<u>TOWARDS A LARGE AREA OF SOLIDARITY AND COOPERATION</u>

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TWO NEGLECTED EFFECTS OF EU ENLARGEMENT RATIONALISATION AND SPECIALISATION

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In the "long transition decade" transforming countries have achieved remarkable success by letting themselves driven ahead by modernisation-inducing FDI. EU integration will however enforce these countries to re-examine their present specialisation patterns. The rationalisation wave expected to occur following enlargement will make local economic policy decision-makers ponder on how to reinvent their countries' world economic position.

Although the trade creation effect of EU-enlargement and the acceleration of inward FDI are oft-proclaimed benefits to accession countries, neither of the two expected consequences is as straightforward as they seem.

Consider the gravity model of trade developed to assess the long-term trade potential between two countries or two groups of countries. Drawing the analogy of the gravity law in physics this model suggests that the amount of trade between any two countries is influenced by their respective size and the (economic) distance between them. In the late eighties, trade flows between Eastern European countries and the west, were far below their gravity norm. As trade liberalisation was proceeding at a rapid pace EU-CEEC bilateral trade increased. The most advanced transforming economies quickly approached the hypothetical level suggested by the gravity model not only because of the dismantling of EU-CEEC trade barriers but also as a consequence of trade augmenting FDI. At the present level of economic interpenetration however, a fully-fledged membership will not automatically involve a significant further increase in bilateral trade. What's more, as a consequence of rationalisation measures, some newly accessing countries or specific non-member countries may take part of other accession countries' present regional and EU-export over.

Who will be the losers? Foreign-owned subsidiaries of large, blue chip MNCs are considered reasonably well prepared to meet the challenges of intensifying competition. Nevertheless, plant closures can be expected since the owners of local subsidiaries will reconsider the issue of location following accession. Locational competition will open up again, as a consequence of local subsidiaries' changing position in their mother companies' global organizations.

Following accession, the owners will have to reassess their organisation, and recalculate factor costs. They will have to decide whether the technological and management capabilities in their individual local subsidiaries are sufficiently developed for an EU-company. So far MNCs' expectations towards their local subsidiaries in candidate (extra-EU) countries have been lower than towards their subsidiaries in EU member-countries. Following accession however, the owners will compare the productivity and profitability-levels, the size, the income generating capability, and the technological level of their production facilities in the new member-countries with their established subsidiaries in core EU-countries.

In order to understand the difference between MNCs' expectations towards an EU-based and an extra-EU subsidiary and thus the difference between the operational properties of EU-based and extra-EU subsidiaries (which goes much beyond simple productivity differences) we have to examine the business history of these companies. In transforming countries, most key actors in the fast moving consumer goods sector (FMCG) were bought by foreign investors. Privatisation offered a unique opportunity to MNCs competing in the saturated market of developed countries, to gain huge new markets. Therefore, they established local subsidiaries with overlapping activity and product mix in several transforming countries. The acquired companies were restructured only up to a specific level to make them capable to meet the local and regional market related expectations. Technology was upgraded and the financial position of these companies was restructured so that the newly acquired companies could provide adequate quality. Besides producing a wide range of products themselves, these companies manage the distribution of their mother company's complementary products that are not produced locally. Domestic market orientation is not exclusive (since these companies also have regional and some EU sales as well) but dominant.

This high share of domestic sales, a wide product line and a relatively low level of technological- and a high level of labour-intensity do not comply with the actual trends in the industries in question. Which are these trends? The optimal size and specialisation level of FMCG companies keep increasing in advanced economies. Companies have to comply with stricter and stricter safety, environmental and hygienic standards. Compliance necessitated huge investments, which made efficiency requirements increase as well. The need for an optimum use of resources involved rationalisation steps. FMCG companies in advanced countries have thus been undergoing painful rationalisation for years. The survivors were large and highly efficient companies, with a relatively narrow product line and consequently, a strong global orientation.

The capital- and technology-intensity of the present EU-companies in these industries are radically higher, the labour intensity radically lower than a decade ago. Since the subsidiaries in candidate countries are far below the optimum level from the point of view of both size, technology level, labour-intensity of production, and profitability – accession will surely lead to rationalisation. Redundancies will become more conspicuous and less tolerable.

The question is, which subsidiaries will be shut down and which ones will be developed in order to make their features comparable with EU companies?

The surviving production facilities among the competing locations in the new EU member-states, will undergo a second wave of restructuring. Investment will have a clear trade-augmenting character. The survivors can expect an increase in their specialisation (a narrowing of their product line) in the length of their production runs as well as in the technology intensity of production.

Which transforming countries are better positioned in the newly opening locational competition? Market size and factor endowment will clearly influence MNCs' decisions. Institutional tightness and the proactive behaviour of authorities: investment promotion efforts, investment after-care programmes will also play a role. Equally or even more important are the management capabilities of local subsidiaries, their ability to assume corporate functions other than production (subsidiaries' independent market acquiring capability and R&D potential will be considered).

The winners of the rationalisation wave will not only expand their activity, but will also undergo significant changes both in technological and organisational term. Production technology will be upgraded so that the length of the production run, the variety of the product mix, as well the capital and labour intensities of production will become more similar to the ones of established subsidiaries in core EU countries. Subsidiaries will gain more extensive product mandates in terms of markets served, and will cover more functional areas (than simple production) in the case of the products they will specialise on. As a consequence, the original market-seeking character of these subsidiaries will change. The motivation of the second investment wave that upgrades the survivors will be of an efficiency-seeking character.

At present, the distribution of market-, resource- and efficiency-seeking investments is uneven across transforming countries. The above-described rationalisation wave hits market-seeking investments i.e. companies that were originally established to serve the domestic market and that proved unable to turn into efficiency seeking investments. Resource-seeking investments may also undergo a rationalisation wave as a result of factor cost changes. Relocation to extra-EU countries can be expected in industries characterised by low local value-added.

EU enlargement will redraw new members’ specialisation patterns. Transforming countries with a large domestic market and a relatively high share of FDI stock in sectors where market-seeking investment is dominant may benefit from further investments in these sectors (carried out to upgrade existing subsidiaries). Small, outward oriented economies with a large share of FDI stock in industries where resource-seeking investment is dominant may face a defensive increase in this type of specialisation as a result of plant closures in industry segments with market-seeking FDI.

According to the most pessimistic scenario, countries with a high share of resource-seeking investment that proved to be unable to moving up the ladder of technological learning and increasing the local value-added during the decade of transition may become the great losers. They may not only be unable to retain their market-seeking investors but will also be hit by a relocation wave in industries where resource-seekers face a reduction in factor cost differentials. Therefore, economic and regional policy-makers are recommended to target the local market-oriented subsidiaries with creative investment after-care programmes and do their best to make them the great survivors of the rationalisation game. Furthermore, they are recommended to do their best (shoulder to shoulder with foreign subsidiaries’ local management) to increase local value-added, and improve existing subsidiaries’ position in their mother companies’ global organizations. Thereby they can contribute to turning investors’ initial resource-seeking motivation into an efficiency-seeking or strategic asset seeking one.