



## PRESS RELEASE OF THE WORKING PAPER 2/13

# Origin of FDI and domestic productivity spillovers: does European FDI have a ‘productivity advantage’ in the ENP countries?

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### OBJECTIVE

The EU plays an important role for the countries in the ‘eastern neighborhood’: as an economic gravitational force, as a normative power for democratization, and as a source of much needed financial and knowledge-related resources. Although economic integration through trade liberalization and the forging of deeper political links are of course important for the further development of the countries in the European periphery, in many respects foreign direct investment plays a distinctive role as it provides the material means (capital flows) and technology transfers (knowledge and other spillovers) to support restructuring and modernization and, through this, creates the conditions for democratic reforms and economic openness. In many respects, however, these benefits are taken for granted and there is often little empirical evidence to support common perceptions or related theoretical claims. In the case of the literature studying the economic gains from capital investments in the ENP and other transition countries, no study has examined to date the size of the (presumed positive) spillovers of European FDI vis-à-vis foreign investments originating from other parts of the world. Thus, it is not known whether the preferential relations offered by EU’s European Neighborhood Policy and related bilateral agreements, and the intensification of economic interactions – including capital flows – that these facilitate, are in fact beneficial for the countries of the region. Also not known are the geographical implications of these – at least with respect to the geography / location and spatial variation of the productivity spillovers generated by FDI. The relevant literature has shown that at the national level these spillovers are by and large positive, raising the productivity of domestic firms (albeit often conditional on a range of factors, such as firm sizes, domestic technology and institutions, etc.) and thus of the economy as a whole. But studies for other parts of the world have shown the geographical distribution of these effects to be highly variable, often favoring the most advanced regions. As a result, FDI can often contribute to a widening of regional disparities in recipient countries. In the ENP context, where spatial asymmetries are often acute and geographical disparities already large, this effect may be particularly difficult to redress.

### MAIN RESULTS

The ENP has transformed EU’s external relations with its near neighbourhood and has linked them inexorably with the processes of institutional adaptation (Europeanization) and economic integration (trade liberalisation and preferential agreements). Because of this, and despite its political and foreign-policy origins, the ENP has become today one of the main economic-policy EU instruments and has accelerated and intensified economic flows and interactions between countries and between businesses across the two regional blocks. Within the ENP context, the examination of the size and direction of productivity spillovers, generated by EU and non-EU FDI, accruing to the domestic economies offers a plethora of interesting findings. The example of the ENP East countries, in particular, suggests that EU-originating FDI appear to have a “productivity advantage” over investments from other parts of the world, in the sense that it tend to generate greater productivity spillovers

for domestic firms or, at least, less significant negative effects. Although theoretically it is possible that this result may emanate purely from technology and other advantages possessed by EU firms relative to other investors, in practice it is difficult to argue that EU MNCs would be systematically more advanced than MNCs of other origins. If this is true, then it can be argued that at least part of this productivity advantage must be related to the process of EU association, which gives a preferential access to EU firms in the host economies and harmonises their institutional and legal environment. Of course, FDI spillovers, including EU ones, have not reached their maximum value in the ENP region. The example of Southeastern European countries, where the involvement of the EU is magnified, indicates that such spillovers are very positive and strong, despite the fact that the recipient countries sharing similar problems of institutional quality and absorptive capacity with many of the ENP countries. This, in turn, suggests that further approximation with the countries of the ENP region and further intensification of economic links and capital flows may prove to be increasingly beneficial for the domestic economies. Of course, at this point it has to be stressed out that the observed productivity spillovers, although not particularly localised, tend to be significantly stronger and more positive for firms located in the capital-city regions of the recipient countries, irrespective of the location of the foreign firms. As FDI tends to concentrate in, or near, capital cities anyway, it follows that it, indeed, acts to amplify within-country spatial disparities. This finding raises important concerns about the role and consequences of foreign capital inflows as the processes of transition, development and internationalization (openness) are long-known to be related to widening regional disparities. This is so as, at least in their initial stages, they benefit the most dynamic, extrovert and human-capital abundant parts of an economy.