Austrian outward foreign direct investment increased quickly since 1989. For Austria this period was characterised mainly by the opening up of Central and Eastern Europe (CEE) economies. The profitability of Austrian affiliates has been modest until the mid 1990s. The picture changed considerably when Austrian FDI had become older and thereby also more profitable. Whilst the return on equity (RoE) which is used as a measure for profitability has been zero in 1992 this measure increased up to 8.0% in 2004. However, the rates differ quite substantially by regions. They are 3.3% for investments in EU-15 but 11.3 for CEE-5 and 9.0 for CEE-14.

After some severe start-up troubles Austrian affiliates in CEE currently contribute considerable amounts to the overall competitiveness of Austrian MNEs. However, we show that it was not only the profitability of affiliates which has improved strongly within this period but also the efficiency of Austrian firms at home. Measured in unit labour costs (ULC) the Austrian manufacturing sector has improved its position against the main trading partners tremendously during the second half of the 1990s. One result of this development has been a strong increase of Austrian exports. Austria’s market share in total OECD-exports has improved by 19% between 1994 and 2002. In contrast, the market share of Germany remained constant over this period. It is obvious that increased profitability of Austrian affiliates and a strong decline in ULC in domestic manufacturing developed simultaneously. Among others, this development did lead to large increases in Austrian total exports. In contrast, real wages did grow slowly and are more dispersed than ever before. Although no causal linkages are tested, it seems to be obvious that improved competitiveness and growing export market shares vs. declining unit labour costs and growing income imbalances are two sides of the same coin. Thus, distributional issues will be the main challenge for economic as well as political perspectives of Austria.

Key Words: Austrian foreign direct investment, EU enlargement, profitability.
1. Introduction

The economic and political opening of Central and Eastern Europe (CEE) in the year 1989 has had a tremendous impact on the Austrian economy. Since Austria’s economy is mainly dominated by small and medium enterprises (SME) its outward FDI stock (measured as a percentage of GDP) has been traditionally very low. In 1989, at the beginning of the transition period this share has been 2.1% only whilst the share of inward FDI stock has been 7.0% (see Figure 1). Only 15 years later these shares have increased up to 19.5% and 21% respectively. In 2003 these shares have been rather balanced for the first time in Austrian history. The exceptional increase of Austria’s outward FDI since 1989 was mainly due to the opening up of the CEE economies where Austrian firms invested rather heavily.

![Figure 1: FDI stock as percentage of GDP, 1980 - 2002](image)

Source: UNCTAD, FDI database;

Although Austria’s share in worldwide outward FDI stock was 0.7% in 2004, its comparable average share in the eight new member states (NMS-8) Hungary, Poland, Czech Republic, Slovakia, Slovenia, and the three Baltic states was 8.8% (see Table 1). The largest investors in the region are the Netherlands, followed by Germany. However, Austria is ranked third. In the adjacent countries to Austria these shares are considerably higher, i.e. 23.2% in

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1 Although eight out of 19 CEECs are already member of the EU we subsume under the he Austrian National Bank ading of CEE-5 Poland, Hungary, Slovenia, Slovak Republic and Czech Republic. Under CEE-19 we subsume CEE-5 and Albania, Bosnia and Herzegovina, Bulgaria, Estonia, Croatia, Latvia, Lithuania, Moldavia, Romania, Russia, Serbia and Montenegro, Slovak Republic, Ukraine and Belarus.
Slovenia and 14.2% in Slovakia. Moreover, most recent figures show that Austria is ranked first in the next EU-member countries Croatia (27.0%) and Bulgaria (17.5%) and second in Rumania (12.2%) (WIIW 2005). These data show impressively the strong activities of Austrian firms in this region. Most of these activities can be explained by geography but also by cultural and historical ties. The most recent investments in Croatia, Bulgaria and Romania are strongly concentrated in finance and oil processing where Austrian firms have a very solid position generally in CEE. Close to 40% of all outward investment in CEE is allocated to finance!

Table 1: Inward FDI stock in NMS-8 by major home countries
December 2004, share in per cent

<table>
<thead>
<tr>
<th></th>
<th>SI</th>
<th>SK</th>
<th>CZ</th>
<th>HU</th>
<th>PL</th>
<th>NMS-8</th>
</tr>
</thead>
<tbody>
<tr>
<td>Netherlands</td>
<td>5,4</td>
<td>25</td>
<td>30,9</td>
<td>19,5</td>
<td>23,3</td>
<td>21,9</td>
</tr>
<tr>
<td>Germany</td>
<td>7,8</td>
<td>18,5</td>
<td>20,6</td>
<td>29,2</td>
<td>17,2</td>
<td>19,6</td>
</tr>
<tr>
<td>Austria</td>
<td>23,2</td>
<td>14,2</td>
<td>11,8</td>
<td>11,2</td>
<td>4</td>
<td>8,8</td>
</tr>
<tr>
<td>France</td>
<td>7,5</td>
<td>3,1</td>
<td>7,9</td>
<td>4,3</td>
<td>14,5</td>
<td>8</td>
</tr>
<tr>
<td>US</td>
<td>1,6</td>
<td>4,2</td>
<td>5,2</td>
<td>5,2</td>
<td>9,5</td>
<td>6,3</td>
</tr>
<tr>
<td>Other</td>
<td>54,5</td>
<td>35</td>
<td>23,6</td>
<td>30,6</td>
<td>31,5</td>
<td>35,4</td>
</tr>
</tbody>
</table>

Source: WIIW 2005

Until now not much analysis has been carried out on the profitability of Austrian investments (Altzinger 2003, Dell’Mour 2004, OeNB 2005). This paper tries to shed some new light on this important issue. Section 2 provides an overview on the theoretical determinants of profitability; section 3 describes the dataset and provides the empirical evidence for Austrian; section 4 discusses open questions and concludes.

2. Various Explanations for the Development of Earnings

2.1. Determinants of Earnings

As the foundation of an enterprise is frequently associated with start-up losses, the vintage of the direct investment enterprise provides valuable information. Moreover, we would assume, the amounts invested become larger over time because the risk has become easier to gauge. Also EU membership should decrease investor’s risks considerably. Further, more reinvestments should be encouraged if the upcoming economic development seems to be promising for the host country. Actual research on this topic shows that the average growth rate of transitions countries has been two percentage-points above the growth rate of EU countries on average over the period 1995-2003. Growth acceleration is possible provided the business
climate in the EU improves. In any case the average rate of catching-up vis-à-vis the EU will stay at about two percentage points per year.

According to these considerations we expect that the profitability of investments depend among others on (see Lehmann 2002; Lundan 2003):

Macroeconomic factors (in particular growth rates and risks of investment in host countries)
- Taxes on affiliate income
- Agency problems (between parent and affiliates)
- Transfer pricing

Since actually we do not have the appropriate data to test these considerations we will focus on an easier question, namely on the general development of affiliate earnings over time.

2.2. The FDI Financial Life Cycle

Firstly, we are in particular interested on the development of earnings over time. Secondly, we want to understand more clearly what has been done with the earnings, in particular whether they have been reinvested in the affiliates or repatriated to the parent firms. Hence we want to test the following hypothesis which is depicted in Figure 2 (see Brada and Tomsik 2003).

At the outset firms made an investment in the host country to found an affiliate. At first, due to start-up problems, affiliates will often operate at a loss (stage 1). In the case of an acquisition, this period may be short if the acquired firm can be easily reorganized to become profitable. In the case of a greenfield investment, during the time taken to build and equip a production facility, the interest on the capital invested may result in longer lasting start-up losses. Thus the affiliate operates at a loss and pays no dividends.
Next the affiliate begins to operate at a profit as production starts or as the firm becomes more competitive as the result of the restructuring or other competitive advantages provided by the parent firm (stage 2). However, as the affiliate becomes more successful on the market, it is likely to have significant needs for additional investment. Thus all profits may be reinvested to meet these needs. As time passes and profits continue to grow, the parent firm may begin to require that the affiliate remit some of the profits.

Finally (stage 3), the affiliate has reached a mature stage, the parent firm will choose to repatriate a larger share of profits in the form of dividends so that these funds can be used to finance investment opportunities that offer more dynamic prospects elsewhere, and reinvested earnings will decline.

The two forms of earnings utilization (reinvestment or repatriation) have critical implications for both host and home countries growth and employment. Hence it is essential to get more information on these issues.
3. Development of Austrian FDI and Affiliate Profitability by Countries

3.1. On the Profitability of Austrian FDI

To compare the profitability of Austrian affiliates we sub-divide all affiliates into four regions, EU-15, CEE-5, CEE-14 (see endnote 2) and RoW (Rest of the World; these are mainly US, Canada and Switzerland). We analyse the development by the median return on equity (RoE). The median provides us a pattern of the average profitability of firms independently of their size and impact on total profitability. In particular the development over time can be traced better by the median profitability instead by the average (see also endnote 3).

The profitability of direct investments was not always substantial in CEE (see Figure 3). At the beginning of the 1990s, when Austria’s wave of investment in CEE began, profitability was rather low, even resulting in net losses. The median of profitability was zero for all CEECs. In CEE-5 these initial period of investment (Stage 1) lasted until 1995. However, in CEE-14 where the first investments took place much later this period lasted until 1999. Only then investments became profitable. However, the period 1992-1995 was characterised by a

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2 We measure profitability by return on equity (RoE). This is net profit (excluding profits and losses carried forward) by the year divided by equity (minus profit or loss for that year). Two indicators for the RoE can be calculated: Firstly, an average RoE by countries or regions which is the total sum of net profits dived by total equity of countries, regions or sectors with aggregate data. Secondly, the median of RoE can be calculated with firm level data only. The first measure can be strongly biased by a few large (loss or profit) making firms. The second measure provides a more general pattern of the development. We have to add that only the aggregate data are freely available. The firm level data have been calculated by senior officials at the Austrian National Bank by request only.
worldwide recession. Hence also investments in EU-15 show partially huge losses. However, in this period the median of RoE in EU-15 countries was always above that of CEE.

In the second half of the 1990s, the picture has changed significantly. Profitability in CEE-5 gained a strong wind and from 1999 onwards it improved to levels far above those measured in the EU-15. Profitability was boosted, among other things, on the back of the rise in labour productivity (sales per employee). However, the high profitability of affiliates in CEE since 1996 applies only to CEE-5. Affiliates in CEE-14 became profitable in 2000 only. However, since that time the median caught up quickly to the CEE-5 median. In 2004 the RoE was 3.3% for EU-15 whilst it was 11.3% for CEE-5 and 9.0% for CEE-14 respectively. Hence profitability in CEE has overtaken profitability in the EU-15 by far.

3.2. Age and Profitability

Since it is quite obvious that the vintage of investment is a detrimental factor for the profitability of investments we will look at his relation more thoroughly. Therefore we have pooled all observations for the period 1992-2004 by regions and years of investment (see Figure 4). We obviously can see the strong increase of the median profitability for all regions after the third year of the initial investment. The starting-up troubles can be observed nearly in parallel for all regions. Nevertheless, these troubles lasted shorter for investments in CEE-14 and moreover, the profitability reached far higher values thereafter. Hence it seems to be the case that Austrian investors in CEE-14 could have taken serious advantage from learning effects of the investments in CEE-5 a couple of years before. One other explanation for which unfortunately we cannot control for could be that the CEE-14 markets do have less competition regulations and are more of a monopolistic character that those of the CEE-5. Both reasons could help to increase the overall profitability.

Generally speaking, the empirical evidence of Austria’s investment supports strongly the FDI financial life cycle pattern which has been explained and hypothesised in section 2.
This pattern emphasises that the future of the affiliates in CEE-5 and in particular in CEE-14 seems to be quite favourable since younger vintages are strongly overrepresented. Although we have to emphasize that such expected development is everything else than certain the forecasts based on previous experiences seem to be bright.

4. Are there any implications on the competitiveness of the Austrian economy?

Although the mechanism between profits, wages and competitiveness is rather complex we want to present here a few stylized facts for the Austrian economy. In particular we will look at the development of unit labour costs (ULC) for the time considered and additionally we want to present some figures for the international position of the Austrian economy measured by OECD export shares as a proxy for international competitiveness.

Figure 5 presents the development of Austrian Unit Labour costs for the manufacturing sector and additionally the profitability of Austrian Affiliates worldwide for the period 1990 to 2004.
4.1. Profitability of Austrian Affiliates, Unit Labour Costs (ULC) and Domestic Competitiveness

The unit labour cost position of Austrian businesses improved clearly in the second half of the 1990s and has remained largely stable since the year 2000. In the second half of the 1990s, productivity of Austria's manufacturing sector rose considerably (+5.3 percent per year), exceeding the average of the trading partners by 2.2 percentage points. The rise in productivity slowed down simultaneously with lower economic growth after 2000. The annual rate of output growth per employee since 2000 has been 3.0 percent on average, exceeding the average of the competing countries by 0.5 percentage point. Consequently, the unit labour cost position of Austrian manufacturing improved considerably in the second half of the 1990s and has remained largely unchanged on average since 2000. Relative unit labour costs have been falling by a good 20 percent since the mid 1990s compared with both EU trading partners and the average of all trading partners (Guger 2005).

On the right hand axis of Figure 5 we have depicted the returns on equity of the Austrian affiliates. Although we do not argue that there is any direct link (causality) between those two indicators it is obvious that they develop completely in opposition. All what should emphasised here is that the improvement of the affiliates profitability (as a proxy of efficiency) developed almost completely in tandem with the efficiency of the domestic manufacturing sector.
4.2. FDI, Trade and Competitiveness

The manifold linkages between outward FDI and domestic competitiveness can be summarized in brief by three effects:

- Market-extension effect
  
  If FDI takes place in emerging and strong growing markets FDI may stimulate profitability of both affiliates and parent firms. Such FDI may stimulate both exports of intermediate as well as capital goods.

- Competition-enforcing effect
  
  The more matured the host economy becomes the more imports to the domestic economy will be provided. This results in tougher competition for domestic production but also in cheaper inputs.

- Competition-enhancing effect
  
  In particular due to cheaper inputs and therefore intensified specialisation the production of the parent company in the domestic economy may become more competitive on the world market, e.g. Austria exports close to 80% of all its exports to highly developed (EU-) countries with strong purchasing power. The overall exports depend mainly on Austria’s market shares within these large EU-markets. Some minor change of these market shares (probably due to improved specialisation) can cause severe export improvements. Such effects are often neglected. However, we can provide (incomplete) data to prove this hypothesis.

Aggregate trade figures present a very straightforward explanation. Austria’s aggregated trade balance with NMS-8 was positive throughout the period 1988 to 2004. Figure 6 shows the strong increase of Austrian exports to and imports from NMS-8, measured as a share of total exports and imports. In 1997 the trade surplus with NMS-8 has been 0.9% of GDP. However, during the period 2002 – 2005 the surplus declined to some extent.
Beside these aggregated figures several studies confirm that Austria’s FDI in and exports with CEE shows a complementary relationship (Pfaffermayr 1996, 1998). Additionally Austria has increased its intra-firm trade with the affiliates in CEE considerable (Altzinger 2000). Also this is an indicator for a stronger specialisation which should improve among others the overall competitiveness of parent firms. If this is true Austria should display increasing worldwide market shares. Therefore we will have a look at the development of Austrian market shares in total OECD-exports. If Austria has improved its competitiveness, among others by improving its efficiency through intensified specialisation, then its export market share should confirm such an improvement.³

³ The overall competitiveness of an economy is certainly the result of many features. However, since Austria has been affected (positively as well as negatively) by the opening-up of the transition countries more intensively than any other old EU-member country it seems plausible that this development has the most severe impact on the overall development of the Austrian economy.
Table 2 provides us some evidence of Austrian and German trade development through the period 1994 to 2002. Since Germans GDP is approximately ten times larger than Austria’s GDP also market shares should be ten times larger. As we can see in Table 2, the market shares are worldwide 15.2% and 1.9% respectively. However, these differences are much more pronounced in the new member countries. At the aggregate CEEC-5 level this relation is only 1 to 5.1 whilst in the adjacent countries to Austria this relation is much more in favour for Austria. These particular favourable market shares of Austria in the adjacent countries contrast strongly to the data for Poland and the Baltic countries. There Germany performs much better. All these figures can be explained to a large extent by gravity considerations. However, what is of additional interest is the development of trade shares for both countries over the transition period 1994 to 2002 (column IV and V). The most striking fact in these two columns is certainly the strong improvement of Austria’s worldwide market shares. Within this period Austria’s market share improved by 19.7% whilst the German market share remained nearly constant. In particular this number emphasizes strongly the improvement of Austria’s international position.
5. Conclusion

Mainly due to the opening-up of the CEECs Austrian foreign direct investment increased rather strongly since 1989. This development has enforced Austrian international economic activities considerably. Starting from nearly zero in 1989 Austrian investment in CEE accounted for 37.9% of Austrian total outward investment in 2004. Austrian investments in CEE started in 1989 with many loss making investments. However, current investments are rather profitable. Most of the initial investment period and its start-up troubles are already over. In 2004 total annual profits translate into an average return on equity of 8.0%. However, the rates differ quite substantially by region. They are 3.3% for investments in EU-15 but 11.3 for CEE-5 and 9.0 for CEE-14. In particular also the most recent investments in Croatia, Romania and Bulgaria became quite profitable. The vintage is the main determinate of profitability. However, controlling for age of investment, affiliates in CEE are more profitable than affiliates in EU-15.

The remarkable profitability of Austrian affiliates in CEE confirms the wide-held impression that the opening-up of CEE economies has helped to improve the overall competitiveness of the Austrian firms considerably. The strong increase of Austrian outward FDI due to the opening up of the transition economies produced an enforced structural change with many winners and losers, both between profits and wages as well as between individuals (by sectors, regions and qualifications). Only the aggregated net effect seems to be rather favourable for the Austrian economy.

In particular due to the tremendous increase of outward FDI Austrian parent firms as well as the affiliates became profitable. Parent firms also increased their worldwide export market shares. Both affiliates as well as parent firms increased their returns on investment. Therefore it seems to be the case that this kind of internationalisation did help to improve the competitiveness of Austrian firms considerably. However, wages did increase only marginally. Consequently, unit labour costs (ULC) did improve considerably. Therefore, the opening up of CEE (and also the current EU enlargement) did not only cause huge structural challenges but also strong distributional divergences. To conclude, appropriate policy measures to smooth these divergent developments are the main challenge for contemporary policies, both at the national level as well as at the EU level.
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