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**

World trade growth

**Low import price inflation**

Manufacturing price inflation

- Trend
- Differential

**Ample global liquidity**

Emerging Market Financing

(Billions of U.S. dollars)
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Structural reforms lag

EBRD Average Transition Indicator, 2005
Growing economic integration with the EU...

Correlation of domestic and Euro-area GDP growth

- SEE-5
- SEE-8

1995-2000 2001-2005
... but a disappointing record in attracting FDI

Privatization and Non-Privatization-Related FDI Stock, 2003
(In billions of U.S. dollars)

Source: United Nations Conference on Trade and Development
Clusters of “leaders” and “laggards”

FDI Clusters in Central and SE Europe
(Logs of total FDI per capita in U.S. dollars and of country rank)
Why?

Factors affecting FDI inflows


“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.
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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”?
Flying Geese