377
Ikarusbus Rt.	Automotive	Closure and relocation to Budapest	Bus production	n.a.	–207
<b>ING</b>	<b>Banking</b>	<b>Regional accounting centre</b>	<b>Regional accounting centre for Europe</b>	<b>n.a.</b>	<b>n.a.</b>
Jabil Circuit Kft.	Electronics	Relocation to Hungary	n.a.	United Kingdom	+600
Kenwood Electronics Bretagne S.A.	Electronics	Consolidation of global production network (from 9 to 5)	Car radios	n.a.	–200
Kronospan Holding	Wood and furniture	Expansion of capacity	Veneer and plywood	n.a.	+100
Küpper Hungaria Ltd.	Metallurgy	New capacity	Metalworking and foundry (for the production of car spare parts)	n.a.	+80
Leoni LKH	Automotive supplier	Expansion of capacities	Cable production	n.a.	+20
Lurotex Kft.	Textile	Closure of factory	Rayon and synthetic fibre production	n.a.	–263
Magyar Suzuki Rt.	Automotive	Expansion of capacities	Car assembly	n.a.	+150
Magyar Suzuki Rt.	Automotive	Expansion of capacities	Car assembly	n.a.	+700
Maxon Motor Hungary Kft.	Automotive supplier	New capacity	Engine spare parts	n.a.	+700
Mary 2000 Cipőgyár Rt.	Footwear	Closure of factory	Shoes	China (import competition)	–700
<b>Merloni Elettrodomestici</b>	<b>White goods</b>	<b>New capacity</b>	<b>Regional marketing and call centre</b>	<b>n.a.</b>	<b>+30</b>
MSC Hungary Kft.	Footwear	Closure of factory/production replaced by imports	Shoes	India (imports)	–400
Ortech Europe Ltd.	Automotive	New capacity	Supplier to Opel Polska and Magyar Suzuki	n.a.	n.a.
Philips Magyarország Kft.	Electronics	Relocation to Hungary	Cathode ray tube televisions	France	330
Philips Magyarország Kft.	Electronics	Relocation from Hungary	Cathode ray tube monitors	China	–500
Philips Magyarország Kft.	Electronics	Expansion of capacities	n.a.	n.a.	+1170
Phoenix Mecano AG	Precision engineering	New capacity	Product assembly and regional sales centre for Eastern Europe	n.a.	+100
<b>Renault Nissan</b>	<b>Automotive</b>	<b>New capacity</b>	<b>Regional logistical centre</b>	<b>n.a.</b>	<b>+60–80</b>
Salamander Hungaria Kft.	Footwear	Closure of factory	Shoes	n.a.	–560
Samsung Magyar Elektromechanikai Rt.	Electronics	Expansion of production	Television production	n.a.	n.a.

Samsung Magyar Elektromechanikai Rt.	Electronics	Relocation to Hungary	Cathode ray tube production	other European countries	+500–700
Sanmina Corporation	Electronics	Relocation to Hungary	European production centre	Sweden	n.a.
Sara Lee Kávé és Tea Rt.	Food and beverages	Expansion of capacities	Filtered tea production for exports	n.a.	n.a.
Sauberbacher Pannónia Kft.	Recycling	Regional centre	Production and management	n.a.	n.a.
<b>SEI Information Technology</b>	<b>IT and business services</b>	<b>European customer support centre</b>	<b>European customer support centre</b>	<b>n.a.</b>	<b>n.a.</b>
SEWS Magyarország Kft. (Sumitomo)	Automotive supplier	New capacity	Car spare parts	n.a.	+300
SEWS Autókábel Magyarország Kft. (Sumitomo)	Automotive supplier	New capacity	Halogen-free cables	n.a.	+150
Shin-Etsu Polymer	Electronics	New capacity	Keyboard production for Nokia	n.a.	+115
Shoe Makers Cipőipari Kft.	Footwear	Relocation from Hungary	Shoes	Romania	–150
Sunarrow Hungary Kft.	Electronics	New capacity	Supplier to Nokia	n.a.	+120 (2004)
TDK Elektronika Kft.	Electronics	Partial relocation from Hungary	n.a.	Ukraine	–200
Toyo Seat Europe Car Parts Producing and Trade Ltd.	Automotive	New capacity	Supplier of car seats	n.a.	+150
<b>Visteon Hungary Kft.</b>	<b>Automotive supplier</b>	<b>n.a.</b>	<b>Product development centre</b>	<b>n.a.</b>	<b>+30</b>
Visteon Hungary Kft.	Automotive supplier	Partial relocation from Hungary	Manufacturing of starters	India (Chennai)	n.a.
<b>Zenon Systems Manufacturing and Services Ltd.</b>	<b>Water treatment</b>	<b>New capacity</b>	<b>R&amp;D centre</b>	<b>n.a.</b>	<b>+32</b>

Source: Author's collection of information, in part presented in UNCTAD, 2003, p. 229. Note: bold denotes corporate services.

US\$ 22 billion in 2002 to US\$ 15 billion in 2003), bringing their share within the region down from almost two-thirds in 2002 to only slightly more than one-half in 2003. This may further confirm expectations about a shift in the geography of FDI from the relatively more advanced countries towards the less developed ones.

In the accession group, the decrease of FDI was particularly pronounced in countries that had wrapped up major privatisation programmes involving foreign capital in 2002: the Czech Republic, Slovakia and Slovenia. With no new large privatisation transactions at sight, the combined inflows of these three countries declined from US\$ 15 billion in 2002 to US\$ 8 billion in 2003, despite a strong performance of greenfield projects. The FDI inflows of Hungary, too, declined, to their lowest level since 1989, mainly due to unusually sluggish intra-company loans. However, other accession countries performed better: the inflows of Poland stood still at US\$ 4 billion both in 2002 and 2003, while the inflows of Estonia and Lithuania experienced major progress.

In contrast to the trends in accession countries, the FDI inflows of South-Eastern Europe (including Bulgaria and Romania, the two countries expected to join the EU in 2007) and of the European members of the Commonwealth of Independent States (CIS) increased significantly in 2003. The inflows of each sub-group stood at around US\$ 4 billion each in 2002. By 2003, the inflows of the former grew to US\$ 6 billion, while the inflows of the latter increased to almost US\$ 7 billion. In South-Eastern Europe, Croatia and Serbia and Montenegro experienced the largest increases. In the European CIS, the Ukraine and, especially, the Russian Federation experienced major gains.

The FDI inflows of the Russian Federation jumped from US\$ 3 billion in 2002 to US\$ 5 billion in 2003, despite the potential negative impact of the legal problems that Yukos, one of the major Russian oil firms was experiencing in the second half of 2003. There may be various explanations of why that impact on FDI has been limited, in addition to the fact that Yukos has practically no foreign shareholders. First of all, foreign investors, especially in the oil and gas industry, interpreted the legal difficulties of Yukos as an isolated case, not transferable to other companies, and especially not to foreign investors. It is rather a case of redistributing wealth within the Russian society after a privatisation process that resulted in a too strong concentration of resources in too few hands, parallel with cases of anti-trust legislation and action in the United States in the early 20th century. It may be foreseen hence that in the short run, the Yukos case will not deter the FDI inflows of the Russian Federation in either natural resources or other activities. But it may result in a high cost for the efforts to attract new large projects to the country in the medium and long term. Investors may insist on wide-ranging guarantees, access to international arbitration and incentives as means to reduce the risk they have perceived increasing after the Yukos case.

The FDI outflows of CEE increased from US\$ 4 billion in 2002 to US\$ 5 billion in 2003. With an outflow of US\$ 3 billion in both 2002 and 2003, the Russian Federation maintained its dominant position within the region. The outflows of Hungary, traditionally the second largest source of FDI, increased fast, from around US\$ 300 million in 2002 to US\$ 700 million in 2003, making the country, for the first time, a net capital exporter (FDI outflows exceeding inflows). On a smaller scale, a similar development towards a net capital exporting status is emerging in Slovenia. This may be a sign of gradually catching up FDI outflows in the middle-income group.

## 5. Why does CEE defy the global downturn?

Why does CEE defy the global downturn in FDI? One can enumerate various reasons:

- The data on cross-border M&As cited above prove that during the downturn of 2000–2001, CEE proved to be more successful than other regions in attracting privatisation and/or M&A-related FDI than other parts of the world. Therefore, from the point of view of the volume of inward FDI, that made a major difference.
- The steady performance of FDI in CEE suggests that it is viewed as a stable and promising region for FDI, especially within the division of labour across the integrating European continent, improving the efficiency of operations in Europe as a whole. Indeed, most of the macroeconomic news from coming from the region have recently been good ones in terms of ever lower inflation rate and recovery in GDP growth.
- CEE has also a major attraction for investors with its unique combination of high labour skills and competitive production costs.
  - These costs in the lower-income CEE countries (one can also call them “new frontier” for FDI given their large untapped potential) can still warrant the attraction of labour-intensive activities.
  - In turn, in the middle-income countries such as the Czech Republic, Hungary, Poland, Slovakia and Slovenia where labour costs are higher and increasing, inward FDI increasingly needs to target logistical centres, R&D, regional headquarters, call centres, back offices and other corporate services, at the expense of activities based on abundant low-skill labour (such as textiles and footwear, on simple assembly electronics). Examples of such moves have been elaborated in the previous section. The move to FDI based on higher labour skills makes the EU accession countries direct competitors with other emerging locations.
  - Differentiation and specialisation between the two groups following the pattern of the flying geese may increase in the near future. From a geographical point of view, the non-accession countries are the most logical candidates for a “new frontier” of labour-intensive activities, on condition that the basic requirements of investors are fully met (Table 6).

In Western European public opinion, it has become an almost commonplace assertion that CEE is attracting away FDI from the current members of the EU. To what degree is that perception right? How frequent and large are the cases of delocalisation to CEE? To what degree are perhaps relocations towards other regions such as Asia lumped to the same phenomenon?

Table 6

The matrix of specialization between accession and non-accession countries of CEE, 2003

Countries	FDI patterns	FDI policies and measures
Accession countries	Upgrading of FDI activities	How to best adjust FDI promotion to EU instruments (regional and cohesion funds, etc.)
Non-accession countries	“New frontier” for efficiency-seeking FDI	How to adjust policies/measures to the status of new frontier, question of business environment

Source: UNCTAD, 2003, p. 67.

It seems that in reality a division of labour between the three Europes is more common than competition for the same investment projects or, for that matter, massive relocation. This emerging division of labour across the integrating European continent improves the efficiency of operations in Europe as a whole. For example, for Flextronics, the existence of R&D in Austria and Germany makes sense only if complemented by some manufacturing operations in CEE (especially Hungary and to some degree in Poland); if production were to move to other continents, so would R&D (UNCTAD, 2003, p. 79, footnote 36). In other words, because “EU enlargement is not a zero sum game in which the new member states will compete against current incumbents for a fixed pool of FDI” (Barry, 2003, p. 189), it remains to be seen how much current EU members have to fear a deviation of FDI towards the accession countries.

The degree of potential relocation between the two parts of the European continent are largely exaggerated from the statistical point of view, too. If one counts the FDI inflows of all the 10 countries joining the EU in 2004 (including even Cyprus and Malta), they together receive only a fraction of the FDI inflows of the EU-15 (less than 6 percent in 2002; Fig. 1). In other words, while in 2002 the FDI inflows of the 10 accession countries increased by US\$ 4 billion (from US\$ 17.5 billion to US\$ 21.5 billion), those of the EU-15 decreased by US\$ 15 billion (from US\$ 389 billion to US\$ 374 billion). So the losses of the EU-15 can hardly be attributed to new EU members. The reasons lie elsewhere such as the weak attractiveness of some of the traditional EU locations.

## 6. Risks and challenges

The momentum provided by EU enlargement is expected to remain strong in the medium term. The process of reorganising economic activities across the integrating European continent is still in an early stage. However, while the good performance of CEE countries in attracting FDI may be generally expected to continue or even improve in the aftermath of EU enlargement, the process is not without risks and challenges. These challenges and risks require special attention and action from the part of CEE countries and their Governments.

For the accession countries, there are two major risks to be tackled:

- One risk is a wait-and-see attitude by investors brought about by uncertainties surrounding the transition of the legal and business regimes of new members to EU requirements and its exact costs. In general, meeting all the labour rules, environmental and safety standards, etc. will make new member countries a better and more attractive place. However, the exact cost of that transition for business are not always clearly known.
- Related to EU accession is the problem of production costs. These will increase but to what degree really matters. For example, a too fast wage increase prompted by political considerations that would exceed productivity gains would precipitate a premature departure of activities based on (unskilled) labour. There is also a risk that exchange rates (overvaluation of national currencies) would be used as a tool to stifle inflation as soon as possible. But that would result in an artificially high local production cost, leading to the irrevocable pricing out of such accession countries once the exchange rates

of their national currencies are fixed at a too high level against the euro as a first step toward the adoption of the common currency. Hence, much caution is required in that area.

Related to those risks, accession countries face two major policy challenges:

- In the area of specific investment promotion policies, the main challenge has been how to harmonise FDI regimes with EU regulations, with the twin aims of conforming to EU norms and maximising the benefits from EU instruments, such as regional development funds. Examples of non-conforming FDI instruments were Slovakia's special incentives for foreign investors and Hungary's 10-year tax holidays granted only to large investors. Both countries changed their investment incentives in 2002 to conform to EU rules, while seeking to provide a framework no less favourable for investors. In their search for international competitiveness under EU membership, and in light of the constraints on incentives, some accession countries may also need to lower their corporate taxes. By 2004, these taxes will be significantly below the average of current EU members, although still higher than those of some FDI front-runners such as Ireland (UNCTAD, 2003, p. 66).
- In general policies related to FDI, the main challenge has been how to establish and develop an institutional framework required to administer and channel EU funds. Originally designed for high-income countries, these funds require sophisticated administrative capabilities. Reaching similar levels of public administration in the short time left until accession will test human and financial resources. Accession countries also have to learn very fast how to make the best use of facilities now available to them for promoting investment, such as EU regional development funds (which are more limited than those for actual EU members). After accession in 2004 new EU member countries will be entitled to 25 percent of the Common Agricultural Policy funds and 30 percent of the regional development funds available to current EU members. Subsequently, those shares will increase by 10 percent per annum till they reaching the level of 100 percent around 2014.

For those countries joining the EU later on—or not considered as candidates for accession—the risks and challenges are somewhat different. This is partly related to the fact that, with the exception of Croatia, these are low-income countries, endowed with weaker local capabilities than the accession countries of year 2004. For them, the risks are two-fold:

- On the one hand, they face uncertainty brought about by the changing geography of Europe. Indeed, with the exception of Bulgaria and Romania, for whom the future is traced by their ongoing EU accession negotiations, it is not yet clearly known what will the new trade and economic agreements the “new frontier” countries with the new EU look like. This is coupled with the fact that among these countries, the network of free trade agreements is incomplete. That patchiness works as a major obstacle towards presenting these countries as large enough regional locations (e.g. South-Eastern European market, or CIS market).
- On the other hand, a too slow improvement in the business and investment environment may prompt cost-reducing investors bypassing the “new frontier”, locating their operations in East Asia instead. This is why it is imperative to improve the business environment in these countries fast and radically. This is also in the interest of the EU-15 and the 10

accession countries of 2004 whose stability and competitiveness as FDI location may also be negatively affected if efficiency seeking investors avoid the new European frontier.

From the previous, there follow two main policy challenges for the “new frontier”:

- They have to improve their general business environment fast. They have to tackle various issues including a consolidation of gains in macroeconomic stability, the stabilisation of the legal framework for business, the tackling of sensitive issues such as security and concerns about corruption.
- “New frontier” countries have to upgrade their specific FDI promotion, too. Compared with accession countries, they have to comply with less international constraints and requirements—they have to comply with WTO rules. In turn, they have to use their scarce resources in the most efficient manner to provide the highest quality services possible to potential investors.

## **7. Conclusions**

At the regional level, EU enlargement is the most important policy development affecting FDI inflows to CEE. It also affects FDI in non-accession countries, but in a different manner. All accession countries but Bulgaria and Romania are upper middle- or high-income (Slovenia) countries. All non-accession countries but Croatia are lower middle-income countries. This leads to an increase in FDI in services and higher corporate functions in accession countries, attracted from current EU members and third countries.

EU enlargement also offers opportunities to non-accession countries, because assembly-type manufacturing may shift to them from higher cost accession countries. With the restructuring of middle-income countries, labour-intensive FDI may move to lower-cost locations, in CEE or in Asia. New EU member countries may become major sources of skill-intensive assets, combining their advanced education with competitive production costs. The legal regime of the EU provides the necessary framework for the free movement of persons, goods and capital within the region, in offering national treatment and in aiming for competitive equality within the grouping.

In this integrating European continent, market size and market growth will increasingly denote the enlarged EU as a whole, providing benefits mostly to new member countries, particularly those with limited domestic purchasing power. Liberalisation in non-accession countries may be more limited. But their trade agreements with EU (preferential or association agreements) may affect market size, one of the key determinants of FDI. And the use of the European cumulation area in the EU rules of origin can add to the flexibility in organising production across the continent. Trade agreements with non-accession countries will also facilitate access to natural resources, with the most important resources outside the enlarged EU, notably in the Russian Federation.

The emerging specialisation of FDI between the accession and non-accession countries does not yet follow the flying-geese pattern. Labour-intensive activities relocated from accession countries now go more to developing Asia (especially China) than to lower-income CEE countries. And the low outflows of FDI from accession countries limit the scope for restructuring to non-accession countries.

With all risks and challenges kept in mind, there is a widespread consensus about the prospects for FDI in CEE, accession and other countries alike. Led by the momentum of EU enlargement, and coupled by a potential of the CIS that can probably untapped in the near future, the region's FDI flows are expected to rise to new records in the near future. That may help overcome the effect of the completion of privatisations in various countries of the region. For efficiency-seeking FDI the region's potential is particularly good. With its technological capabilities and skilled workforce, it could become a major international production and services hub. The ball is in the policy makers' court.

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