Foreign Direct Investment in SE Europe: the Story So Far

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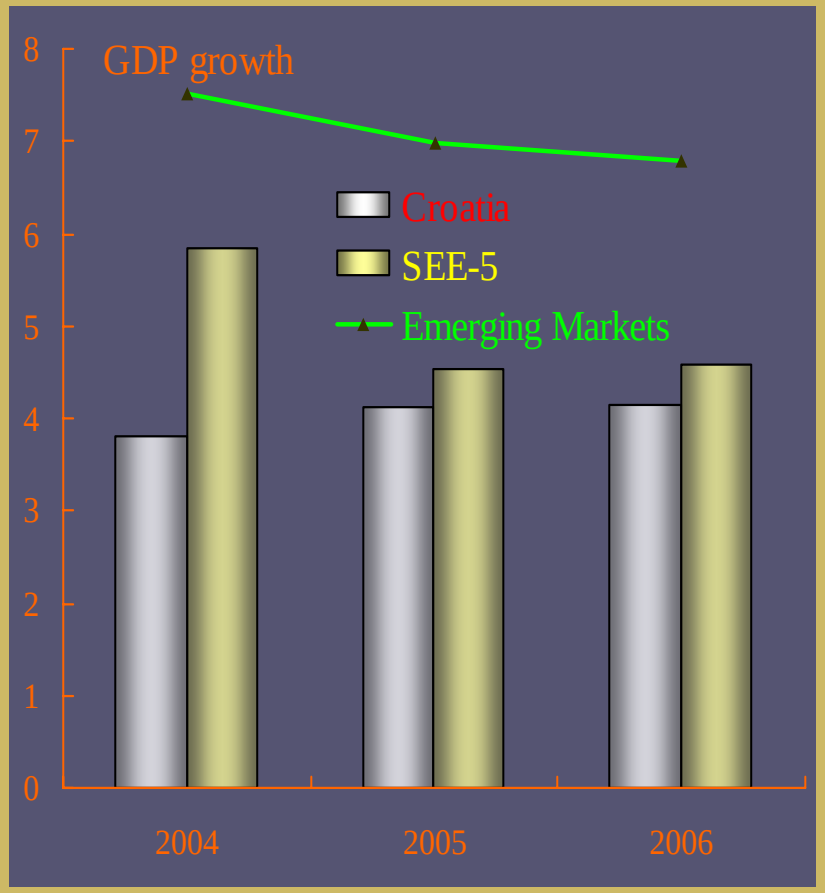
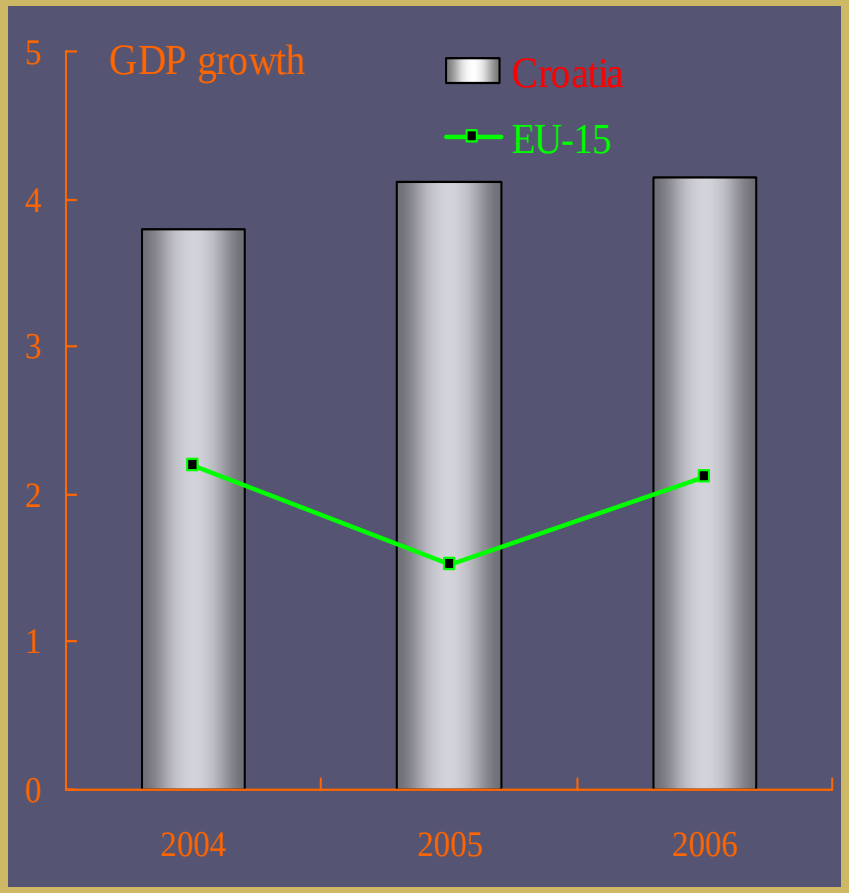
Economic performance: SE Europe in perspective

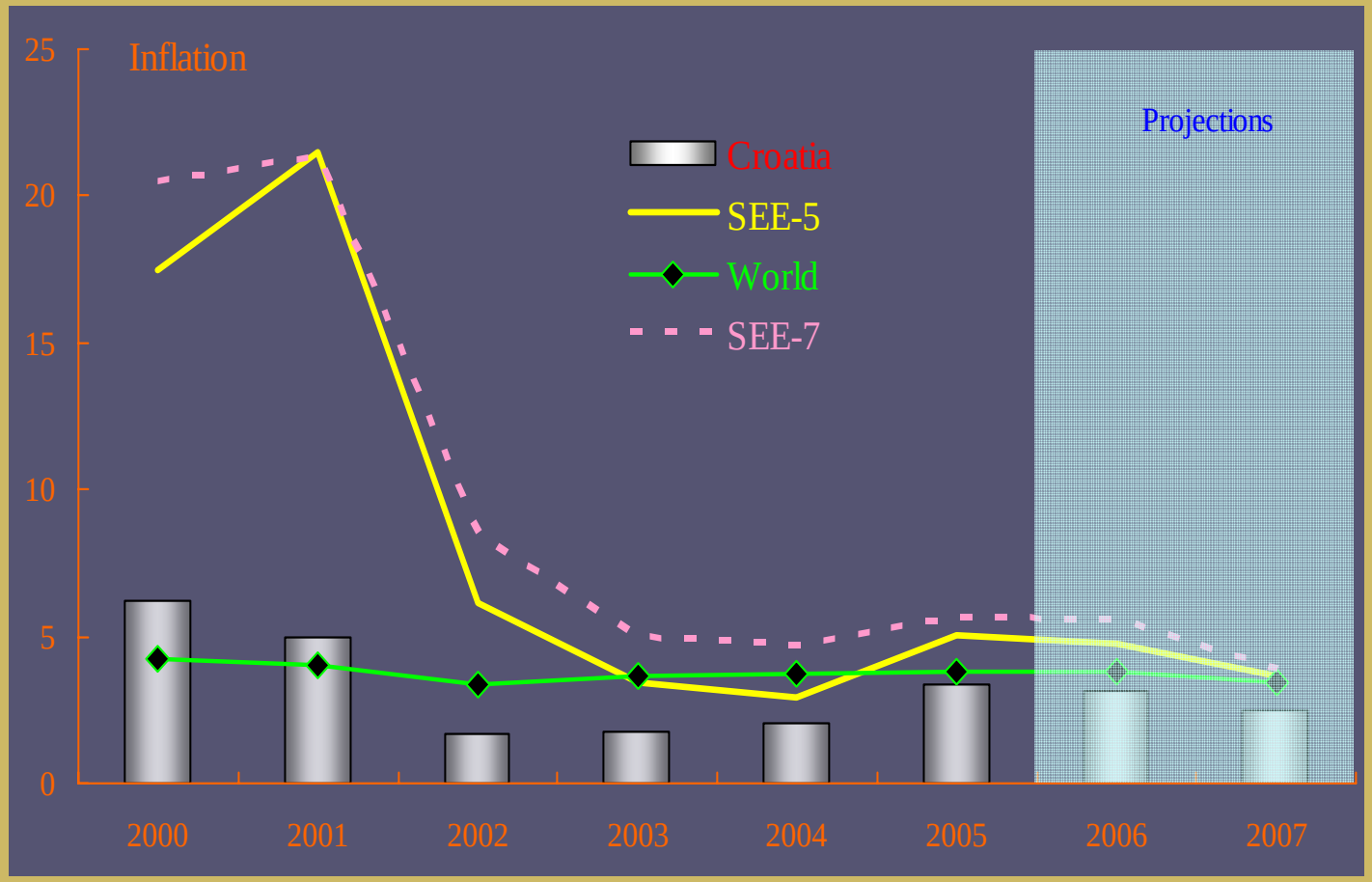
Lower growth than other emerging markets ...



... but better than in EU

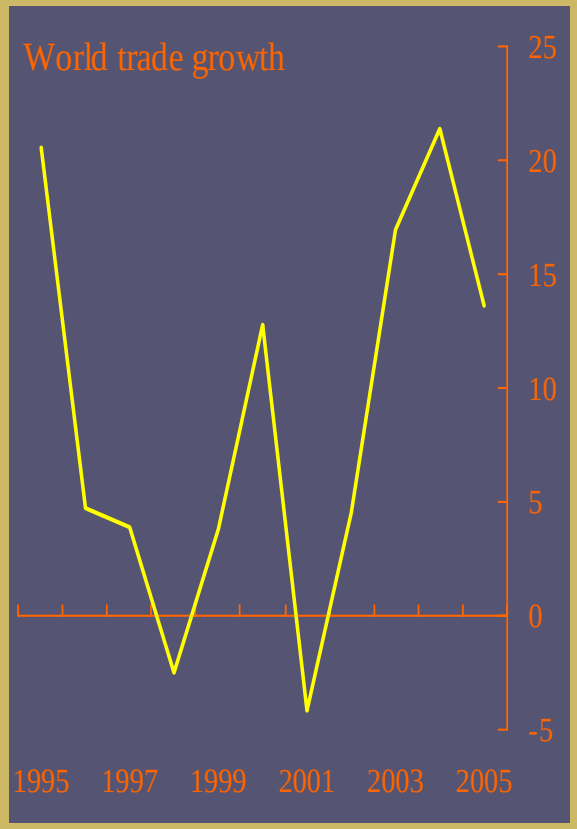


Inflation remains contained

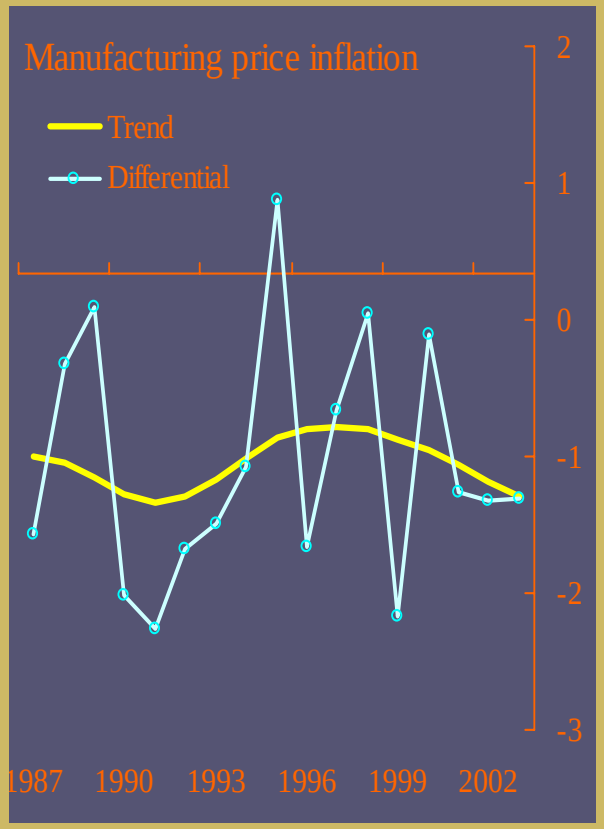


Benign global trends

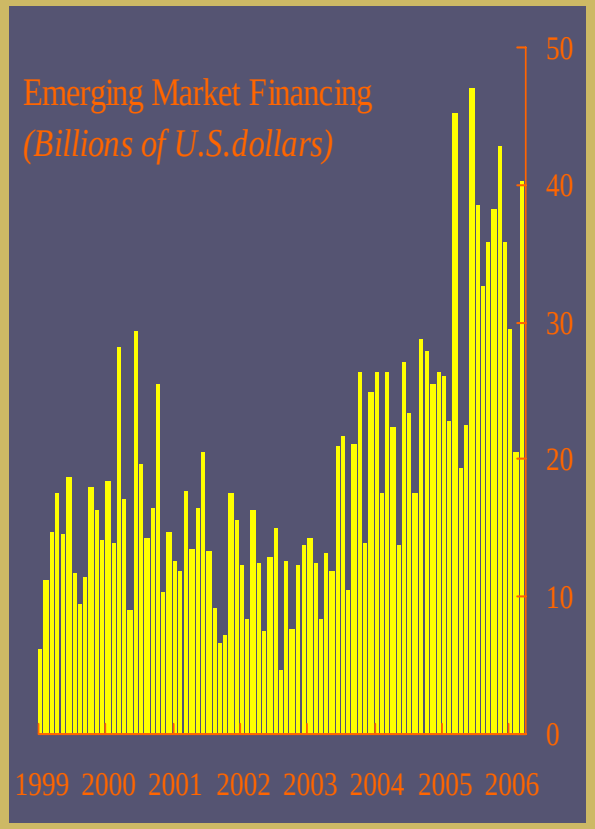
Buoyant world trade



Low import price inflation

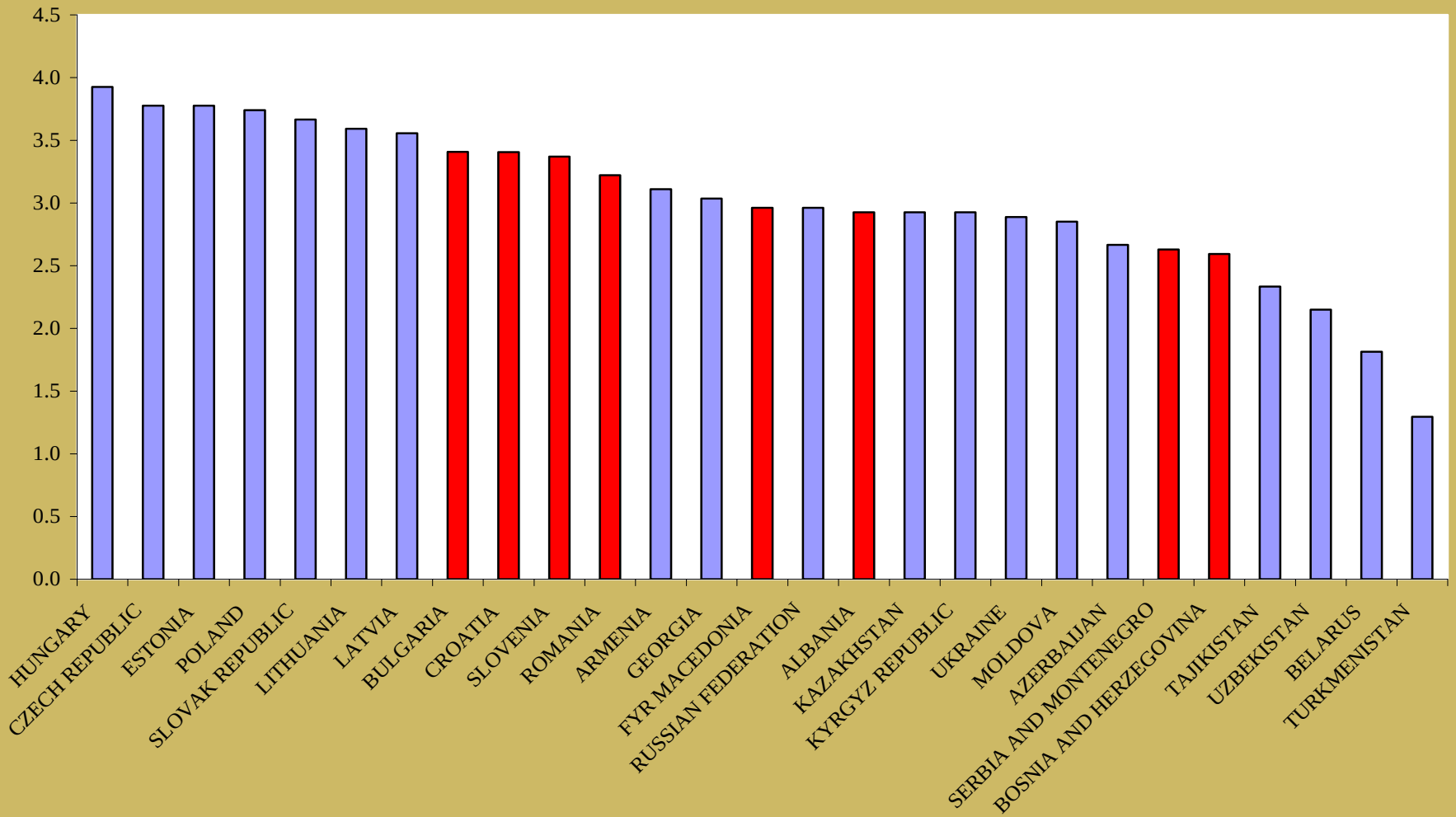


Ample global liquidity

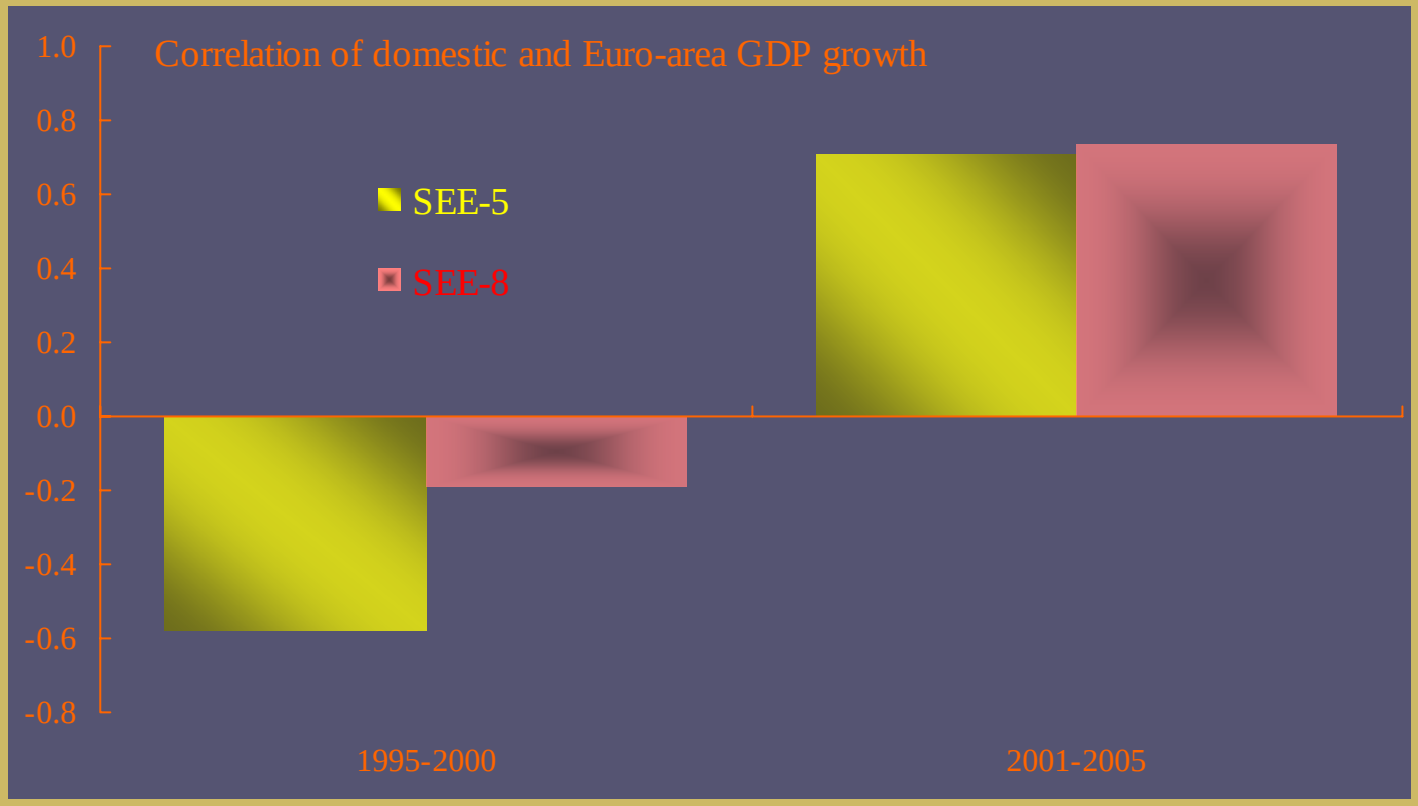


Structural reforms lag

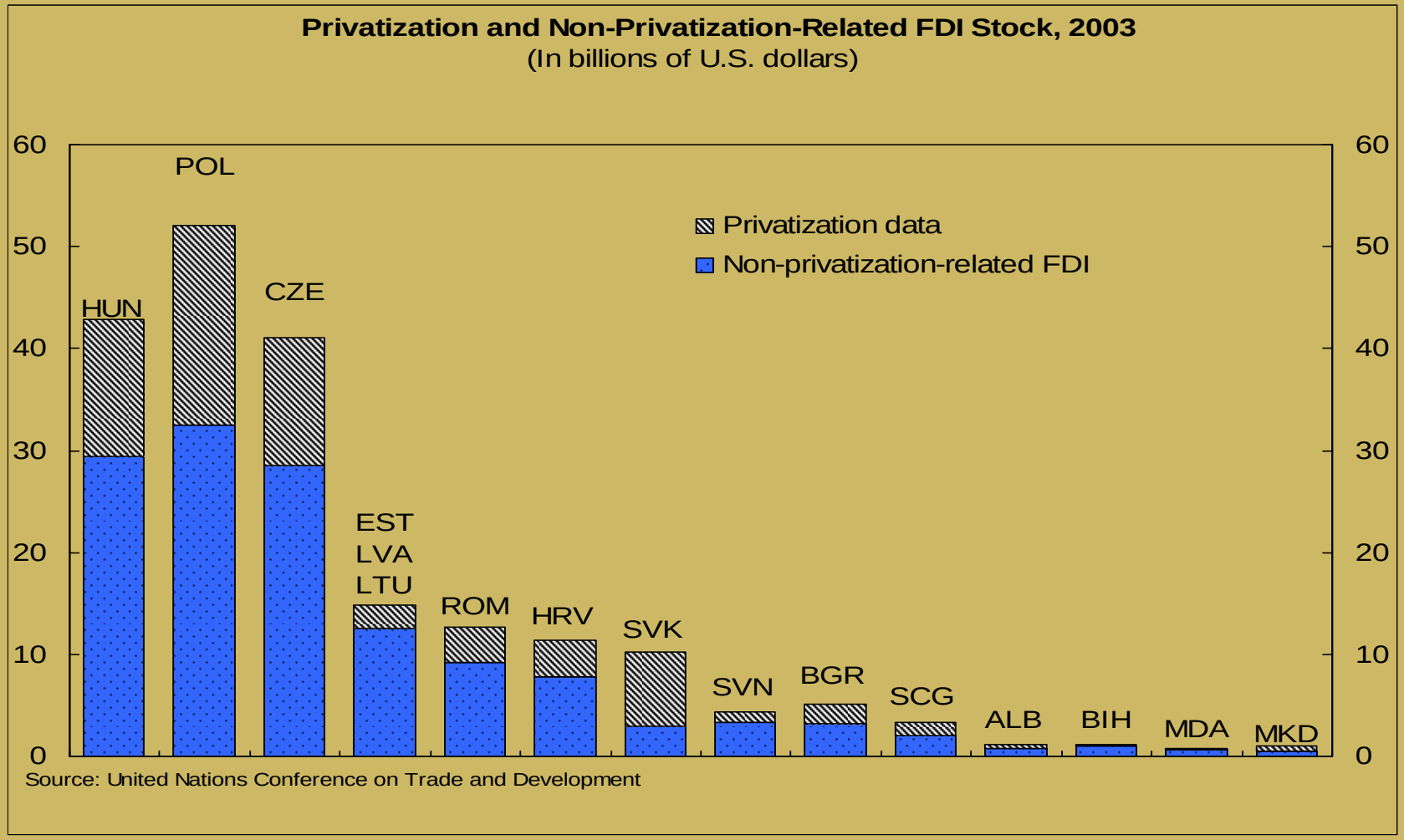
EBRD Average Transition Indicator, 2005



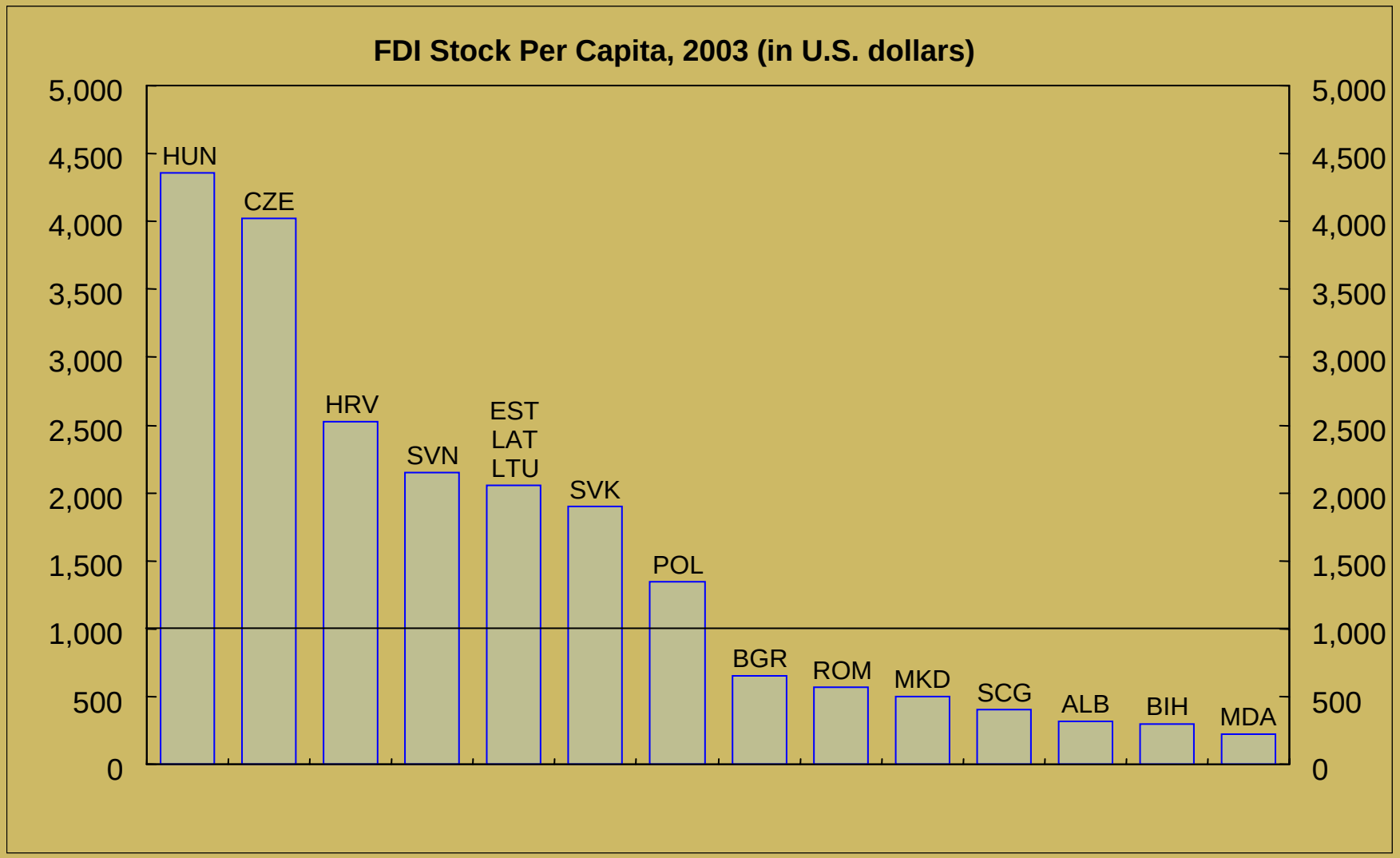
Growing economic integration with the EU…



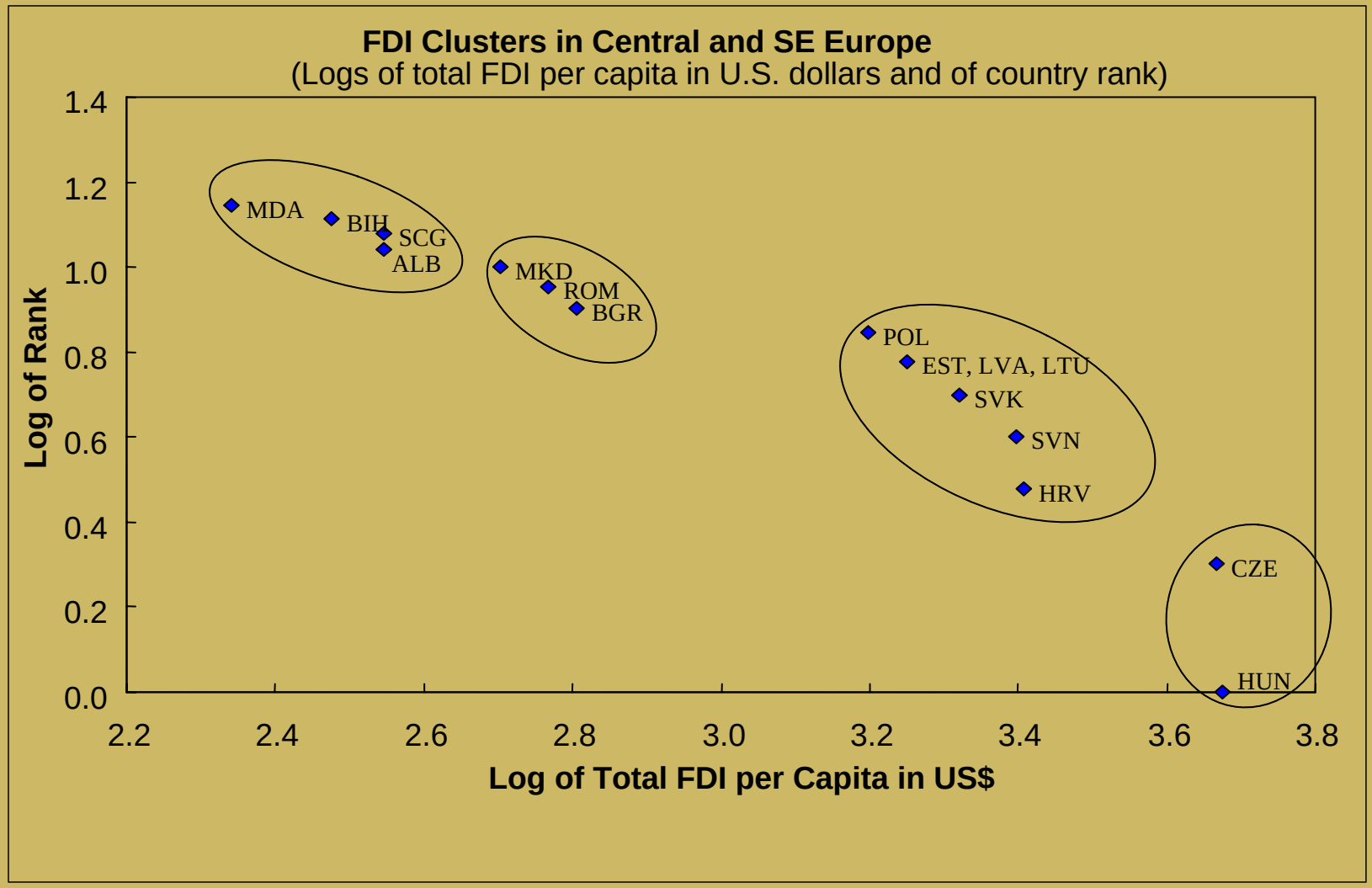
… but a disappointing record in attracting FDI



Economic Cooperation & Investment Opportunities in Southeastern Europe



Clusters of "leaders" and "laggards"



Why?

Factors affecting FDI inflows

("*Foreign Investment in SE Europe: How (and How Much) Can Policies Help?*" IMF WP/05/110).

- "Gravity" factors (market size, geographical/cultural proximity) explain about 60 percent of FDI inflows.
- But policies also matter: high labor costs, taxes, tariffs discourage FDI; liberal forex & trade regime, reforms in infrastructure encourage it.
- No direct impact of improved governance, lower corruption. They probably stimulate *all* investment indirectly (lower transaction costs). Tax holidays: insignificant impact.

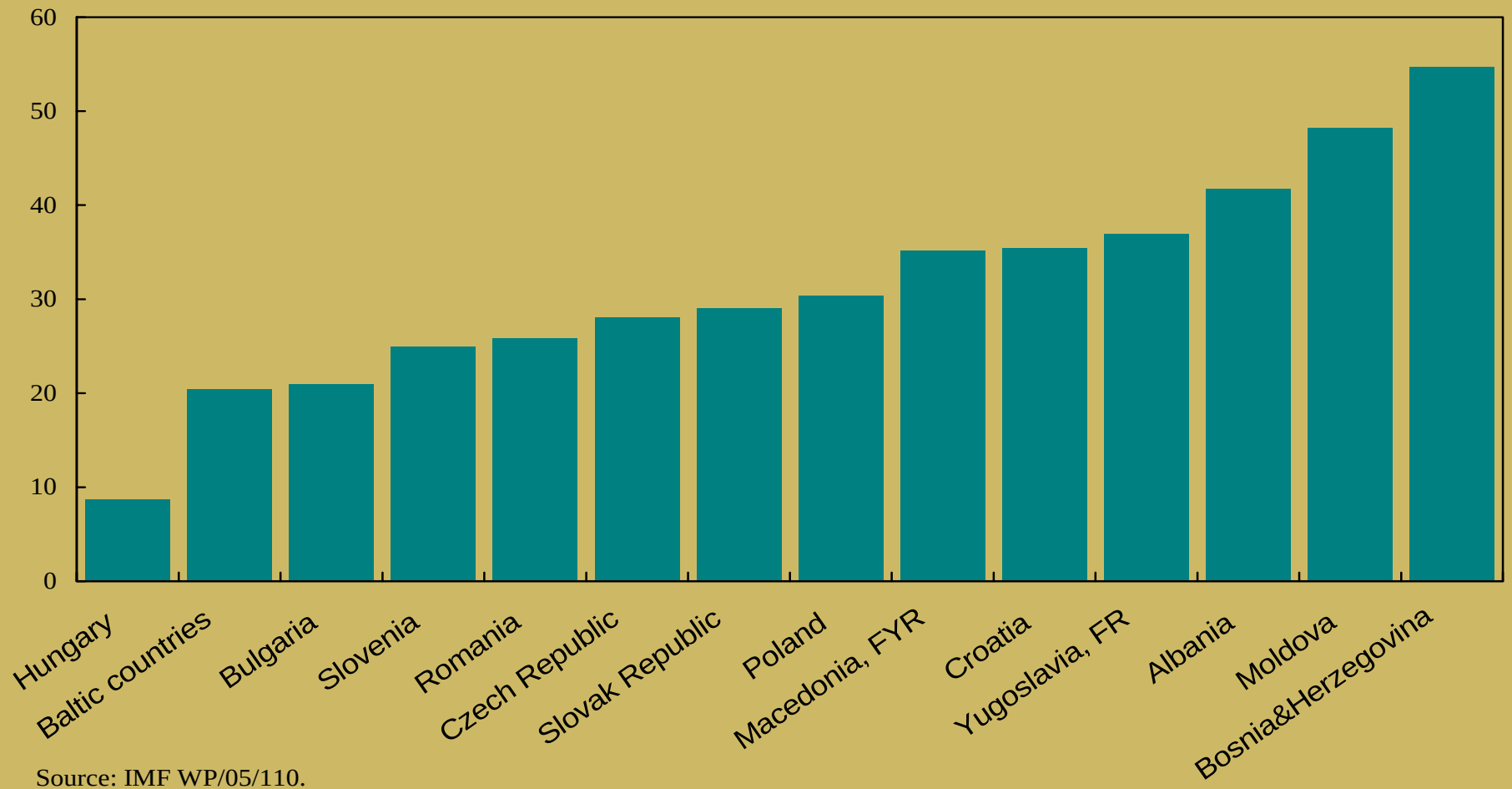
What can economic policies achieve?

"Potential" FDI

- Take "gravity" variables as exogenous
- Estimate level of FDI in each country if policy variables are set at their "best" value
- "Best" value = best practice in SE and CEE Europe

Who stands to gain most from getting policies right?

Estimated gap between "potential" and actual non-privatization FDI stock, 2003 (in percent)



Source: IMF WP/05/110.

Are all policies equally important for all FDI?

"Threshold effects" estimation

- The emergence of clusters suggests that the influence of various factors may change as FDI increases...
- ... and empirical results confirm this.
- The critical mass of FDI appears to be around 12 percent of GDP (roughly the stock of FDI in Poland in 2003).

Below critical mass:

Foreign investors are attracted mostly by “gravity” variables (proximity and market size), low labor costs, and openness of the trade and foreign exchange regime.

Above critical mass:

Proximity becomes less important, although size still matters; labor costs become insignificant; the tax and regulatory regime become more important.

Foreign investors as “flying geese”?