

## FDI AND INCOME CONVERGENCE IN THE CENTRAL EUROPEAN TRANSITION COUNTRIES

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### Abstract

*Foreign direct investment generates a number of benefits, especially for developing and transition countries, and, therefore, it is a major factor in economic development. Some of the advantages of foreign direct investments are technology and knowledge spillover; increased employment and competition and improved balance of payments. The aim of this research is examining the effect of foreign direct investment on income convergence of Central European transition countries. Regression analysis is used to test this effect. The results indicate that Central European transition countries with a higher inflow of foreign capital achieve more propulsive convergence towards the average income of developed countries of the European Union. The results of the research can be useful for the economic policy makers of transition countries.*

**Keywords:** *foreign direct investment; economic growth; income convergence; Central European transition countries.*

**JEL Classification:** F21, F43, O47, O52

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### Introduction

International movement of capital is one of the most important factors in the economic development, especially in the case of developing and less developed countries. The importance of foreign direct investment (FDI), as a form of international capital movement, has the potential to create positive externalities generated by multinational companies in their operations and investments in the host country. FDI has a positive impact on economic growth in the host country through capital inflows, job creation, technology and knowledge transfer and increased competition [Milutinović & Stanišić, 2016; Joseph *et al.*, 2019; Cvetković *et al.*, 2021]. FDI can also generate growth by promoting technological innovation [Bevan & Estrin, 2004]. Over the past decade, FDI has played “an increasingly important role in the process of functional integration of the world economy” [Crescenzi & Petrakos, 2016, p. 587]. FDI is often considered “as a necessary resource for the progress and growth of an economy, especially for the transition countries” [Pantić & Milojević, 2019, p. 100].

Generally speaking, FDI is a form of international capital movement, although different definitions of FDI can be found. FDI represents real investments in production factors, i.e. in capital goods, in land or in stocks, where the investor is involved in both investment and management, while maintaining control over the use of invested capital [Salvatore, 2009]. In the modern phase of the world economy development, FDI is “a key development factor, and along with trade, become the basic mechanism of globalization of the world economy” [Nestorović, 2015, p. 273].

However, the most widely accepted definition is given by the Organization for Economic Cooperation and Development (OECD). According to this definition, “FDI reflects the objective of establishing a lasting interest of a resident enterprise in an economy (direct investor) in an enterprise (direct investment enterprise) that is resident in an economy, other than the economy of the direct investor. Lasting interest implies the existence of a long-term relationship between the direct investor and the direct investment company, as well as a significant degree of influence on the management of the company” [OECD, 2008, p. 7].

Using regression analysis, the hypothesis that Central European transition countries with higher flows of foreign capital achieve more propulsive income convergence towards the average income of developed members of the European Union (EU) is tested in this paper. For the purposes of the analysis, the Western Balkan states (Albania, Bosnia and Herzegovina, Montenegro, North Macedonia

and Serbia) and, so called, “new” member states of the EU (countries that joined the EU from 2004 to the present) are included in the group of Central European transition countries.

Since this topic is still insufficiently researched on the example of Central European transition countries, the contribution of the paper is to reduce the gap in the literature. The novelty of this research, in relation to the previous ones, is the analysis of this effect, not only for the entire period (1995-2019), but also for subperiods. Such an analysis leads to the results that show the strong impact of the Global Economic Crisis on the effects of FDI on income convergence.

The first section of the paper presents the theoretical background of income convergence and previous empirical research on the effect of FDI on income convergence. Data and research model are provided in the second section. The results of the research are presented in the third part of the paper, while the fourth part is intended for concluding remarks.

### **Theoretical Background and Literature Review**

The theoretical discussion about income convergence among countries or regions began with Robert Solow’s neoclassical growth model. The basic assumption of this model is diminishing returns on capital, which means that lower returns on capital will first occur in the those countries that are rich in capital, ie in developed countries [Solow, 1956]. Consequently, these countries will also have a lower gross domestic product (GDP) per capita growth rate. Situation is opposite in the less developed countries, that is, due to a smaller volume of capital, capital growth is higher, which causes a higher GDP per capita growth rate. Solow (1956) concluded that that, due to diminishing returns on capital, income convergence occurs, i.e. less developed countries have faster growth compared to developed ones.

The question of whether economies converge over time has occupied relatively much attention among economists. Many empirical studies show contradictory results depending on samples and measurement techniques. Nevertheless, most attention is paid to the concepts of  $\sigma$ -convergence and  $\beta$ -convergence (absolute and relative). When less developed countries have faster growth than developed ones,  $\beta$ -convergence exists. In other words,  $\beta$ -convergence exists when countries converge to the same level of GDP per capita regardless of their initial conditions. Absolute  $\beta$ -convergence occurs when countries have the same savings rates, population growth rates and depreciation rates, differ only in the initial income level and strive for one identical steady state [Milutinović, 2015]. Barro & Sala-i-

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Martin (1991) and Mankiw *et al.* (1992) introduced the concept of relative  $\beta$ -convergence, which is considered a much more realistic concept compared to absolute  $\beta$ -convergence. When countries strive to a different steady states, due to different savings rates, population growth rates, and different levels of technology, relative  $\beta$ -convergence occurs. Therefore, countries converge towards their own, different steady states [Milutinović, 2015]. When a country is further from steady state, it will have faster growth than those countries that are closer to their steady state, i.e. richer countries. It can be concluded that relative  $\beta$ -convergence represents faster growth of poor, compared to rich countries, towards different steady states.

In addition to the concept of  $\beta$ -convergence, the existence of  $\sigma$ -convergence is also tested in the literature. If the income gap between the two countries decreases over time,  $\sigma$ -convergence exists [Milutinović, 2015]. Several methods are used in the literature to determine the existence of  $\sigma$ -convergence, that is standard deviation and coefficient of variation. If standard deviation decreases over time, i.e. the absolute difference between the income levels of countries is decreasing,  $\sigma$ -convergence exists. Upward trend of the coefficient of variation indicates existence of convergence. Otherwise, the downward trajectory of the coefficient of variation over time indicates the existence of divergence.

Empirical research on income convergence emerged in the 1980s. Baumol (1986) conducted one of the first studies and proved that a homogeneous group of countries converges towards a certain growth rate. On the contrary, divergence was found in the heterogeneous group of countries. Barro & Sala-i-Martin (1991) also proved income convergence between Western European countries. Numerous empirical studies by various authors followed, which showed the practical application of the income convergence hypothesis. A special place is occupied by research that examines income convergence in the process of economic integration. Following the accession of Central and Eastern European countries in the European Union in 2004, a number of papers have emerged examining the existence of income convergence between “old” and “new” EU members [Matkowski & Próchniak, 2007; Vojinović *et al.*, 2009; Stanišić, 2012; Gligorić, 2014]. These research results prove that income convergence exists between the observed countries, i.e. groups of countries. These two concepts of convergence (beta and sigma) are considered complementary and irreplaceable with each other.

In addition to a large number of papers examining income convergence between the “old” and “new” EU members, there have been papers testing income

convergence between the Western Balkan states and the EU [Murgasova *et al.*, 2015; Stanišić, 2016; Milutinović & Durkalić, 2018]. However, there is not enough paper that could answer the question of whether the countries of the Western Balkan states are catching up with the EU.

Empirical research of the relationship between FDI and income convergence are numerous. However, results and conclusions are far from uniform. Using bilateral FDI flows on the example of 57 countries, Choi (2004) tested the effect of FDI on income convergence. Author also included the geographical proximity between two countries in the analysis, as well as the language they speak. The starting assumption was that the effect on income convergence is greater if the two countries are closer and use the same language. Regression analysis showed that an increased FDI flow between the two countries positively affects income convergence. This effect is even greater if countries are closer and use the same language. Choi (2006) also pointed out that “increase in FDI intensity, measured by internal, external and total FDI as a percentage of GDP, affects the increase in income inequality” (p. 814). In particular, external FDI, rather than internal FDI, have a greater negative effect on income distribution.

There is not a large number of scientific papers that test the relationship between FDI and economic growth in the EU countries, as it is the case in developing countries. Examining the effects of FDI on economic growth in the EU, Moudatsou (2003) concluded that there is a positive effect of FDI on economic growth, both direct and indirect. The results showed that these effects, unlike those in the case of developing countries, are unconditional and do not depend on the level of human capital, probably because the stocks of human capital in them are large and do not represent a limiting factor of economic development. Tang (2015), in contrast to Moudatsou, found no evidence that FDI contributes to economic growth in the EU countries. Bonetto *et al.* (2009) examine the impact of financial variables on the process of income convergence between selected EU countries and Balkan countries from 1999 to 2007. Testing the absolute and relative convergence on a sample of 21 countries, the authors came to the conclusion that active policy of domestic loans and market capitalization in Balkan countries leads to an increase in convergence speed. However, too active market capitalization can lead to destabilization of the Balkan economies.

Abiad *et al.* (2007) analysed the impact of financial integration and international financial flows on income convergence in Europe. Financial integration, has led to the capital transfer from rich to poor countries, leading to an acceleration of income

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growth. However, it is necessary to point out the negative and unstable effects of capital flows, such as the decline of international competitiveness and appreciation of the exchange rate. The severity of these effects depends on whether capital inflows are directed to increase productivity. The authors proved that FDI was accompanied by an increase in productivity.

Fabricio *et al.* (2006) also proved the positive effect of international capital in the “new” members of the EU. These countries transformed production structures, by increasing the content of technology and the quality of their products. However, authors concluded that risk of the appreciation of the exchange rate still exists. Abiad *et al.* (2009) concluded that this transition, enabled by rapid financial integration, was self-limiting because it enables further separation between domestic savings and investments. Financial integration leads to the capital movement from rich countries to the poor ones, which accelerates income convergence. However, with increased incomes, financial integration no longer plays a major role in attracting foreign capital, leading to a reduction in growth momentum.

Aghion *et al.* (2005) examined how the development level of the country’s financial system affects income convergence. The results showed that a more developed financial system accelerates income convergence. Medium and highly developed countries convert not only in the amount of GDP per capita, but also when it comes to a degree of financial system development. This link between economic growth and the degree of financial system development is more intense in the early stages of economic development, and weakens over time as the country approaches sustainable development. Thus, underdeveloped and developing countries, which have a relatively developed financial system, are more likely to catch up with developed countries, while those countries with a relatively underdeveloped financial system will remain trapped in the poverty trap. In a study of the International Monetary Fund, effects of various factors on income convergence were tested, including the impact of the degree of financial system development [Murgasova *et al.*, 2015]. The authors came to the conclusion that more developed financial system accelerates income convergence between developed and less developed countries.

### **Data and Model**

In order to test the hypothesis that Central European transition countries with higher flows of foreign capital achieve more propulsive income convergence

towards the average income of developed members of the European Union (EU15), the following regression model is used:

$$\text{GRGDP}_{i,t} = \alpha_0 + \alpha_1 \text{DIST}_{i,t-1} + \alpha_2 \text{DIST}_{i,t-1} \times \text{FDI}_{i,t-1} + \alpha_3 \text{FDI}_{i,t-1} + v_{i,t}$$

where  $\text{GRGDP}_{i,t}$  represents GDP growth rate per capita in current prices of the country  $i$  in year  $t$ ,  $t =$  from 1995 to 2019.  $\text{DIST}_{i,t-1}$  is the gap in GDP per capita between the country and the EU15 average in the previous period, and  $\text{FDI}_{i,t-1}$  is FDI of the country  $i$  in the previous period.  $\alpha_0$  is constant, and  $v_{i,t}$  standard error.

FDI per capita in current prices and FDI as a percentage of GDP are used as a measure of FDI. A positive value of the coefficient  $\alpha_2$  means that a higher inflow of FDI into the country contributes to faster income convergence of Central European transition countries, towards the average EU15 income.

When coefficient  $\alpha_1$  is positive, income convergence between the Central European transition countries, on the one hand, and the EU15, on the other, exists. A higher value of this coefficient implies faster convergence.

Data for the analysis were obtained from The World Bank and UNCTADstat.

### Results and Discussion

Results of the regression analysis of the effect of FDI on the income convergence of the Central European transition countries are shown in Table 1. Regression analysis was performed for the period 1995-2019, and for the subperiods 1995-2000, 1995-2007, 2001-2010, 2001-2007, 2008-2010 and 2011-2019. FDI per capita and FDI as a percentage of GDP were used as indicators of FDI. If the coefficient with the variable related to the factor is positive and statistically significant, the factor, in this case FDI, contributes to more propulsive income convergence. In the entire observed period (1995-2019), the coefficients with independent variables are not statistically significant, so it cannot be concluded that FDI contributes to a more propulsive income convergence of Central European transition countries.

However, when observing the subperiods, the coefficients with the independent variables are statistically significant, and therefore affect income convergence, only in the two subperiods, i.e. 2001-2007 and 2011-2019. The period 2001-2007 covers the period from the beginning of the XXI century to the Global Economic Crisis. In this period FDI shows the impact on income convergence in Central European transition countries. Namely, a higher inflow of FDI per capita contributes to a

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faster GDP growth rate per capita in the Central European transition countries. That is, there is a reduction in the income gap between the Central European transition countries and the EU15. However, effect of FDI, measured as a percentage of GDP, is not significant, and therefore does not affect income convergence of the Central European transition countries in the period from 2001 to 2007. These results can be explained by a significantly higher inflow of FDI per capita in the Central European transition countries since the beginning of the 2000s.

**Table 1. Effect of FDI on income convergence of Central European transition countries**

		$DIST_{i,t-1}$	$DIST_{i,t-1} \times FDIpc_{i,t-1}$	$FDIpc_{i,t-1}$	$DIST_{i,t-1} \times FDI\%_{i,t-1}$	$FDI\%_{i,t-1}$	Constant	$R^2$
1995-2019	Coeff.	-0.103	0.292	-0.883	-0.275	0.708	4.925	0.048
	<i>p</i>	0.091	0.706	0.253	0.771	0.467	<0.0005	
1995-2000	Coeff.	0.114	-0.504	0.499	0.347	-0.279	1.634	0.02
	<i>p</i>	0.549	0.490	0.629	0.793	0.860	0.675	
1995-2007	Coeff.	0.288	2.550	-3.568	-1.225	0.693	1.269	0.11
	<i>p</i>	0.003	0.447	0.344	0.681	0.490	0.270	
2001-2010	Coeff.	-8.944E <sup>-5</sup>	-1.423E <sup>-8</sup>	-1.423E <sup>-8</sup>	3.090E <sup>-6</sup>	-0.025	6.258	0.051
	<i>p</i>	0.1	0.475	0.938	0.525	0.828	<0.0005	
2001-2007	Coeff.	0.292	8.610	-11.408	-4.913	7.607	2.245	0.186
	<i>p</i>	0.018	0.091	0.055	0.249	0.111	0.081	
2008-2010	Coeff.	9.480E <sup>-5</sup>	4.631E <sup>-8</sup>	-0.003	-2.501E <sup>-5</sup>	0.997	-3.157	0.053
	<i>p</i>	0.476	0.298	0.190	0.184	0.173	0.493	
2011-2019	Coeff.	3.247E <sup>-5</sup>	5.549E <sup>-8</sup>	-0.002	-1.455E <sup>-5</sup>	0.480	2.184	0.256
		0.292	<0.0005	<0.0005	0.001	0.001	0.032	

Legend:  $DIST_{i,t-1}$  - GDP per capita gap between the country and the EU15 average in the previous period;  $FDIpc_{i,t-1}$  - FDI per capita in the previous period;  $FDI\%_{i,t-1}$  - FDI in the previous period, as a percentage of GDP

Source: author's calculation

FDI show significant effect in the years following Global Economic Crisis (2011-2019). Positive value of the coefficient with variable  $DIST_{i,t-1} \times FDI_{pc,i,t-1}$  means that higher inflow of FDI per capita contributes income convergence in the Central European transition countries. On the contrary, the negative value of the coefficient with the variable  $JAZ_{i,t-1} \times FDI\%_{i,t-1}$  means that a higher inflow of FDI, expressed as a share of GDP, does not contribute to reducing the income gap between the Central European transition countries and the EU15, but widens it.

The obtained results, which show the opposite direction of FDI per capita and FDI as a percentage of GDP on income convergence, are in line with the results obtained by Choi (2004). Namely, authors' results indicate that increased FDI flows between the two countries have a positive impact on income convergence. However, the results are opposite when FDI inflows are measured as a percentage of GDP. Choi (2006) pointed out that FDI inflows expressed as a percentage of GDP increase the income gap between the two countries. A possible explanation for the opposite effect of these two indicators may be that FDI, presented as a percentage of GDP, already contains GDP and its effect.

In conclusion, regression results indicate a positive effect of higher FDI inflows on income convergence in Central European transition countries, from the beginning of XXI century until the beginning of the Global Economic Crisis. Also, in the years after the Global Economic Crisis, when economies started to recover, and FDI flow slowly began to rise, FDI have had positive effect on income convergence in Central European transition countries. Taking this into account, it can be concluded that FDI contribute to a more propulsive convergence rate of the Central European transition countries towards the average EU15 income level.

Overall results are strongly influenced by the Global Economic Crisis. Also, lack of positive effect of FDI on income convergence for the entire period (1995-2019), as well as in the first decade of transition, could be the result of structural imperfections of transition economies, inefficient domestic firms and insufficient absorption capacity. In other words, it can be under the influence of transition process itself.

### Conclusions

Foreign direct investment can play a vital role in the transition, generating a number of benefits that include more funding sources available for investment, technology and skills transfer, improved risk management between domestic and foreign investors, and faster development of the domestic financial sector. In

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addition, access to foreign capital can lead to more stable spending and more efficient specialization. Furthermore, foreign capital can impose external discipline, increasing country's ability to attract further capital inflows. However, globalization and greater mobility of international capital may also pose a potential macroeconomic risk to recipient countries if foreign investment dries up or if there is wider global disruption. Of course, this potential instability varies depending on the type of international capital flow. Given their long-term nature, foreign direct investment tends to be less volatile than most other forms of capital inflows.

The subject of this paper is the relationship between foreign direct investment and income convergence in Central European transition countries. Namely, the aim of the paper is to test whether the higher inflow of foreign direct investment generates more propulsive income convergence of Central European transition countries towards income level of developed European Union countries.

Research results didn't show positive effect of foreign direct investment on income convergence for the entire period (1995-2019). However, the positive effect of foreign direct investment on income convergence was proven for following subperiods – from the beginning of XXI century until the Global Economic Crisis (2001-2007) and after the Global Economic Crisis (2011-2019). This indicates that the results are under the strong influence of Global Economic Crisis. In addition, the results are influenced by structural imperfections of transition economies and their insufficient absorption capacity. Taking all into account, it can be concluded that, higher inflows of foreign direct investment, can lead transition countries converging towards average gross domestic product per capita level of the developed countries of the European Union, and reaching a higher standard of living.

The main limitation of this paper lies in the observation period. In that sense, future research should cover a longer period of observation, i.e. the entire last decade of the XX century, in order to perceive the period from the beginning of the transition. The research results show the effect of the Global Economic Crisis, so that future research can be focused on the effects of the current health crisis caused by the COVID-19 virus.

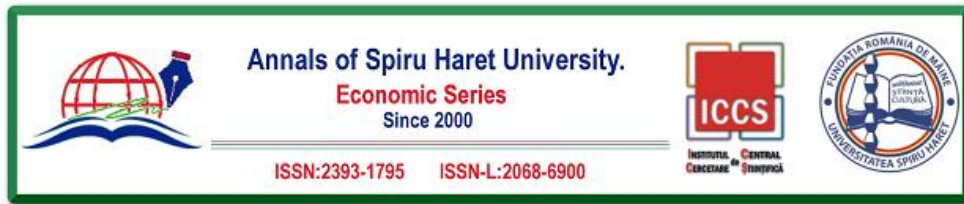
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