Trends in Foreign Direct Investment – the Austrian Perspective

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Ladies and gentlemen!

I have been invited to present the Austrian perspective on global trends in foreign direct investment. The Austrian audience will probably be quite aware of current developments in the Austrian FDI landscape, since we – that is the Oesterreichische Nationalbank – regularly communicate the results of our statistical work. Nevertheless, for guests from abroad it might be helpful – or even necessary – to provide some facts concerning Austria's position in the international FDI network.

I would like to start with a brief look back into recent history and then highlight several characteristics of the current situation of direct investment in Austria and abroad.

Slide: FDI Flows in Relation to GDP

This slide captures FDI flows in relation to GDP. It is taken from the Austrian BOP statistics and allows us to go back into the sixties. As you can see on the slide, 40 to 50 years ago outward FDI was almost non-existent, while direct investment in Austria remained in the range of 0.3 to 0.4 percent of GDP.

The situation did not change very much until the late 1980s. FDI flows remained low by international standards – which are represented by the blue dots in the chart. Austria continued to show a negative FDI balance, which means inward FDI was bigger than outward FDI.

Of course, there were reasons behind this situation: After World War II capital was scarce and capital imports were urgently needed. But there were limitations to capital imports: On the one hand, quite large parts of the Austrian economy were directly or indirectly state-owned; on the other hand, there has always been a certain amount of mistrust vis-à-vis foreign owners. Another important reason for the relatively low levels of FDI was the dominance of small and medium-sized companies in Austria and the correspondingly "thin" market on the stock exchange. Finally, one should not forget that Austria was situated on the periphery of the western world, bordering on the Iron Curtain.

The picture changed dramatically – within one month – in 1989, when the first part of the Iron Curtain between Austria and Hungary was torn down on June 27 and Austria officially applied for membership in the European Union on July 17.

There had already been some earlier signs of a "climatic" change in favor of FDI: At the beginning of the 1980s, a much debated investment project by General Motors had taken off. Around the same time, in 1982, the "Austrian Business Agency," Austria's investment promotion agency, was established. Outward investment started growing too, but

frequently the investors were criticized for not investing “at home,” and a number of those projects finally failed.

But in 1989, FDI suddenly started skyrocketing and, in the early nineties, Austria for the first time experienced a net outflow of FDI. This upturn was – as you can see – fully in line with a worldwide tendency of growing numbers of mergers and acquisitions. While worldwide FDI flows peaked in 2000, FDI in Austria stagnated at high levels and Austrian direct investment abroad even continued to grow.

Where has Austria arrived with this recent boom in cross-border investment?

Slide: FDI Stocks at End-2004

The next slide presents an international comparison based on UNCTAD’s annual World Investment Report. FDI data are, of course, not fully comparable. Despite many efforts to harmonize definitions and compilation procedures, bilateral comparisons – even within the European Union – show significant discrepancies in some cases. Nevertheless, one still may say, that Austria’s FDI position has come close to the world average, with a slight outward bias.

Like in the foreign trade statistics, we observe relatively low levels of integration for large countries and higher percentages for smaller countries. High-income countries tend to have a positive outward balance, while transition countries, for example, typically have a negative one.

The comparison gets more interesting, if we look at the regional details of inward and outward FDI.

Slide: Inward FDI Stocks by Source Country

The following slide compares direct investment stocks in Austria at end-2004 with global direct investment stocks, broken down by country of origin. What will immediately catch your eye is the dominance of European Union investors in Austria, which implies that investment from the USA and other non-European OECD countries is relatively small. Investment from emerging economies, transition economies or OPEC countries is rather insignificant in Austria.

A closer look at the details identifies Germany as the main investor in Austria. While German investors account for roughly 9% of worldwide FDI according to UNCTAD, their direct investment share in Austria is 38%. Only a few years ago this share peaked at approximately 47%. Although this predominance can be explained by geographical proximity, language and historical relations, one has to note that such a major share is really exceptional for just one country. Spain’s share in Portuguese FDI and French FDI in Belgium, for instance, are significantly lower. The only case of a similar predominance seems to be Swedish investment in Estonia. The envisaged change of ownership of Bank Austria from the German Hypo-Vereinsbank to the Italian Unicredito may change this picture in the future, at least when it comes to the amounts invested.

The fact that such a major share is held by just one investing country may partly explain why there are still concerns about undue influence by foreigners on the domestic economy.

The regional structure of Austrian direct investment abroad also has its distinct characteristics.

Slide: Outward FDI Stocks by Host Country

The most striking feature of Austrian direct investment abroad is again the overwhelming share accounted for by European countries. While less than half of worldwide FDI stocks are hosted by Europe, 90% of Austrian shareholdings are located within Europe. Austrian FDI has a clear focus on Central, Eastern and Southeastern Europe, which for analytical purposes has to include the new members of the European Union. Starting from virtually nothing, the CEEC-19 have attracted 50% of the number of investments, 38% of the capital invested abroad and 72% of employment in Austrian affiliates abroad.

By contrast, the relative importance of the "old" EU members has declined from more than 50% of capital invested in the early nineties to only one-third in 2004. Within Western Europe it is again Germany which attracts Austrian investors most strongly; in fact, Germany is still the single most important target area for direct investment abroad.

Investment *outside* Europe is very limited: Some big manufacturing enterprises invest in Asia, taking advantage of cheap labor; others set up production facilities to get market access in the USA. Then, there are holding companies and banks established in certain off-shore centres, relatively small trade companies almost everywhere and a limited number of investments in raw materials.

Slide: Going Eastward

The next slide is dedicated to the interesting step-by-step expansion of Austrian enterprises into Eastern Europe: The chart represents the development of employment figures, since they seem to be a useful proxy for indicating economic activity.

Target country number one was Hungary. Austrian investors had started their first economic activities in Hungary even before 1989. In the year of the fall of the Iron Curtain our FDI statistics already registered close to 100 investments with around 2,000 employees. Investment activities peaked as early as in 1990 and 1991 and employment figures started levelling off in the middle of the 1990s. Of course, Austria continues to invest money in Hungary, e.g. through reinvestment of profits, and there are new investments too. Nevertheless, these investments seem to be offset by rationalization and productivity gains, which has lead to stagnating employment figures since 1997.

With a time lag of about two years, Austrian enterprises started investing in another neighboring country, which still was still called Czechoslovakia at that time. The number of new investments peaked even before the separation into the two successor states on January 1, 1993, which created the Czech and the Slovak Republic. Due to several large investments, the Czech Republic reached similar employment levels as Hungary in 2000.

The third graph in the chart represents the sum of six countries: Poland, Slovakia, Slovenia and the Baltic states (two of them neighbor countries of Austria and all now members of the EU). Here, the development was slightly less dynamic, which could be attributed to different country-specific reasons, like distance, regulatory framework or size. Clearly, the growth phase of Austrian affiliates' economic activity in these three countries concentrates on the second half of the 1990s. While in the case of Hungary and the Czech Republic investments were strongest even before the two countries applied for EU membership, one can assume a correlation with the accession perspective in the case of these new member states.

A positive effect of potential EU membership on Austrian investment abroad can clearly be seen in the next group of countries: Bulgaria, Romania and Croatia. The European Union started to negotiate with Bulgaria and with Romania in 1999, and it is exactly around that time that investments in this area picked up. Privatization and improved regulatory and economic conditions laid the ground for some of the biggest Austrian foreign investments ever.

Austrian investment is definitely less advanced in the European part of the Community of Independent States. In 2004, employment in Austrian affiliates, mostly in Russia and Ukraine, reached almost 20,000. It is still an open question whether Austrian investment in that region will ever reach levels like in Central Europe. Personally, I have some doubts that Russia is a realistic target for many Austrian investors. There will be fierce investment competition among multinationals all around the world, and I cannot see specific advantages for Austrian investors there. It might be somewhat different in the case of Ukraine. Not everybody is aware that Lviv, center of western Ukraine, once was the fourth-largest city in the Austro-Hungarian Empire. So, the oft-cited argument of historical links and cultural relations would hold even in the case of Ukraine. Currently, we can observe steadily growing volumes of investment in Ukraine, and according to Ukraine's statistics Austria ranked third among foreign investors at the beginning of this year, just in front of the U.S.A.

Finally, I would like to show you the development of Austrian employment in the Western Balkans. Until recently it was almost non-existent due to political and economic circumstances. But since 2001 more and more money has been invested in a growing number of projects, mainly in Bosnia and Herzegovina, and Serbia and Montenegro[1]. Assuming that economic and political reforms progress, this area could become a growth area for Austrian direct investment in the future.

According to data collected by wiiw (The Vienna Institute for International Economic Studies), Austria currently is the most important investor in Bulgaria, Bosnia, Slovenia and Croatia and ranks second or third in six further countries.

Bridgeheads

[1] Separate data for Serbia and Montenegro will not become available until 2007.

When we name some of the important investors in Eastern Europe, like e.g. Siemens, from which we will hear a case study tomorrow, or others like Henkel or even Bank Austria, it becomes apparent that not all Austrian investment abroad is purely Austrian in a narrow sense. Regional headquarters of multinational enterprises have always played an important role in the Austrian economy. In the years before 1989, their activities mainly focused on trade with Central and Eastern Europe, but during the transition process many of them turned into regional headquarters which are also responsible for investment and the management of affiliates in the region.

There are no specific statistics on regional headquarters, but our FDI statistics can provide some insights into their possible importance. Let me show you three slides related to this topic:

Slide: The Role of Bridgeheads (Regional Headquarters)

Slide: The Role of Bridgeheads (Capital Invested in Austria)

Slide: The Role of Bridgeheads (Employment Abroad)

The first slide shows the development of the number of direct investment enterprises in Austria. It has been hovering slightly above the 2,500 mark since 1998. By matching our inward and outward surveys we can identify those enterprises which in turn make investments abroad. There are around 200 of them, represented by the small lighter columns, which is less than 10% of the total. Even if we take into account that these numbers are only a lower limit and the true figures might be somewhat higher due to indirect ownership structures, this does not seem like a lot.

If we look into the amounts of capital involved, the picture changes dramatically: Bridgeheads are steadily gaining importance. In 2004, more than 50% of *inward* direct investment in Austria was attributable to enterprises, which were *outward* investors at the same time.

The important role of regional headquarters in Austria can also been looked at from the opposite angle, i.e. from the *outward* direct investment perspective. The following slide captures the development of employment in Austrian affiliates abroad in the last 15 years. Employment in affiliates abroad grew more than 12-fold, from less than 30,000 in 1989 to 370,000 in 2004. Again, the lighter columns indicate the importance of bridgeheads, meaning resident investors which are influenced or controlled by nonresident owners. As one can see from the black line, at least 40 percent of economic activity abroad is related to this type of intermediate investors.

Slide: Employment in Direct Investment Enterprises by Economic Activity

Finally, I would like to show you a breakup of the Austrian FDI structure by economic activity and briefly address the question whether FDI in Austria can be characterized as horizontal or more vertical. When we ask for the main motives for foreign direct investment in our surveys, we always get the answer that “market access” is the by far

most important factor for both inward and outward FDI. This could be interpreted as *horizontal* FDI, which basically means doing the same somewhere else. The most important share of Austrian direct investment abroad, i.e. investment in the financial sector, is clearly of that type. Austrian banks successfully entered the fast-growing markets in Central and Eastern Europe offering the same services they offer at home. In the manufacturing sector we can also find examples of clearly horizontal FDI, for instance in the brickmaker trade, where transportation costs are relevant, or in the case of highly specialized niche areas like the construction of cable cars, the production of die-casting machinery or railway equipment.

Inward FDI for many years took advantage of relatively low labor costs in Austria, but meanwhile this location-specific advantage has disappeared. Nowadays, FDI in Austria is either looking for specific skills and know-how, or it is simply an extension of the home market, as is the case with many German firms.

Nevertheless, there are also signs of *vertical* FDI, which means international division of labor between countries. In Austria, this particularly applies to inward FDI: Big multinational enterprises have set up plants in Austria, which are closely linked within worldwide production processes. This is true for the automobile industry, where the activities range from assembly and parts supply to engineering, research and development. The same can, for instance, also be observed in the pharmaceutical industry, which has set up or bought highly specialized producers or research facilities in Austria.

It is more difficult to find traces of vertical FDI on the outward side, although differences in factor endowment between Austria and its eastern neighbors are significant. The main reason for the scarce occurrence of vertical FDI is most likely size: investors – apart from regional headquarters – are usually not big enough for a far-reaching international division of labor. Anyhow, at least some investors in CEE report that cheap labor is an important motive for their investment, and there are a number of medium-sized enterprises which have outsourced certain labor-intensive steps of their production into neighboring countries. The high labor intensity of direct investment in CEECs – when compared to investments in Western Europe – underlines the importance of the availability of labor force for investment.

Summary

Austrian FDI is a *recent* phenomenon, which started less than two decades ago. It is *centered in Europe* with Germany as the dominant investor and Central and Eastern Europe as the most favored target area. The range of direct investment abroad has grown steadily, starting off in Austria's immediate neighbor countries, but investments outside Europe are still very limited. One could call this process "globalization on a regional scale." There is vertical FDI on the inward side, with indicates an international division of labor, while investment abroad is mostly of the horizontal type. Bridgeheads or regional headquarters play an important role in Austrian FDI, as is the case – almost by definition – with inward and outward investment in general.