

**Macroeconomics**

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**REINDUSTRIALIZATION
OF THE EUROZONE COUNTRIES
AS A PREREQUISITE
FOR INDUSTRIAL RENAISSANCE
OF ECONOMY IN UKRAINE****Abstract**

This paper describes the role of industry as one of the key engines of economic growth in the countries with transition economies. The process is analyzed of change in global investment strategies, and related perspectives for reindustrialization of the European economies. The main positive and negative aspects of Ukraine as a recipient country of FDI are singled out. Empirically assessed is the relationship between FDI flows to the European countries and Ukraine.

Key words:

Deindustrialization, reindustrialization, foreign direct investment, structural distortions.

JEL: F43, O14.

Introduction

Since the 1980s dynamic deindustrialization of the economy is observed in Ukraine that led to the formation of numerous structural distortions (Zadoya, 2012, pp. 22–24). Hypertrophied development of domestic trade of goods sector,¹ the predominance of low-energy-consuming sectors in industry and exports are significant obstacles to sustained economic growth, as far as they significantly increase vulnerability to internal and external macroeconomic shocks. Under such conditions the problem deserves attention of finding effective tools to overcome these strains and the transition to sustainable economic growth. In the scientific community there is no shortage of demonstrations that it is just the industrial capacity building of the country that can be such a tool (Tregenna, p. 16–18, 12, p. 4, 6, p. 16, 13, p. 5, 4, p. 147, 1, p. 24–26). Specifically, A. Lavop and A. Szirmai identified some mechanisms explaining the role of industry as one of the key engines of economic growth (Lavopa and Szirmai, 2010, p. 6–8) including: 1) better opportunities for the accumulation of capital, 2) higher labor productivity as compared to many other areas 3) using economies of scale; 4) dynamic or indirect effects of industrial development (investment in the industry produces an indirect impact on many other sectors of economy), 5) easing the balance of payments constraints, which is a significant barrier to economic growth in transitional economies, 6) dynamization process of economic development.

Despite awareness of the significant benefits of the restoration of the industrial potential, the most significant obstacle in Ukraine is the lack of internal investment resources as well as technological backwardness, which implies the need to attract foreign capital. The most effective, in our view, is foreign direct investment (FDI), which, unlike portfolio investment, is of real character (not only transfer of capital but also of technology and «know-how»). One of the important prerequisites to attract additional investment capital to the economy of Ukraine may be changing of investment strategies in the leading world countries, which marked the post-crisis period of the global economic development.

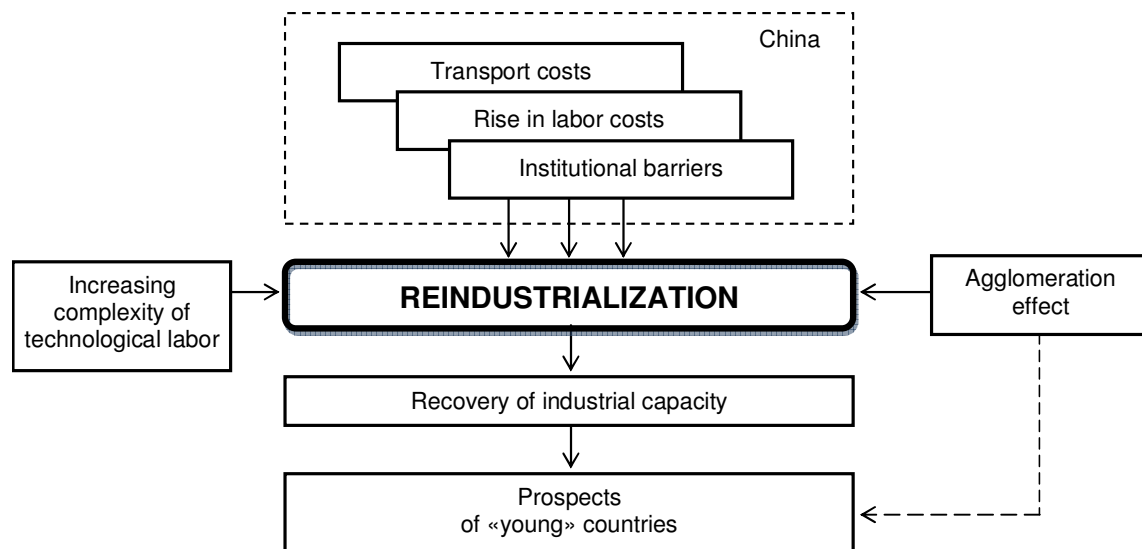
¹According to W. Baumol law the growing share of services (it is the basis of internal trade goods sector) in GDP leads to lower productivity in the economy, which is associated with significant labor intensive sectors of this field. Mostly the growth in labor productivity in service sector is not due to an increase in production efficiency, but because of deterioration of the quality of services or the provision of fewer services for the same price (Szirmai, 2012, p. 10].

End of a «cheap» China era

Over the past 20 years the geo-economic strategy of most highly developed countries have been focused on the transfer of industrial production to China in order to gain competitive advantages by reducing production costs. Since the beginning of the last decade, cheap labor force and favorable business conditions were the main attractions for foreign investors, that led to a rapid de-industrialization not only of highly developed countries, but also of most transitional economies (for example, the share of industry in gross value added in the economies of the EU countries for the period from 2000 to 2011 reduced to 16%). However, the conjunctural changes that began recently, initiated the reindustrialization policy of industrial countries (Figure 1).

Figure 1

Reindustrialization prospects of the European economies



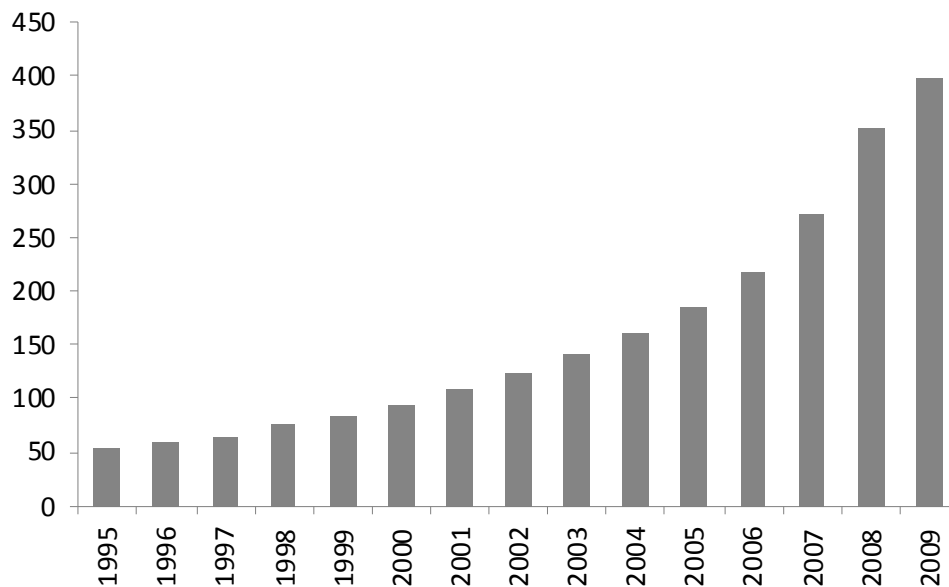
Source: Developed by the author.

The end of the «cheap» China area became the instrumental factor which is due to several reasons: increase in land prices, increase of environmental standards and safety regulations, fiscal pressures, expectations of «bubble» elimination in real estate market, corruption scandals and more. However, the

most significant factors were the rapid growth of wages and the expected increase in transport costs, which is observed at the background of increased world oil prices. Labor costs in Chinese industrial enterprises in dollar terms had been annually increasing during 2002–2009, in particular, in Guangdong province – by 12%, and in Shanghai – by 14% (The Economist, 2012, p.75). Today, the salary at an average Chinese textile factory is 188–300 euros, which is higher than the corresponding wages in a number of countries in Eastern Europe, including Ukraine. While labor productivity in China over the past 20 years has increased tenfold, this figure is still three times lower than in the European countries. Moreover, the situation is complicated by low production culture, which significantly increases the cost of new technologies introduction. The positions of China as a production base of cheap labor were shaken by scientific progress, enabling extensive use of automation technology industries; the number of employees is reduced to a minimum, and the emphasis is shifted from labor costs to the level of its qualification. Additional pressure on investment decisions has a gradual strengthening of the Chinese national currency – the yuan, which for the last 7 years made about 30%.

Figure 2

China: the average monthly nominal wage (USD), 1995–2009 year



Source: calculated according to the International Labor Organization.

Reindustrialization of the EU countries

Upon conditions of labor and vehicles costs increasing in China, there economically feasible is the relocation of production closer to sales markets. L. Resmini and I. Siedschlag empirically demonstrated the presence of stable inverse relationship between foreign direct investment to China and to the new EU member states, especially it is true for vertical FDI (Resmini and Siedschlag, 2008, pp. 10–14). Under condition of permanent complications of the technological series of industrial products through main advantages of the EU countries, there is a high level of technological development, the availability of skilled labor, good infrastructure, and what is the most important, agglomerative effect, which can significantly improve the efficiency and velocity of the production cycle.

The reindustrialization was speeded up by the crisis events of 2008–2009, which caused a sharp drop in employment rate and created the preconditions for the mitigation of social standards (it enabled to reduce the cost of labor and freed up additional manpower for the development of industries). A special chance received the new member states and the European periphery countries, specifically Ukraine, which has advantageous geographical location respectively the main markets of industrial products and at the same time are characterized by lower wages than the EU15 countries. According to the Boston Consulting Group, in Poland, labor costs are 35% lower than in neighboring Germany, and the cost of transporting goods from Warsaw to Frankfurt is 40% lower than from Shanghai. (Džikija) Thus, the European periphery countries are particularly attractive to manufacturers of heavy and over-dimensioned products such as furniture, motor vehicles, heavy equipment, batteries, and other metal structures. In favor of the EU reindustrialization there shows the lack of customs and cultural barriers, that significantly facilitates cooperation between the countries.

A chance for Ukraine

Under these conditions, Ukraine is provided a special opportunity. The main advantages that increase its attractiveness for foreign investors are the following:

- 1) geographical proximity to the EU and access to the sea. Like the CEE countries, Ukraine is favorably located in relation to major industrial products markets in Europe, which significantly reduces the cost of transportation;

- 2) the presence of a large domestic market for industrial products. A negative balance of trade in industrial products, observed over a long period in

Ukraine, indicating the sustained demand for industrial products, which currently can not be satisfied by domestic producers. This is a significant advantage compared to most of the CEE countries, which have much smaller volume of the domestic market, despite the higher solvency of the population;

3) lower than in neighboring countries, cost of wages to employees. Comparing the data of national statistics committees, in terms of average salary Ukraine (337 US dollars.) rather falls behind the neighboring Poland (759 US dollars.) Slovakia (811 US dollars.) and Hungary (691 US dollars.);

4) more loyal social and environmental standards;

5) the presence of a strong resource base.

However, there is no shortage of both internal and external factors that can prevent the inflow of foreign capital into Ukrainian economy. In the process of re-industrialization significant competition is made by the U.S., who besides the above-mentioned advantages has extra benefits implying much cheaper energy resources (this has been contributed by «shale revolution»), much larger domestic market and more loyal legislation regulation. In addition, the U.S. government under President Barack Obama has long proclaimed a policy of the industrial potential recovery of the country, as well as it managed to implement a number of measures that increased the attractiveness of the country for foreign and domestic investors. In particular, the system of tax incentives was introduced for manufacturers that create new jobs in promising for the country industries. This U.S. activity can significantly reduce the reindustrialization potential of the European region, since at present the EU leadership has not offered any clear measures to facilitate the return of FDI.

Much more significant, however, are internal factors, in particular, the following:

- poorly developed production infrastructure. Lack of proper infrastructure to support the performance of industrial enterprises is the most important factor that deters foreign investors, as far as it significantly complicates the manufacturing process and makes it more costly;
- lack of skilled labor and low level of production culture;
- administrative difficulties in obtaining rights to land and real estate ownership. Investment in industry is often associated with the need to purchase land for the construction of its production facilities. The absence of a unified land cadastre in Ukraine and proper land laws rather complicates the investment processes;
- tariff barriers that increase the cost and delivery time;
- abuse of governmental bodies, and political uncertainty.

Only the formation of a coherent policy aimed at eliminating the above-mentioned factors can provide a proper climate for FDI inflows into the country. An important step towards overcoming the above obstacles can be conclusion of the Association Agreement between Ukraine and the EU that will simplify customs procedures and significantly raise the country's credibility among potential investors.

The empirical results

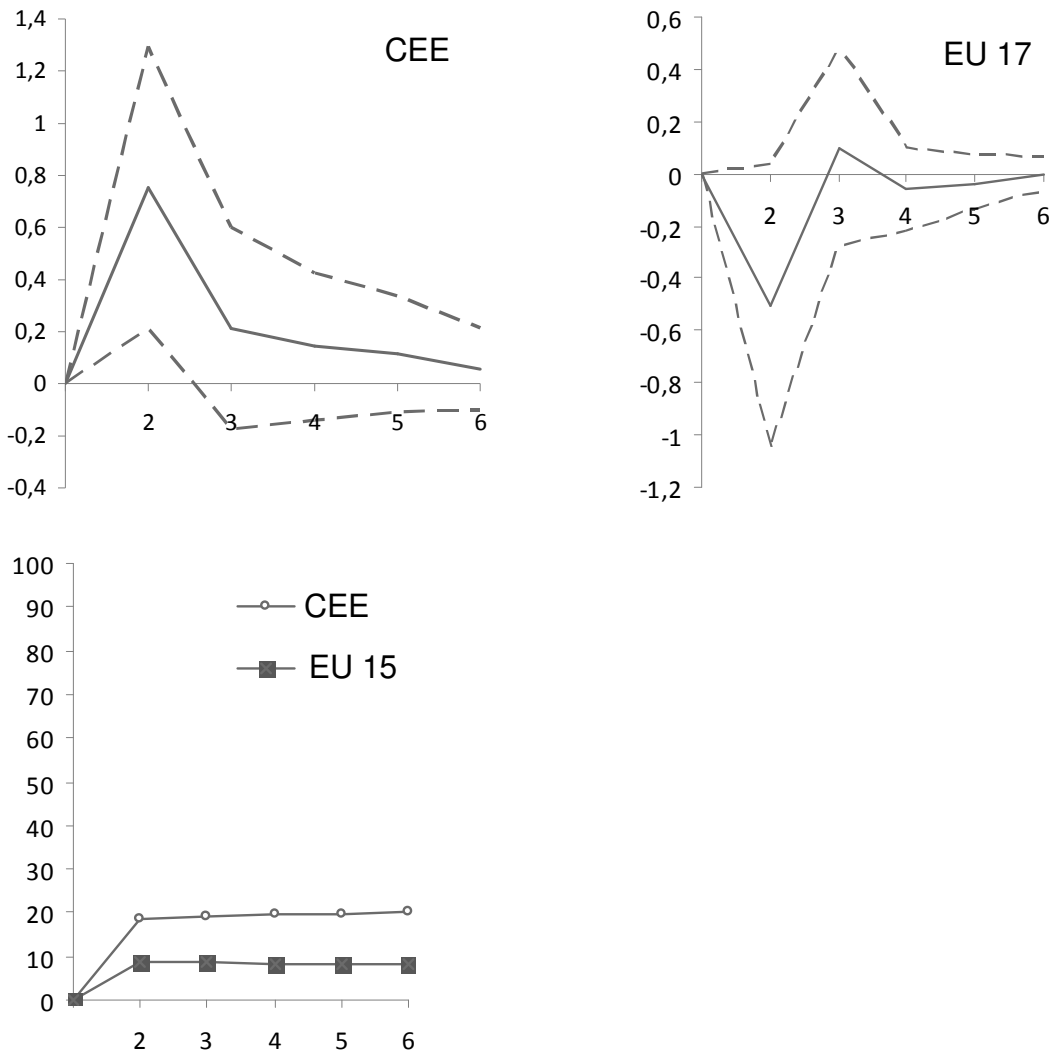
For the empirical evaluation of the relationship between FDI flows to Ukraine and to other European countries there was selected an auto-regression vector model (VAR). The advantage of the VAR method is a dynamic consideration of mutual relations between the two figures and the ability to determine the weight of the individual components in the changes of the studied parameters. The chosen model delivers a brief description of the short-time dynamics of the dependent variable (first differences) taking into account the lagged values – its own and other dependent variables corresponding to the long-term (co-integrating) relationships and independent variables. For empirical evaluation there were used quarterly data for the period from 2005 to 2012

Fig. 3 demonstrates an impact of FDI produced in the Central and East European countries and in the EU15 countries. The FDI influence on the Ukraine's economy is illustrated by appropriate pulse functions and decompositions of the residues. Expressive direct impact of FDI in the CEE countries for FDI in Ukraine is observed by a lag of one quarter, besides their weight in the dynamic of flows of foreign direct investment in Ukraine is quite large – about 20%. This suggests that reindustrialization of the CEE countries influenced by changes in global investment strategies will encourage the attractiveness of foreign capital in the domestic industrial sector. However, this trend does not apply to the EU 17 countries as far as the relation between FDI into the EU17 and FDI in Ukraine is inverse and rather unstable, which suggests that FDI in Ukraine is not associated with a potential influx of foreign capital into the countries of «old» Europe.

The conducted empirical analysis in general confirmed the previously presented hypothesis that reindustrialization of the countries in Europe can become a strong prerequisite for the industrial revival of the national economy.

Figure 3

Impact of FDI flows to Central and Eastern Europe and the EU17 produced on FDI in Ukraine (VAR estimates)



Conclusions

The development of industries is a key factor in overcoming structural deformations in the economy of Ukraine, and a necessary prerequisite for the transition to sustainable economic growth. However, the limited domestic investment resources provoke searching for external sources of funding. The most conven-

ient tool of foreign investment in the industry can become the foreign direct investment, whose inflow conditions to the country are provided by a process of the European economies reindustrialization, which is associated with the change of global investment strategies because of China's lost of its appeal as a cheap manufacturing base. The VAR-analysis found a robust positive relationship between investment processes in Central and Eastern Europe and Ukraine, which eventually confirmed the hypothesis about the relationship between the reindustrialization processes in CEE and Ukraine. However, too maximally use of similar perspectives Ukraine is able only under condition of strict adherence to the economic policy aimed at creating favorable conditions for investment in industrial sectors. Following from the above, the perspective of future studies is seen in finding the effective tools of investment policy in Ukraine.

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