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FDI AND THE MACROECONOMY IN THE TRANSITION ECONOMIES

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The potential contributions of FDI flows to economic development are well known. This paper focuses on two related aspects of FDI, its implications for the external financial positions and economic growth of the host countries. It commences with a discussion of the main determinants of FDI flows into the transition economies, which, it should be noted, is not intended to be comprehensive. This is followed by an empirical section, based largely on balance of payments data, which quantifies FDI flows according to various indicators. The paper concludes by raising a number of policy issues associated with FDI promotion and the growing disparity of FDI inflows within the ECE region.

1. Principal determinants of FDI flows.

There is widespread agreement on the determinants of FDI flows: countries attracting large amounts of FDI generally have good economic fundamentals: that is to say they have achieved a high degree of macroeconomic and political stability and growth prospects look favourable. They also tend to possess a good infrastructure and legal system (including enforcement of laws), a skilled labour force, and the foreign sector has been liberalized to some extent (membership in free trade areas is a particular attraction). Location, country (market) size and natural endowments are generally important as well. In the former centrally planned economies, the degree of progress made in moving from plan to market has been a key explanation of FDI inflows (table 1 and charts 1 and 2; appendix tables).¹ More generally, those transition economies which have attracted substantial amounts of FDI have followed policies which have created friendly investment environments (although they often possess certain natural advantages as well).

The following section will first discuss some determinants of FDI flows into the first group of transition economies chosen for EU accession (Czech Republic, Estonia, Hungary, Poland and Slovenia). These countries have received the bulk of FDI flows into

the ECE region during the past decade, never less than 60 per cent of the total annual inflows. The focus then switches to the countries which have failed to attract much FDI. In some cases, they have been in a favourable position to do so, but domestic political and/or economic policies have discouraged investment. In certain countries, the causes appear to be more fundamental and intractable.

The first wave of EU accession countries were among the first to achieve macroeconomic stabilization and their economic reforms have been the most advanced in the ECE region. Although there have been considerable policy differences between them, a key element of the reforms has been the privatization of state assets with the involvement of foreign strategic investors. These acquisitions, the timing of which has been determined by national timetables for the sale of specific assets and the political process, have accounted for a considerable share of total FDI receipts. Exclusive of Slovenia (see below), the early investment promotion efforts of these countries not only signalled to the world that foreign investment was welcome in the former state run economies, but they also capitalized on the enthusiasm of western investors. At various times, investment incentives schemes have been introduced² which still seem retain their effectiveness.

Geographical proximity to major western European markets and production centres is also a major advantage as four countries share borders with the EU while Estonia enjoys easy maritime access. The size of the Polish economy has contributed to its leading position as a domicile for FDI. Most of these countries embarked on the transition with poor market supporting institutions and physical infrastructure. However, considerable progress has been made in some areas, often with the assistance of the international development banks³ and

¹ The relationship between the degree of economic reform and FDI inflows has been commented on previously. See for example, EBRD, *Transition Report 1998*, London, 1998.

² G. Hunya, *International Competitiveness Impacts of FDI in CEECs*, The Vienna Institute for International Economic Studies (WIIW), Research Reports, August 2000.

³ These countries have received the assistance of the EBRD, World Bank, the EU (through PHARE and EIB loans) and, more generally, the G-24 programme (from the latter early in the reform process). Institution building has also been advanced through the process of the harmonization of national laws with the EU *Acquis Communautaire*.

the involvement of foreign strategic investors.⁴ In particular, these investments have been instrumental in upgrading the important telecommunications sector.⁵ Local corruption appears to be less of a problem than elsewhere in the region. Corruption is often cited by foreign business as a deterrent to FDI, and this appears to be the case in the transition economies as well.⁶

Prospects for (or actual) EU membership have often proved a magnet for FDI in the accession countries.⁷ The acceleration of FDI flows into the EEC after the Treaty of Rome and into Portugal, Spain and Greece prior to accession to the EU is well known. The first wave countries have tended to have similar experiences with FDI.⁸ Initially, foreign investors were probably attracted by the free trade provisions of the Association Agreements (negotiated in the course of 1991).⁹ Although these accords did not promise EU membership, they were widely seen at the time as first step. More recently key announcements of the progress in EU accession seem to have resulted in larger FDI flows into the candidate countries, but much more so into the first wave than into the second (Bulgaria, Latvia, Lithuania,

Romania and Slovakia).¹⁰ From the very beginning of the decade, investors have differentiated between these two groups of countries (chart 1), although the official announcements began to do so only in 1997.

An asset of interest to foreign investors which is broadly shared by the transition economies is the abundance of a well-educated but low cost labour cost. The five countries lead the region in terms of educational attainment,¹¹ and nominal wages are several times lower than in the lowest-wage EU economies. Wages in the first wave countries make them competitive as hosts for FDI even after adjustments are made for their lower productivity.¹² However, relatively rapid increases in unit labour costs seem to discourage foreign investors.¹³

Given their favourable locations, educated labour force, and other assets, several other transition economies have been well placed to receive foreign investments, but the results have been largely disappointing (table 1 and chart 1). Slow economic reform and a lack of restructuring have been general features, but there have been specific factors as well. For example, in Slovakia until recently the political climate and official attitudes toward foreign investment were viewed unfavourably by foreign investors. Bulgaria and Romania were characterized for years by policy immobility and periodic economic crises. Subsequent changes in policy stances have led to their acceptance in the second wave of EU accession countries. FDI has increased, but so far mainly because privatization programmes have been accelerated.

The republics of the former Yugoslavia also possess assets of potential interest to foreign investors. However, risks associated with the break-up of the country have dominated foreign perceptions: regional and internal conflicts, financial difficulties (e.g. FYSR default on foreign debt, loss of official reserves, negotiations with foreign creditors, etc.) and, most recently the Kosovo conflict (which adversely affected the whole Balkans). Slow economic reform and the political situation (which disqualified Croatia from the PHARE programme) were also factors. However, investment into Croatia has increased following the cessation of hostilities and again

⁴ The EBRD has become the largest single investor in the transition economies. By mobilizing private investors, its influence on FDI inflows extends beyond its stake holdings.

⁵ According to the Hungarian Institute of World Economics, the world ranking of the first wave of accession countries in telecommunications facilities has risen since 1990, and all except Poland are in the upper third of sample in 1999. However, Bulgaria, Romania, Russia and Ukraine have lost ground. Similar differences were found in internet penetration. Berend, citing E. Erlich. Berend, *From Regime change to sustained growth in Central and Eastern Europe*, UN/ECE, *Economic Survey of Europe*, 2000, No.2.

⁶ According to the indices calculated by Transparency International, the 5.0 average for the first wave countries is much better than those for other groupings of transition economies (Appendix Table 2). The secretariat found a significant negative relationship between the corruption index and cumulated FDI inflows/GDP of the host transition economy. For a more general statistical analysis of corruption and FDI flows see Wei, Shang-Jin, *How Taxing is Corruption on International Investors?*, NBER Working Paper, Number 6030, 1997.

⁷ The potential benefits of EU membership, including for foreign investors, have been extensively discussed. Very briefly, accepting EU rules and regulations reduces investment risk by creating a business environment similar to that in western Europe. In particular, the risk of arbitrary policy changes in, for example, market access and taxation are diminished and property rights become more secure, and there is a reduction in the transaction costs of cross-border business. See, for example, R. Baldwin, J. Francois and R. Portes, *The Costs and Benefits of Eastern Enlargement: The Impact on the EU and Central Europe*, *Economic Policy*, April 1997, Vol. 24, p. 127-170.

⁸ This issue has received considerable attention. For instance, Havrylyshyn found that all potential EU accession countries, which he defined as all non-CIS economies, attracted more FDI than the non-accession group did. Havrylyshyn, Oleh, *EU Enlargement and Possible Echoes Beyond the New Frontiers*, WIIW 25 Years Anniversary Conference *Shaping the New Europe: Challenges of EU Eastern Enlargement – East and West European Perspectives* Vienna, 11-13 November 1998.

⁹ Under the interim arrangements of the Association Agreements between the EC and Czechoslovakia, Hungary and Poland, measures liberalizing trade in industrial products entered into force on 1 March 1992. *Economic Survey of Europe in 1991-1992*, 1992, p. 188.

¹⁰ A. Bevan and S. Estrin, *The Determinants of Foreign Direct Investment in Transition Economies Centre for New and Emerging Markets*, London Business School, Discussion Paper Series No. 9, October 2000, Vol. 9. The EU accession-related announcements by the European Council were Copenhagen (June 1993), Essen (December 1994), Madrid (December 1995) and Agenda 2000 (July 1997). The first three announcements were not country specific, but the most recent defined the first and second wave countries.

¹¹ In general the transition economies rank very high by world standards, significantly above the average of developing countries (Appendix Table 3).

¹² Bevan and Estrin op.cit. have found that unit labor costs in a selection of transition economies is a significant determinant of FDI inflows. They note that nominal wages alone are not a good explanatory variable.

¹³ Ibid.

after the election of reform-minded government. On the other hand, peace and huge foreign aid have done little help attract FDI into Bosnia and Herzegovina, which for the time being remains a dysfunctional state subject to ethnic tensions. The FR Yugoslavia has been viewed as a high-risk country, subject to a UN embargo and pursuing an inward looking economic policy. Its only significant foreign investment has been the FDI-related privatization of the telecommunications company. After the recent elections, prospects for fundamental change have improved. Slovenia has attracted only modest amounts of investment (see below) despite peace, a good location (bordering on two EU countries) and solid economic fundamentals. The explanation seems to be their policy toward foreign investment, which, however, seems to have become more welcoming in the past year.

Within the CIS, countries well endowed with natural resources – Azerbaijan, Kazakhstan, Turkmenistan (oil and gas) and Kyrgyzstan (gold) have attracted relatively large amounts of FDI into the extractive sector. However, generally unfavourable investment climates (including, for example, slow economic reform, a high level of corruption, a poor record of enforcing existing laws and agreements, etc.), great distances from world markets, and landlocked locations appear to have generally deterred investments in other sectors. Some of these same factors help to explain the low levels of foreign investments in other CIS countries. This includes, Russia,¹⁴ which has a huge natural resource base and great potential for foreign investment.¹⁵

Although a number of the factors discussed above appear individually to explain FDI inflows into the transition economies, they are in fact interrelated. It is doubtful that their separate contributions can be unravelled. The countries of central Europe (and the Baltics to a lesser extent), have benefited from their location, political history and initial economic conditions which facilitated the early the launching of economic reforms and stabilization programmes and the achievement of political stability. These factors, too, are likely to explain the development of various institutions (especially of the market supporting type), the relatively lower level of corruption and early aspirations for EU membership. The confluence of all these factors, individually important to foreign investors, is likely to have created a virtuous circle of an improving investment climate, above average economic prospects and FDI inflows. Other transition countries, more distant from

west European markets and with different political histories seem to have been less fortunate.

2. The development of FDI flows.

Foreign investment was generally prohibited during the period of central planning. Only Hungary, Poland and Romania permitted FDI (in the form of joint ventures) and the amounts received were small. Yugoslavia, which was considered a mixed economy, received modest foreign investments in the 1980s. From this low base, FDI flows to the transition economies increased at a modest pace in the early 1990s. In fact, with the exception of Hungary, inflows were generally considered disappointing, far short of some expectations.¹⁶ However, in the second half of the decade, FDI flows accelerated (table 1 and charts 1 and 3). In 1999, annual investments reaching nearly \$27 billion (4 per cent of GDP),¹⁷ and cumulated inflows amounted to some \$130 billion. Preliminary data for 2000 suggest that annual FDI inflows increased again.¹⁸

Policy decisions in Hungary and Estonia gave these countries an early lead in attracting foreign investment. Their objective was to rapidly sell off state assets to foreign strategic investors and thus achieve increased economic efficiency and integration into world markets. In addition to Hungary, the Czech Republic¹⁹ and Poland attracted sizeable inflows through the middle of the decade, which resulted in a high concentration of FDI (these three countries accounted for two-thirds of total annual flows to the ECE region in 1995). The subsequent acceleration of privatization programmes and generally improving investment climates in other transition economies boosted their FDI inflows and resulted in a somewhat more even geographical distribution. However, in 1999-2000 the concentration of inflows increased again, due to the fast pace of investments in the three leading countries. Other noteworthy developments in the second half of the 1990's are:

- Poland became the main destination of FDI in 1996.
- An acceleration of flows into Latvia, and with a lag, into Lithuania (second wave countries), but their cumulated flows continue to lag those of Estonia.

¹⁶ Early in the transition, some observers expected a rush of FDI which would play a major role in creating market systems, restructuring economies and stimulating economic growth.

¹⁷ The interpretation of the indicators of FDI penetration (including FDI/gross domestic fixed capital formation) and methodological issues are discussed in the appendix. It should be noted that the data for Poland are on an accrual basis, and thus the relevant regional aggregates presented here are somewhat higher than those published regularly in the *Economic Survey*. The latter source uses balance of payments data on a cash basis which are available monthly.

¹⁸ *Economic Survey of Europe, 2000 No.2.*

¹⁹ Although Czech voucher privatization discouraged FDI in the affected enterprises, there were several large FDI-privatizations (e.g. of Skoda involving VW) and greenfield investments.

¹⁴ R. Ahrend, "Foreign Direct Investment Into Russia - Pain Without Gain? A Survey of Foreign Direct Investors", *Russian Economic Trends*, June 2000.

¹⁵ A major reason for Russia's failure to attract much investment in the extractive sector is the lack of a comprehensive legal framework for production sharing agreements (PSAs) and protracted legislative procedures. Chapter 5, "A note on Production Sharing in Russia", *Economic Survey of Europe, 1998 No. 3.*

- FDI into the Czech Republic surged following the passage of a new investment law in 1998 and accelerated privatization.²⁰ For two years the country has received FDI amounting to around 10 per cent of GDP, the highest ratio in the region.
- Accelerated privatization in Bulgaria, Romania and Croatia significantly boosted inflows in 1996-1999. The sale of the national telecom companies in the latter two countries markedly raised FDI in 1998 and 1999, respectively.
- Azerbaijan, Kazakhstan, and Turkmenistan (1994-1997) have received relatively large investment in the natural resource extraction sectors.
- Changes in Slovak policy on FDI receipts are reflected in the 2000 sale of Slovak Telecom (€1 billion) and the VSZ steelworks (\$500 million plus \$700 million in promised follow-up investments over 10 years).

The global financial crises of 1997-1998 had only a limited impact on foreign direct investment in the ECE region. In fact total inflows continued to rise, which reflects the long-term planning horizon characteristic of foreign direct investors and the more immediate opportunities presented by depressed asset prices. Foreign investors also remained interested in acquiring strategic assets, including especially stakes in telecommunications companies. However, FDI into Russia has fallen sharply in the wake of the rouble crisis, exacerbating a persistently unfavourable investment climate. Moreover, it has been reported that some new investments intended to supply the CIS market were postponed, particularly in the Baltic States. The Kosovo conflict also discouraged some investments in southeast Europe, at least temporarily, but several key privatizations did go ahead.

Several major privatizations in 2000 (e.g. Poland's TSPA for \$4 billion; Slovak Telecom for euro1 billion) show their continuing importance as a determinant of FDI inflows. The experiences of Hungary and Estonia indicate that the winding down of privatization programmes results in a downward adjustment of receipts. In most east European and Baltic states, these programmes are to be completed in 2001-2002, but in other countries the process is much further behind.

Considerable differences have emerged in the amounts of FDI received by the transition economies. In 1999, the ratio of cumulated inflows to GDP, a measure of the penetration of FDI in the host economy, is in the range of 30-40 per cent in Hungary,²¹ Estonia, Latvia and

the Czech republic, compared to around 10 per cent or less in many other countries (chart 1). This indicator is calculated using the nominal GDP of the host countries - i.e. GDP at current prices and nominal (generally undervalued) exchange rates - a methodology which has certain shortcomings discussed in the appendix. The FDI ratios have also been calculated using GDP estimates based on PPPs (table 2 and chart 3).²² Although the regional average has increased from 0.5 percent in 1993-1996 to 1.0 percent in 1997-1999, the ranking of countries remained broadly similar. By this measure, too, several east European and Baltic countries (and Azerbaijan) always rank near the top, while a number of CIS members occupy the lower ranks. In these CIS countries, the degree of FDI penetration has remained below the regional average, implying that they have failed to narrow the gap with the leading countries. FDI has become another source of disparity in the region, with the highest income countries having received the most FDI (chart 4).

Attention is drawn to Slovenia which has been considered one of the FDI leaders on the basis of cumulated inflows per capita (it ranked number 6 in 1999; Appendix Table 3). However, taking the size of its economy into account, it ranks considerably lower (12th relative to GDP-PPP and 22nd relative to GDP-nominal). These latter ratios suggest a much smaller FDI penetration of the Slovene economy than is generally supposed. The ranking of Azerbaijan, Moldova,²³ Kazakhstan, Kyrgyzstan also vary considerably depending on the indicator used (Appendix Table 3).

From a global perspective several transition economies have become strong competitors for FDI. Even though they generally began to open up to investment only early in the decade, in 1998 their average FDI/GDP (nominal) ratio increased to 3 per cent, around that of both east Asia and South America (chart 5). Given that the developing countries had decades of headstart and an acceleration of FDI inflows in the 1990s, their cumulative FDI/GDP ratios in 1998 still exceeded those of the transition economies by a considerable margin (chart 6). Nonetheless, FDI penetration of Azerbaijan, Kazakhstan, Hungary, Estonia, Latvia and the Czech are roughly comparable to leading developing country FDI recipients such as Chile and Malaysia. The growing presence of the transition economies as domiciles for FDI is also reflected in their increasing share of FDI outside the developed market economies, which has risen from 7.6 per cent in 1993 to 12.4 per cent in 1998. The corresponding percentages relative to

²⁰ According to R. Samek, a spokesperson for CzechInvest. Bureau of National Affairs (BNA), *Eastern European Reporter*, Vol. 10, No. 1 (London), January 2000.

²¹ Hungary leads in the rankings despite the fact that its cumulated FDI is underestimated by the absence of reinvested profits (see Appendix).

²² These ratios are lower (because the degree of exchange rate undervaluation tends to be adjusted for) and the inter-country variance is smaller than that of the ratios based on nominal GDP. (Also Appendix Table 3).

²³ The ratio of Moldova has also been raised by the collapse of output in 1998-1999 (see Appendix).

global FDI flows are 3 per cent and 3.5 per cent, respectively.²⁴

3. Implications of FDI for external financial positions and the balance of payments

FDI flows can have a considerable and immediate positive impact on countries' external financial positions and, thus, on their development prospects. Such flows can be particularly beneficial when access to other types of foreign capital is limited. The financial effect of FDI complements its potential technological, management and restructuring impact. In Hungary and Estonia, for example, early privatization-related FDI inflows helped to permanently boost foreign exchange reserves and/or reduce external debt (i.e. net debt reduction). Indeed, reducing the high debt burden was a consideration determining Hungary's particular privatization strategy. Revenues increased official reserves and net debt fell in 1990-93 and again in 1995 when privatization activity peaked. Estonia benefited comparably in 1992-1993. Toward the end of the decade, FDI-related privatization helped to strengthen the reserve positions of Lithuania, Romania, Bulgaria and Croatia. In 2000 Poland retired \$940 million of Brady bond debt using some of the proceeds from the sale of the telecommunications company, TSPA.

FDI inflows have also contributed to a loosening of balance of payments constraints facing the region early in the decade. The growth of FDI has been associated with increasing current account deficits. However, despite a fourfold increase in the combined current account deficit of eastern Europe in the 1990's, 86 per cent was financed by FDI in 1997-1999 (table 3 and appendix table 3). This means of finance has been viewed favourably since it is relatively stable (see below), often promotes exports and is largely non-debt creating.²⁵ Despite periods of sizeable current account deficits in the 1990's, the Czech Republic and Poland could forgo sovereign borrowing and hold down external debt. On the other hand, there was a marked increase in the foreign indebtedness of several low - FDI, high current account deficit countries (e.g. Croatia, Romania, and Slovakia). FDI-related privatizations proved to be an attractive financing option for several countries nearing a debt ceiling.

FDI is generally considered more stable than other financial flows, because investments in fixed assets may be difficult to withdraw (unlike financial investments) and because direct investors tend to make long-term commitments. Indeed, despite the lumpiness of

privatization-related foreign investments, the volatility of FDI flows into the transition economies has been less than that of other types of capital. For example, in the wake of the global financial crises (1997-1998), FDI into these countries generally continued to rise, but most of them lost access to the international financial markets (at least temporarily) and experienced reversals of short-term and portfolio investments.²⁶ The notion of a relative stability of FDI flows is supported by the calculations in (table 4),²⁷ particularly in the case of the east European and Baltic countries.²⁸ This shift to a more reliable means of external financing has contributed to the strengthening of financial positions in many transition economies.

These generally positive features of FDI and its association with more dynamic export growth may improve foreign perceptions of the host country's creditworthiness. Thus FDI flows may contribute to the creation of a virtuous circle, which may also involve a reduction in borrowing costs, access to a broader range of financial instruments, and more stable capital inflows. In Hungary, for example, the record (\$4 billion) privatization-related FDI inflows at the end of 1995 contributed to the upgrading of its credit rating in 1996.²⁹ This rating and the continuation of substantial, although reduced, FDI inflows helped the country to maintain access to the international capital markets in the aftermath of the global financial crises.

The potential financial benefits of FDI do not seem to have been widely appreciated by policy makers early in the transition. FDI, if it was considered important at all, was viewed as complementing domestic savings and as a source of technology and advance management techniques. That is to say, it was seen largely as an element of industrial policy. More recently, and especially among the countries recently accelerating economic reforms, FDI-related privatization revenues have often been counted on as a means of financing current account (and fiscal) deficits and boosting official reserves.

²⁶ External bond issues were particularly affected, syndicated loans to a lesser extent.

²⁷ These results are similar to those obtained for the developing countries. UNCTAD, *World Investment Report, 1999*, New York, Geneva, 1999.

²⁸ Attention is drawn to the fact that the calculations in table 4 may not fully reflect the volatility of all FDI-related flows i.e. those outside identified the FDI item in the financial (capital) account of the balance of payments. During a period of financial turbulence, for example, a TNC may accelerate (outward) profit remittances (a current account item) or it may borrow locally, using fixed assets as collateral, and transfer the funds abroad (perhaps selling the currency short). This latter transaction would be recorded in "other investment" in the balance of payments and thus would be excluded from the FDI volatility measure used here. However, the scope for such operations is a function of the sophistication of the financial system in the host country.

²⁹ More generally, Bevan and Estrin op cit. found that FDI inflows improved the credit ratings of a sample of transition economies with a lag. There was also evidence of a feedback effect whereby the amelioration of credit ratings attracted more FDI.

²⁴ The source of data on global flows is UNCTAD, *World Investment Report, 2000* (New York and Geneva), 2000.

²⁵ Discussions of FDI as a source of finance, however, often overlook the fact that loans by a TNC to its foreign subsidiary count as part of the host country's foreign debt and that interest on the loans is counted as an outflow (in the current account).

It is often maintained that FDI will increase a country's exports and improve the current account balance. Thus, the argument goes, an increasing current account deficit financed by FDI should not be a cause for concern. However, assessing the full impact of FDI on the balance of payments is difficult, not least because of data limitations. Four items in the balance of payments accounts deal specifically with the transactions of TNCs: FDI flows, including reinvested earnings, in the financial (capital) account and, in the current account, interest on intercompany debt, repatriated profits and reinvested earnings from direct (equity) investment (see appendix).

A narrow measure of the direct impact of foreign investment enterprises (FIEs) is net transfers, calculated as the difference between FDI inflows and repatriated profits.³⁰ Repatriated earnings can be expected to increase as a function of the growth of the FDI stock and FIE profitability (This outflow is a reminder that FDI is not a "free" source of finance (such as grants are)). However, since earnings repatriation can only occur under conditions of FIE profitability, FDI is still likely to be preferable to debt, which requires servicing irrespective of the asset's performance. Data for the transition economies indicate that net inward transfers have been positive, owing to the small scale of profit repatriation so far (generally repatriated earnings have amounted to less than ten per cent of net FDI inflows). This is likely to change as FDI stocks increase and FIEs move out of the start-up phase and become profitable. For example, in Hungary (the country with the most FDI profit repatriation has risen steadily, the \$920 million recorded in 1998 representing nearly 60 per cent of net FDI inflows. In Azerbaijan, the first repatriation of earnings by foreign petroleum companies exceeded FDI in the first half of 2000 (tables 5 and 6).

A broader measure of direct-FIE cross border activity includes their exports and imports of goods and services. Typically a foreign direct investment finances the import of machinery and equipment,³¹ which *ceteris paribus* causes a temporary deterioration of the current account balance. The current account remains under pressure if the FIEs import merchandise for production or distribution. If the FIEs begin to export (as is generally assumed for investments in the tradable goods sector) and/or if they replace imported inputs by local products (i.e. a positive spillover effect), the current account balance will improve. However, even when FDI-linked activities incur foreign exchange deficits, such investment may still improve the balance of payments if it creates significant externalities that enhance the export

potential of the whole economy.³² This could happen, for example, if the presence of FIE contributes to the improved export performance of domestic firms, because of increased competition, demonstration effects, technology transfers. Overall, the direct net balance of payments impact of the foreign investment and its contribution to economic integration depends on many factors including the eventual success of exports, the sector of operation (some sectors such as services export little or nothing at all), the development of downstream linkages, etc. Although the net effect is often assumed to be positive it can very well be negative.

To take a specific example, Malaysia is one of the few countries for which data permit an evaluation of the direct balance of payments impact of FDI. Considered one of the most successful countries in attracting and using FDI, the impact of FIEs on the combined trade balance and income flows of the current account has been estimated as negative in every year during 1980-1992.³³ The trade balance of the FIEs became positive in the late 1980s owing to their strong export expansion. However, as their exports became more import-intensive, the current account became negative. Eventually, in the late 1980s, these outflows on current account were offset by new FDI inflows on capital account, but the cumulative impact during the whole period was negative. There are indications from other parts of the world that a negative trade impact of FDI is not unique to Malaysia.³⁴ In Austria, the aggregate merchandise trade balance of resident FIEs has been persistently negative during 1990-1997.³⁵ The case is interesting because Austria is a developed country where FIEs might have been expected to quickly establish linkages with local suppliers and reduce dependence of imported inputs.

In the transition economies the growth of total merchandise exports has been associated with FDI inflows (chart 7).³⁶ At the sectoral level the role of FDI as a driving force is suggested by the increases in the shares of FIEs in the exports of the manufacturing sector.

³² UNCTAD, *Trade and Development Report*, 1999, (New York and Geneva), 1999, p. 121.

³³ Ibid.

³⁴ A similar picture emerges for Thailand. Ibid. pp. 122-123. In the Mercosur FTA, FDI has been associated with a deterioration of the trade balance. FIEs export to other Mercosur countries but they import capital goods and inputs from the USA. Presentation of Professor D. Chudnovsky, UNCTAD High-level Segment of the Trade and Development Board (Geneva), 16 October 2000.

³⁵ Presentation of W. Altzinger, *A Few Data of Austrian FDI in CEE*, Seminar on Foreign Direct Investment and Privatization in Central and Eastern Europe, (Vienna), 2-3 March 2000. On the other hand Austria's FDI abroad has generated a trade surplus for the country, lending support to the notion that outward foreign investment is often undertaken to promote exports.

³⁶ This correlation is significant at the five per cent level. However, the robustness has not been tested with the addition of other potential explanatory variables. The correlation is much stronger in the smaller sample of east European and Baltic countries.

³⁰ The net transfer calculation excludes the following FDI related flows for which data are often lacking: royalties, license fees, wage remittances and net interest paid on loans to the parent firm.

³¹ The FDI may also represent goods in kind imported for use in the FIE.

They rose from nil at the beginning of the decade to substantial proportions by 1998 (table 7), in Hungary to 86 per cent. This high share suggests that virtually all the recent rapid export growth of Hungarian manufactures originates in FIEs. In the Czech Republic and Poland, the shares of FIE's are smaller, but their rapid rise in the second half of the decade also suggests a powerful impact of FIEs on export growth. In all these countries FIEs have invested more heavily than domestic firms in new assets (e.g. relative to total sales, see table 7).³⁷

A broader assessment of the BOP impact of FDI is possible only for Hungary and Azerbaijan, both of which have attracted large amounts of FDI (tables 5 and 6). In Hungary, the foreign trade balance of FIEs located in industrial foreign trade zones (IFTZs) worsened in the first half of the 1990s because of imports of high-value machinery and inputs. However, between 1996 and 1999 IFTZs became net exporters, their aggregate trade surplus increasing from 0.3 billion to \$2.2 billion.³⁸ This performance is noteworthy because many FIEs have been involved in assembly operations based on imported components. In consequence, the balance on FDI-associated current account items has moved into surplus, despite increased profit repatriation (direct investment income) and reinvestment of earnings by TNCs. This has helped to keep the total current account deficit in check (on a cash basis it fell to 3.5 per cent GDP in the first half of 2000).³⁹ From these estimates, it appears that the overall balance of payments impact of FDI has so far been increasingly positive, amounting to over \$3 billion in 1999.

In Azerbaijan large foreign investments in the oil sector have helped to boost oil exports,⁴⁰ while oil-related imports (presumably equipment funded by FDI) peaked in 1998 (table 6). However, the service imports of the oil sector and the compensation of employees (associated with oil consortia) have remained substantial. In the first half of 2000, the first (large) repatriation of profits occurred which caused the current account to remain in deficit. Overall the FDI in the oil sector appears to have made a net contribution of \$500 - 600 million to the

balance of payments in 1998 - 1999 and the first half of 2000.

The evidence presented here suggests that FDI has so far had a positive impact on the balance of payments of two transition economies. However, for some of the other countries less is known about the development of FIE imports than of exports (in general total export and import growth seem closely linked in the transition economies).⁴¹ It should be noted that if the payments outcome of TNC-related activities is constantly in deficit, the economy would need to generate net foreign exchange elsewhere since meeting such a deficit by simply relying on a new inflow of FDI would mean engaging in an unsustainable process of "Ponzi" financing.⁴² Moreover, FDI may pose some of the same risks and financial management challenges as do other capital flows. Depending on the exchange rate system, capital inflows can cause an appreciation of nominal and/or real exchange rates and thus undermine export competitiveness.⁴³ This danger is accentuated if foreign investments flow into the non-tradable sector (e.g. as real estate), which, in addition, is not likely to generate foreign currency receipts.

4. FDI and economic growth.

(a) Evidence from the developing economies

A growing number of studies have found a statistical relationship between FDI inflows and domestic economic activity in host developing countries.⁴⁴ In many cases, they had received FDI for decades although, the inflows accelerated in the early 1990s. In this section, some of these empirical findings, generally relating to FDI-rich developing countries in Asia and Latin America, are drawn on. Their experiences may hint at the eventual macroeconomic impact of FDI in the

³⁷ The assumption here is that FIEs are more dynamic exporters than domestic firms. However, the increased export share of FIE's may also be explained by a compositional effect, as TNC's become foreign investors in local export firms. While such a FIE/domestic firm shift has undoubtedly occurred, the relative investment intensity of FIEs is likely to have resulted in increased export performance as well.

³⁸ IFTZs account for the bulk of foreign investment in Hungary, and thus their trade is a good proxy for the trade of all FIEs. The trade deficit of enterprises located in non-IFTZs (largely domestic enterprises) rose from \$2.8 billion to \$5.2 billion, respectively, which caused the total merchandise trade deficit to increase (table 5).

³⁹ UN/ECE *Economic Survey of Europe, 2000 No. 2*, op. cit.

⁴⁰ It is estimated that oil exports in 2000 will nearly double to 9 million tons. *Financial Times*, 4 July 2000. Receipts have also risen because of higher oil prices. Foreign investment in Azerbaijan has taken the form of production sharing agreements under which the government and foreign partner share the costs and output.

⁴¹ At the enterprise level, results of the UNCTAD survey of mainly import oriented firms privatized through FDI (i.e. M&A) show that import growth accelerated after privatization, boosting import surpluses. These results, of course, do not reflect the impact of any spillovers on the economy. The main reasons for a growing import intensity were deemed to be the increasing use of local affiliates as a distribution channel for imports, the substitution of earlier local sourcing by suppliers from the TNC's own network, and the generalized increase in the pace of capital investment, particularly in imported capital goods. The sample consisted of 23 firms in seven central and east European countries. G. Hunya and K. Kalotay, "FDI and privatization in central and eastern Europe: trends, impact and policies", UNCTAD Seminar, op. cit.

⁴² UNCTAD, *Trade and Development Report*, op. cit., p. 12.

⁴³ The anticipation of large inflows from planned privatizations motivated the Czech and Polish authorities to create special foreign currency accounts to avoid disruption of the currency markets.

⁴⁴ For example, E. Borensztein, J. De Gregorio and J. Lee, "How does foreign direct investment affect economic growth?", *Journal of International Economics*, Vol. 45, 1998. L. De Mello, "Foreign direct investment in developing countries and growth: a selected survey", *The Journal of Development Studies*, Vol.34, 1997. K. Zhang, "FDI and economic growth: evidence from ten East Asian economies", *Economia Internazionale*, November 1999.

transition economies, an issue also taken up briefly below.

The empirical studies pertaining to the developing economies generally seek to establish a statistical relationship between FDI inflows and a measure of output growth and/or domestic investment. (Investment is most directly affected by FDI, but FDI may also impact GDP independently of the fixed investment channel). Such work is of interest because it attempts to capture the net effects of FDI in the economy as a whole. Negative effects may stem from various distortions in an economy – for example, those which offer profit opportunities to foreign investors without improving efficiency. Such distortions may occur, for example, if protectionist trade policies motivate TNCs to enter a country purely for reasons of obtaining market share and monopolistic power.⁴⁵ Or, governments may attract FDI to strategic industries by offering investment incentives which offset any benefit the TNC may generate. Even FDI which is not motivated purely by rent seeking or incentives may create various negative spillovers (which affect aggregate output but may be difficult to identify from enterprise or sectoral data).

The three studies cited below have found a relation between FDI flows and economic growth in various samples of developing countries. The first, applying a model of endogenous economic growth finds that FDI stimulated the long-term expansion of per capita GDP.⁴⁶ The contribution of FDI is likely to come from two effects: the more important, the results show, seems to be that the productivity of FDI is higher than that of domestic investment.⁴⁷ This occurs because FDI embodies advanced technology and management skills and enhances access to world markets, factors which can stimulate the host country's efficiency and internal competition. However, it appears that the higher productivity occurs only when the host country has a minimum threshold stock of human capital (because there is an essential interaction between FDI/technology and human capital in the host economy). Second, FDI has the effect of increasing total domestic investment more than one-for-one. Estimates of the "crowding in" phenomenon⁴⁸ place the total increase in investment at

between 1.5 and 2.3 times the increase in the flow of FDI.⁴⁹ This increase in total capital accumulation occurs in addition to the positive impact of FDI on technological progress. Overall, in developing countries with an average stock of human capital, the total effect of a 1 per cent increase in the FDI-GDP (PPP) ratio is associated with a 0.4-0.7 per cent rise in long-term GDP per capita growth.⁵⁰

In the second study⁵¹ FDI flows were found to stimulate the long-run growth of China, Indonesia, Hong Kong, Japan, Taiwan, and the short-run growth of Singapore.⁵² However, no relation between FDI and economic growth was found in South Korea and the Philippines. The third work, examining the impact of different types of capital flows in 18 countries, determined that FDI had the most pronounced positive impact on economic growth and domestic savings.⁵³ It had less of an effect in the Asian countries in than in Latin America, presumably because domestic savings play a larger role in the Asian economies.

(b) Direction of causation

To this point, it has been assumed that FDI inflows stimulate growth (FDI-led growth). Such a relationship might be expected because FDI can enhance the factors which play an important role in promoting economic development: investment, technical progress, and, in the new growth theory, R+D, the accumulation of human capital and various positive externalities. However, the causation may run in the other direction, whereby rapid economic growth attracts FDI (growth-driven FDI).

customers) with technology and finance while holding out the prospects of a stable market for their output. On the other hand, FDI may "crowd out" equal amounts of investment by domestic entities through aggressive competition in local product or financial markets, especially in cases where domestic firms are already financially strapped.

⁴⁹ Estimates by UNCTAD suggest that there are marked regional differences among the developing countries with FDI tending to crowd in investment in much of Asia and crowding it out in Latin America. Also there are sectoral differences, mining and other raw material extraction projects, for example, generate little indirect investment because the FDI firms create few domestic linkages. *World Investment Report 1999*, op. cit., pp.172-173.

⁵⁰ Human capital stock is measured by the average level of secondary school attainment in a sample of 69 developing countries.

⁵¹ Zhang, op. cit., has noted two problems of the studies relying of cross-section analysis, applied by Borensztein et al and Kamin and Woods. All make a priori presumption that FDI responds to or causes economic growth (also see below) and have not considered the possibility of feedback effects and a long run equilibrium relationship between FDI and economic growth. Second, there is evidence of considerable parametric variation across countries in regard to estimates of growth equations and FDI. In effect the methodology involves imposition of a common (average) structure, thus masking these differences.

⁵² *Ibid.* These countries appear to have experienced FDI-led growth. Except for China and Indonesia, where relationship was found to be bi-directional. The issue of causality is discussed below.

⁵³ W. Gruben and D. McLeod, "Capital Flows, Savings, and Growth in the 1990s", *The Quarterly Review of Economics and Finance*, Fall, Vol. 38 (No. 3), 1998. There is no theoretical reason why FDI ought to increase domestic savings.

⁴⁵ In the extreme case, a TNC may close down an acquired asset to reduce capacity in the region and increase its market power.

⁴⁶ Borensztein, op.cit. The data sample covers the years 1970-1989.

⁴⁷ Using a different sample of countries Kamin and Wood found a significant positive relation between FDI and real investment. The study covers the period 1983-1994, which includes the first years of the FDI boom. S. Kamin and P. Wood, *Capital inflows, financial intermediation, and aggregate demand: empirical evidence from Mexico and other pacific basin countries*, Board of Governors of the Federal Reserve System, International Finance Discussion Papers, Vol. 583, June 1997.

⁴⁸ FDI may stimulate more domestic investment ("crowding in") if there is complementarity in production between FDI and domestic firms. In this case, the FIE may develop backward and forward linkages, perhaps even assisting partner firms (subcontractors or downstream

Very briefly, under this hypothesis, expanding domestic economic activity is likely to be associated with an improving investment environment and increased opportunity for boosting profits. The expansion of income and domestic markets makes it possible for TNCs to exploit economies of scale. In the longer term, growth-associated improvements in human capital, labour productivity and infrastructure are likely to increase the marginal return to capital and, thus, the demand for domestic and foreign investment.⁵⁴ Improved economic performance should also generate profits and encourage their reinvestment (reinvested earnings being a component of FDI). Evidence of a growth-led FDI relationship has been found in Malaysia and Thailand.⁵⁵

Another possibility is a bi-directional causal process, under which FDI and growth have a reciprocal causal relationship. Evidence of such a virtuous circle has been found in China and Indonesia.⁵⁶

In the transition economies, Hungary and Estonia showed early signs of FDI-led growth. In Hungary, there were significant inflows of FDI early in the early 1990's (chart 8), before GDP started to recover (from the transition recession) in 1994. The output of FIEs expanded already in 1992-1993 while that of domestic firms continued to decline (it was only later that FIE dominated economic performance). In Estonia, too, relatively large FDI inflows preceded the economic upturn in 1995. (A similar case can be made for Latvia.) In both cases, the governments' strategies involved an early infusion of FDI through the sale of strategic state assets. On the other hand, in Poland an economic recovery (starting in 1992) preceded the surge in FDI by several years. Due to its size, location etc., Poland was from the very beginning of the transition considered one of the most attractive countries for foreign investment. However despite this and its early favourable economic performance, foreign direct investors essentially held off until 1996, after the country's large external debt overhang was reduced in agreements with London and Paris Club creditors. Subsequently, FDI inflows and good growth performance appear to have joined in a virtuous circle (as has probably been the case in Hungary and the Baltic states). The fact that Croatia, Slovakia and Slovenia achieved extended periods of fairly rapid growth without attracting much FDI is explained by domestic policies (as noted)⁵⁷. The experiences of Croatia and Slovakia underline the fact that FDI will only

begin to flow after a commitment has been made to reform (including a privatization programme) and investor friendly policies are in place.

(c) FDI and growth in the transition economies

Studies of the impact of FDI inflows on GDP in the transition economies are lacking.⁵⁸ In most of these countries it might be difficult finding such a relation given the known importance of other factors: the degree of economic reform, stabilization policies, import demand in major trade partners, and so on. The data in chart 9 suggest a positive association of FDI and economic growth, but the correlation falls slightly short of being significant.⁵⁹ As regards indirect evidence, in Hungary, FDI-driven export growth (see above) appears largely responsible for the improvement in economic performance in the second half of the 1990's.⁶⁰ Exports were by far the most dynamic component of final demand, far exceeding the combined contribution of consumption and investment (table 7).⁶¹ This was also the case in the Czech Republic – GDP actually contracted due to falling domestic absorption. In all the countries in this sample, GDP and export growth were nearly always positively related and FDI is likely to have contributed to this outcome (also see discussion of the FIE role in manufactures exports above). More direct evidence of the effects of FDI on economic activity is available at the sectoral level.⁶²

The results of the analysis of FDI inflows in certain developing countries suggest that FDI could also boost

⁵⁴ See Zhang op. cit. for a more systematic development of the growth-led FDI hypothesis.

⁵⁵ Ibid.

⁵⁶ Ibid.

⁵⁷ Bevan and Estrin op.cit. found a strong relation between growth in GDP and FDI increases in their eleven country statistical sample. Perhaps with the exception of Hungary, Poland and the Baltic states in the second half of the 1990's, their results seem at variance with the data presented in chart 8.

⁵⁸ The time series covering the transition years are still too short for the types statistical tests applied to the developing economies. At most, 10 years of data are available, less for all countries of the former Soviet Union. The period includes falls in domestic output early in the transition and following the external shocks in the late 1990s, events independent of FDI activity. Moreover, in the early part of the transition inward FDI was small and, with the exception of Hungary and perhaps some others could not have contributed much to economic growth. A recent study of growth factors in the transition economies (1990-1998) the IMF excludes FDI for this reason. O. Havrylyshyn and T. Wolf et al, *Growth Experience in transition Countries, 1990-1998*, Occasional Paper 186, IMF, (Washington D.C.), 1999.

⁵⁹ A preliminary statistical analysis suggests that whether or not a country experienced a serious economic crises (i.e., resulting in a fall in output) is a much more important determinant of its average growth performance in the second half of the 1990's than is FDI. Large foreign investments in the natural resource sector are also important in this regard.

⁶⁰ Already in 1992-1993 the output of FIEs in the industrial sector increased by 9 percent, in contrast to the 5 per cent decrease reported by domestic firms.

⁶¹ Exports in the national accounts also include traded services, some of which have benefited from FDI (i.e., tourism and transport).

⁶² For example, the dynamic motor vehicles (and components) sector in the Czech Republic, Hungary, and Poland is dominated by foreign firms (their share ranged from 82 to 97 per cent in 1998). Hunya, op.cit. In Kyrgyzstan FDI in gold production has contributed heavily to overall output growth, and gold is the only export which has increased in value between 1996 and 1999. National Bank of the Kyrgyz Republic, *Bulletin*, 7/2000. The contribution of foreign investment to output in Azerbaijan's oil and gas industry has already been mentioned.

the long-term growth of the transition economies. For example, the FDI/GDP ratio of eastern Europe increased from nil at the beginning of the decade to around 4 per cent in 1997-1999 (using nominal GDP) and to 1.8 per cent (using GDP (PPPs)). Applying the elasticities estimated by Borensztein (0.4-0.7, based on PPP GDPs) to the latter yields an increase of some 0.7-1.3 percentage points in the long-term per capita growth rate of the area, with larger increases in, for instance, the Czech Republic, Hungary and the Baltic States. It should be noted that these elasticities reflect a human capital stock of an "average" developing country. However, the Borensztein study also found that the FDI-growth elasticity is directly related to a country's human capital. That is to say a given FDI inflow has a greater impact in a country with a high average level of human capital than in a country with a low one. Since the transition economies are relatively well endowed in this regard, generally rating much higher than the developing countries in terms of, say, secondary school attainment, it could be argued that the impact of FDI in eastern Europe would be greater than the "average" elasticities would suggest.⁶³

It is, of course, impossible to judge the applicability of the Borensztein elasticities to the transition economies. Doubts arise simply because FDI in a transition economy may not have the same impact as in a developing country with a long-established market system (however rudimentary it may be). While examination of this question is beyond the scope of this paper, it may be useful to raise the issue of mergers and acquisitions (M&As). Their share in total FDI flows in the region has been high, probably higher than in the developing countries in the period of estimation. A large share of M&As in FDI might suggest a smaller impact on economic growth because they represent a change of ownership rather than an injection of new fixed investment (see appendix). However, the growth impulse could come, first of all, from better corporate governance and restructuring of the privatized firms, both reflecting possible efficiency gains without new investment. Second, the presence of these FIEs could generate positive spillovers and externalities. Finally, as time passes and M&A's undertake new investments and restructure, they begin to look more and more like greenfield investments.

In fact, statistical evidence from some transition economies indicates that the economic performance of manufacturing firms privatized through M&A is eventually as good as that of greenfield FDI.⁶⁴ A Secretariat study has also found positive spillovers in the

manufacturing sectors of some transition economies.⁶⁵ Moreover, the large foreign investments in telecommunications, financial and various business services could be expected to generate positive externalities and improve export efficiency.

5. Conclusions/Policies/ prospects

(a) FDI and the process of catching up

A recent ECE study has documented the income gaps between the transition economies and western Europe.⁶⁶ Even with the surge in growth in 2000, only a few central European countries have made any progress in narrowing this gap in the past decade and, in many cases (especially the CIS) income differences have actually widened. The economic growth literature of the past decade has highlighted the role of the technology available in more advanced countries as a factor in the process of "catching up". An important component of this process is FDI which is a major channel of international technology transfer. This raises the question whether FDI can move countries from the "economic periphery" into the group of economically advanced nations.⁶⁷ Within western Europe FDI is credited with helping to sharply narrow the income differences between Ireland and the EU. In Portugal and Spain, the effects of the surge in FDI inflows in the first half of the 1980s appears to have been more modest in this regard. In Greece FDI seems to have had no impact at all, apparently because other policies were not supportive.⁶⁸ Evidence from Asia also indicate that FDI inflows do not automatically lead to improved economic performance.

As regards the transition economies, it is difficult at this time to assess the role of FDI in output growth (the most convincing evidence is at the sectoral/enterprise level). In the case of Hungary FDI-driven exports/export-led growth appear to be the key factor helping to narrow the gap with western Europe. In some other countries, too, at least a part of export-led expansion can be attributed to FDI. In Poland, where the catch-up process has gone on the longest and been the

⁶³ Note, however, that there is not much evidence of such spillovers in Hungary.

⁶⁴ "Catching up and falling behind: economic convergence in Europe", *Economic Survey of Europe 2000*, No. 1, chap. 5.

⁶⁵ For example, Berend argues that an appropriate response to the challenge of the structural crisis is impossible without massive western investments. Berend, op. cit.

⁶⁶ Ireland's income rose from 42 to 74 percent of EU income between 1986 and 1998. Comparable figures for Portugal and Spain are 37 to 45 and 47 to 52 per cent respectively. *Economic Survey 2000*, No. 1, op. cit, charts 5.3.1. All three countries, of course, also benefited from the single market effect. Also see B. Lane and R. Torres, "Is convergence a spontaneous process? The Experience of Spain, Portugal and Greece", *OECD Economic Studies*, No.16, Spring 1991.

⁶³ See appendix table 3. In some countries there is concern about the quality of education which appears to be adversely affect by years of tight budgets.

⁶⁴ A. Zemplerova and M. Jarolim, *FDI through MNA & vs. greenfield FDI: the case of the Czech Republic*, UNCTAD, seminar, op.cit.

most significant,⁶⁹ it is likely that domestic resources have played the leading role. Whatever the impact of FDI, fundamental economic reform has been a precondition for attracting it and using it efficiently.

Many transition economies have attracted significant amounts of FDI, and several now rank quite high in this regard by global standards. However, huge disparities in FDI penetration have emerged in the region, and there are some recent signs that the differences are becoming even larger. In particular, the low-income transition economies have lagged in attracting FDI. To the extent that FDI can stimulate economic growth, the current pattern of FDI is likely to exacerbate income gaps between the transition economies themselves and vis-à-vis the developed market economies.

Growing FDI inflows have contributed to the relaxation of the balance of payments constraint, increasing the availability of resources for development. In recent years, policy makers have counted on FDI as a source of current account and other external financing, a pattern that is likely to continue since the income gap will not be eliminated any time soon. However, as large-scale privatization winds down, FDI inflows are expected to diminish, with possible implications for external adjustment.

The current economic situation in the ECE region seems favourable to further FDI growth in transition economies. With improved growth prospects of western Europe (the main source of FDI into the transition economies), further increases in FDI can be expected in the transition economies as part of the continuing process of economic integration and “internationalization” of production processes.

(b) Measures to promote FDI inflows and increase their effectiveness

To different degrees all the transition economies need to promote FDI flows. There is considerable international experience on the means to do so. However, FDI promotion has occurred in an atmosphere of intense global competition for FDI (more so than was the case in the 1970-1980's). Moreover, given the legacy of industrial development under central planning the transition economies are often in competition for FDI among themselves, including for large strategic investments. Several selected issues of FDI regarding the attraction of FDI are raised below.

A general policy approach to FDI promotion involves strengthening domestic economic fundamentals:⁷⁰ i.e. political and macroeconomic

stability, long-term growth potential, market access, availability of skilled workers, and infrastructure. (In the transition economies the fundamentals also include necessary market reforms and structural transformation.) It has been observed that while policy successes in these areas may not necessarily result in more foreign investment, they are nevertheless necessary conditions for growth based on domestic resources.⁷¹ In the end, domestic and foreign investors tend to be motivated by similar factors.

With the tendency to focus on central Europe, sight may be lost of the fact that in 2000 about one third of the transition economies have yet to achieve macroeconomic stabilization (as indicated by their very high inflation rates) and to make much progress on structural transformation. Beyond stabilization and fundamentals, the above discussion suggests that policies toward FDI do seem to matter a great deal. The mode of privatization (via vouchers or management buyouts; Czech Republic, Slovakia, Russia), discouragement of foreign investors (Slovenia), introduction of investment incentives (conforming to EU and OECD rules; Czech Republic) can make a big difference as to whether FDI flows in or not. In a number of natural resource-rich countries, a workable production sharing agreement (PSA) law has attracted foreign investment to large projects but in Russia, the PSA framework still needs to be improved.

As a part of a strategy to attract FDI, some countries have used business surveys to identify, monitor and, where possible, eliminate specific obstacles to foreign investment. The experience of Estonia is of particular interest because it has long been one of the most successful countries in this regard. Nevertheless, the survey results indicate that there is still room for improvement (table 8). This approach may be especially important for countries seeking FDI as a source of external financing, to replace dwindling privatization revenues as the stock of state assets runs out. As this occurs, there is an increasing role for greenfield (and follow-up) investments which may be more sensitive to the types of obstacles listed in table 8 than are large strategic FDI-privatizations.

Measures may also be required to help maximize the long-term benefits of FDI inflows, by fostering positive externalities (e.g. creation of backward and forward linkages). This may involve the implementation of effective competition policies, improving the functioning of the banking system and capital markets, educational reforms to provide the required skills, new infrastructure, etc. In particular, domestic firms may need to be strengthened so that they can compete more effectively with FIEs (i.e. to avoid negative spillovers/bankruptcies of domestic firms) or so they can become

⁶⁹ *Economic Survey of Europe 2000, No. 1, chart 5.3.1*

⁷⁰ Interviews with corporate managers indicate that investors, when selecting the site for a major investment project, tend to attach priority to the “fundamentals”, more so than to receiving fiscal or financial incentive from the prospective government. C. Oman, “Policy Competition for

Direct Foreign Investment”, *OECD Development Centre Studies* (Paris), 2000.

⁷¹ Ibid.

more viable partners for FIEs in upstream and downstream operations. Such policies could also help to avoid the emergence of FDI enclaves and an economy stratified according to FDI/domestic enterprise lines. While the problem of low (or negative) spillovers has been observed in eastern Europe, it is of a more general concern. A related question is how to channel foreign capital into productive investment and exports, as opposed to, for example, real estate speculation.⁷² Recent experience has shown that a concentration of FDI in the non-tradeable sector may weaken export performance (due to real exchange rate appreciation) and make the host countries more vulnerable to economic crises.⁷³

Special attention attaches to the countries which have received very little FDI. Fundamental economic reform is essential (and not only for the sake of attracting FDI), but often the commitment of the authorities (including the parliaments) is doubtful. This is largely a domestic matter and there is little the international community can do until a change in thinking occurs. Pervasive corruption (often at both the centre and local levels) and political tensions (ethnic conflict in Tajikistan) may stifle both economic reform and FDI. Nonetheless, some natural resource rich countries have attracted large investments and more projects are in the pipeline. However, one of the conditions appears to be a workable law on production sharing agreements. Although FDI can boost the output of primary materials, exports and improve the external financial situation, the spillovers from this sector are generally small⁷⁴ (in part because of the limited capacity to produce the required capital goods). Moreover such a pattern of investment can perpetuate dependence on primary material exports, and large revenues might be viewed by domestic policy makers as a substitute for necessary reform.

It has been argued that certain natural deterrents to FDI and technology transfer are virtually insurmountable by policy measures. Even if a country gets the economic fundamentals (and reforms) right and otherwise follows recommendations for promoting FDI, it still may not receive much. According to one view, these countries are fundamentally disadvantaged by geography because they are:⁷⁵

- at great distances from major world markets and primary sea routes;

- land-locked, often remote mountainous regions (i.e. as opposed to the coastal areas preferred by foreign investors, especially for manufacturing);
- poor in infrastructure (which is also expensive to build given local conditions and distances); and
- small, with only limited possibilities of market growth.

All these factors tend to raise transport costs, increase travel time and raise the risk of transport disruptions (especially if the neighbours are unstable or uncooperative). Several transition economies (Asian especially) face one or more of these challenges. The problem is highlighted by the challenge of attracting FDI into China's western regions (adjoining several Asian CIS), despite their mineral wealth and the availability of some investment incentives. Yet, China is well known to international investors, having received more FDI than any other developing economy (over \$40 billion annually in the late 1990's). However, they are deterred by the remoteness of the regions, weak infrastructure and communications links, inefficient state industries, corruption and ethnic unrest.⁷⁶

Concern has persisted in a number of countries that hesitant reforms and FDI promotion programmes have caused them to fall permanently behind in the competition for FDI among transition economies (globally). In part these fears stem from the notion that competition for at least certain types of FDI is a zero sum game. Elements of this view are: first, that countries which attracted FDI early in the game have gained advantages which are difficult for others to overcome: for example, investor friendly reputations, stronger financial positions (reducing the risk of doing business), etc. Second, these advantages are reinforced if not totally overshadowed by the status of first wave EU accession countries.⁷⁷ Third, there is room (at least in eastern Europe) for only a few large foreign companies in key sectors such as automobiles. Once established in a country, the TNC will make any additional investment there, for reasons of scale economies, etc. Moreover, such strategic investments will also attract foreign suppliers or downstream firms (as VW has done in the Czech Republic). These concerns receive some support from the findings presented here which show that the ranking of countries has remained broadly similar (i.e. there has been no closing of the FDI gap) and that the concentration of FDI flows in the three leading countries has recently increased. What is more, there is evidence for a virtuous circle whereby FDI improves credit ratings

⁷² Thailand, for example, tried to curb foreign speculation in the real estate market by taxing foreign investment.

⁷³ Work by UNCTAD has shown that in the later stages of South-East Asia's expansion, FDI flows had a reduced impact on export growth because they were directed to the non-tradeable goods sectors. TDR, 1999, op. cit.

⁷⁴ UNCTAD, *World Investment Report 1999*, op. cit.

⁷⁵ See J. Sachs, "A New map of the world", *The Economist*, 24 June 2000.

⁷⁶ Report on a government investment promotion conference, Chengdu, China. *International Herald Tribune*, 31 October 2000.

⁷⁷ The issue of diversion of FDI to potential EU candidates was raised by Havrylyshyn, op. cit.

which in turn attract more FDI, thus increasing the differential between the leaders and laggards.⁷⁸

Among other things, transition economies beyond central Europe may currently suffer a locational disadvantage – the combination of distance from west European markets and inadequate infrastructure. However, this problem should not be insurmountable. The Bulgarian Black Sea coast (and all the states of the former Yugoslavia, the Baltic States, Belarus, Moldova, most of Ukraine and parts of Russia) is 1500 kilometers from the center of Germany, much less than the dimensions of the current EU and the United States single markets. It is likely that these outlying countries could become more attractive to FDI if they were connected with western Europe by an efficient integrated telecommunications and transport infrastructure (clearing the Danube will also help). The international investment banks (EBRD, World Bank and the EIB) are engaged in an upgrading of infrastructure in the transition economies, but the question remains as to whether there are coherent infrastructure plans on a sufficient scale to meet the needs of potential investors?

⁷⁸ Bevan and Estrin, *op. cit.*

APPENDIX

Methodological Issues

This Appendix briefly discusses the balance of payments statistics upon which this study is based, the limitations of the data and the various FDI indicators.

I. Definitions and coverage of data

Direct investment is a category of international investment that reflects the objective of obtaining a lasting interest by a resident entity in one country ("direct investor") in an enterprise located in an economy other than that of the investor ("direct investment enterprise"). The lasting interest implies the existence of a long-term relationship between the direct investor and the enterprise. A direct investment relationship is created when a foreign investor owns 10 per cent or more of the ordinary shares or voting power in the direct investment enterprise (incorporated or unincorporated).⁷⁹

The FDI flows in the balance of payments comprise three components:

- *Equity*: comprises equity in branches, all shares in subsidiaries and associates and other capital contributions.
- *Reinvested earnings*: consist of the direct investor's share (in proportion to direct equity participation) of earnings not distributed as dividends by subsidiaries and earnings of branches not remitted to the direct investor.
- *Other direct investment capital*: covers the borrowing and lending of funds between direct investors and subsidiaries, including both short- and long-term investments.

The transition economies have made good progress in reporting the components of FDI flows. By 1998 twelve of them reported reinvested earnings, several having done so for a number of years (Appendix Table 1).⁸⁰ The decision to report earnings results in a break in the series. In most cases, this is not serious because reinvested profits have been small, given the relatively recent establishment of direct investment enterprises. However, a number of countries report reinvested earnings of over 10 per cent of current equity investments. For those countries, failure to report reinvested profits (and inter-company loans), means that total annual and cumulated FDI flows are

underestimated, with implications for the international comparability of these statistics. The largest underestimate is likely to have occurred in Hungary where non-reported reinvested earnings are estimated to have reached 1.3 per cent of GDP in 1997.⁸¹

FDI inflow data from the balance of payments generally begin in 1990, later for the CIS and the republics of the former Yugoslavia. In consequence any investments made prior to those dates are not reflected in the cumulations. For reasons discussed above, this is not likely to be a problem except perhaps in Hungary and Yugoslavia.⁸²

II. Indicators of FDI flows and their interpretation

Three types of ratios are typically used in the analysis of inward FDI: the FDI/GDP ratio, calculated from annual flows; the ratio of cumulated annual FDI flows⁸³ to GDP (using current year GDP); and the ratio of annual FDI flows to gross fixed capital formation. All three ratios are a measure of the penetration of FDI in the economy and give some idea of the potential economic impact of foreign investment.

The GDP statistic generally used in these ratios is calculated at current prices and exchange rates (nominal GDP). One of its shortcomings stems from differences in the degree of undervaluation of national currencies relative to the US dollar and from the often large depreciations of nominal exchange rates which, for example, occurred in several transition economies following the 1997-1998 financial crises. A partial solution is to use dollar GDP estimates at PPP exchange rates.⁸⁴ This raises the GDP of the transition economies, most of all those of the CIS (whose exchange rates are the most undervalued). FDI/GDP ratios (including those based on PPP GDP) are also sensitive to economic downturns, the resulting increases in the ratios implying (incorrectly) increases in FDI penetration. This is important because some countries have experienced falls in output from time to time during the transition, particularly in the early 1990's and again in 1997-1999.

A variant of these measures replaces GDP with the country population, yielding per capita flows or stocks. Population can be established accurately over time, which facilitates cross-country comparisons (problems not entirely solved by GDP PPP), and it eliminates the problem of economic downturns. However, since per

⁷⁹ IMF, *Balance of Payments Manual*, Fifth Edition, 1993.

⁸⁰ By comparison, in 1991 only eleven industrial countries surveyed in the *Godeaux Report* compiled reinvested earnings. In 1997 an OECD survey concluded that about three-fourths of OECD countries reported compiling reinvested earnings. "Foreign Direct Investment: Survey of Implementation of Methodological Standards", OECD, *Financial Market Trends*, Paris, November 1998.

⁸¹ IMF, op. cit.

⁸² Slovenia is estimated to have inherited an FDI stock of \$666 million which is not reflected in cumulated inflows. Estimates for the other republics are not available. *World Investment Report 1999*.

⁸³ Cumulated annual FDI inflows are a measure of the country's stock of foreign assets.

⁸⁴ UN/ECE, *International Comparisons of Gross Domestic Product in Europe*, 1996 (United Nations publication, Sales No. E.99.II.E.13).

capita incomes vary considerably between countries, population figures are not likely to provide an accurate measure of economic size. Appendix table 3 contains FDI ratios calculated using GDP (nominal), GDP (PPP) and population and country rankings based on each indicator.

The FDI/domestic investment ratio is often analyzed assuming (at least implicitly) that FDI contributes to local gross fixed capital formation. This can be justified if FDI inflows represent capital goods in kind or if FDI cash flows are used to purchase capital equipment (as is typically the case with greenfield or follow-up investments in existing facilities). In both cases FDI increases the capital stock and productive capacity. The ratio loses this interpretation when FDI takes the form of M&A's, which represent change in ownership (rather than fixed investment). In many transition economies M+A activity has accounted for the bulk of FDI. Also the inter-company loan component of FDI may be used for transactions other than the finance of capital goods (e.g. financial speculation).⁸⁵ As privatization comes to an end, FDI will increasingly reflect capital investment (as is already the case in Estonia and Hungary).

⁸⁵ It was argued above that M&As can still positively effect economic efficiency (independently of new investment) through new management, integration in global marketing networks, etc.

TABLE 1
Foreign direct investment ^a inflows, 1990-2000
(Million dollars, per cent)

	Million dollars							FDI/GDP, nominal (per cent)					
	1990- 1992	1993- 1996	1997- 1999	1998	1999	January-June		1990- 1992	1993- 1996	1997- 1999	1999	January-June	
						1999	2000 ^b					1999	2000 ^b
Eastern Europe^c	6 583	31 655	44 848	15 502	18 865	5 824	7 018	1.0	2.6	4.0	4.9	3.3	4.0
Albania	20	271	134	45	41	15	31	0.6	3.3	1.6	1.1	0.8	1.6
Bosnia and Herzegovina	-	-	160	100	60*	30*	30 ^d	-	-	1.3	1.4	1.4	1.7
Bulgaria	101	345	1 848	537	806	286	250	0.3	0.8	5.3	6.5	5.2	4.7
Croatia	16	844	2 788	898	1 408	299	582	-	1.3	4.5	7.0	3.0	6.3
Czech Republic	1 649	5 513	9 128	2 720	5 108	1 430	2 052	1.9	3.0	5.7	9.6	5.5	8.4
Hungary	3 241	10 213	6 153	2 036	1 944	712	910	3.1	6.0	4.4	4.0	3.1	4.0
Poland (accrual basis)	1 058	11 747	18 543	6 365	7 270	2 210 ^e	2 737 ^e	0.5	2.6	4.0	4.7	3.0 ^e	3.6 ^e
Romania	117	1 117	4 287	2 031	1 041	673	257	0.1	0.9	3.9	3.1	4.9	1.7
Slovakia	200	949	999	508	330	130	130	0.5	1.5	1.6	1.7	1.3	1.3
Slovenia	180	612	804	248	181	51	39	0.4	0.9	1.4	0.9	0.5	0.4
The former Yugoslav Republic of Macedonia .....	..	44	164	118	30	20	30*	-	0.3	1.5	0.9	1.1	1.7
Yugoslavia .....	..	..	740	..	..	..	..	..	..	..	..	..	..
Baltic states	119	1 836	4 144	1 863	1 139	627	462	..	3.8	6.5	5.2	5.9	4.1
Estonia	82	729	1 152	581	305	208	145	..	6.2	7.7	5.9	8.2	5.8
Latvia	29	821	1 225	357	348	157	179	..	5.3	6.8	5.6	5.3	5.4
Lithuania	8	286	1 767	926	486	262	139	..	1.4	5.7	4.6	5.1	2.6
CIS .....	..	12 799	24 077	6 733	6 599	3 104	2 353	..	0.8	2.0	2.4	2.6	1.7
Armenia .....	..	52	395	221	122	60	60 ^d	..	1.2	7.3	6.6	9.4	9.1
Azerbaijan .....	..	1 039	2 648	1 024	510	401	85	..	12.1	21.3	12.7	23.7	4.2
Belarus	7	115	574	149	225	175	47	..	0.3	1.6	2.1	4.1	1.2
Georgia .....	..	54	551	265	82	42	41 ^d	..	0.6	5.7	3.0	3.5	2.9
Kazakhstan	100	2 964	4 056	1 151	1 584	760	620 ^f	..	4.6	6.7	10.0	9.6	8.3
Kyrgyzstan .....	..	191	228	109	36	4	-2 ^f	..	3.8	5.0	2.9	0.9	-0.4
Republic of Moldova	42	116	195	81	34	6	66	..	2.1	4.1	2.9	1.1	12.9
Russian Federation	1 554	6 346	12 709	2 761	3 309	1 393	1 085	..	0.5	1.4	1.8	1.8	1.0
Tajikistan .....	..	66	75	24	21	9	9 ^d	..	2.0	2.3	1.9	2.2	2.7
Turkmenistan	11	523	267	64	60*	30*	30 ^d	..	2.8	3.0	1.8	1.9	1.5
Ukraine	170	1 145	1 862	743	496	166	252 ^f	..	0.8	1.5	1.7	1.1	2.6
Uzbekistan	9	187	518	140	121	60*	60 ^d	..	0.5	1.1	0.7	1.0	1.0
Total above^c .....	..	46 290	73 069	24 137	26 697	9 555	9 833	..	1.7	3.1	3.9	3.1	3.0
<i>Memorandum items:</i>													
CETE-5	6 328	29 034	35 628	11 877	15 563	4 532	5 868	1.3	3.1	4.0	5.0	3.2	4.1
SETE-7^c	254	2 621	9 220	3 629	3 326	1 292	1 150	0.1	1.0	4.1	4.5	4.0	3.5
Asian CIS .....	..	5 076	8 737	2 998	2 535	1 365	903	..	3.4	5.8	5.5	6.9	4.5
3 European CIS^g	194	1 376	2 631	974	755	346	366	..	0.7	1.6	1.8	1.8	2.6
Poland (cash basis)	411	5 022	14 677	5 129	6 471	2 210	2 737	0.2	1.1	3.2	4.2	3.0	3.6

Source: UN/ECE secretariat based on national balance of payments statistics.

^a Inflows into the reporting countries.

^b Data for 2000 are preliminary.

^c Excluding Bosnia and Herzegovina and Yugoslavia.

^d Estimate, assumed to be the same as in 1999.

^e Cash basis.

^f Estimate, twice first quarter value.

^g Belarus, Republic of Moldova and Ukraine.

TABLE 2

FDI inflows as a percentage of GDP (PPP), 1993-1999
(Period averages, per cent)

1993-1996		1997-1999	
Range 1.0-2.9		Range 2.1-5.1	
Hungary	2.9	Azerbaijan	5.1
Estonia	2.0	Estonia	3.4
Azerbaijan	1.7	Croatia	2.9
Latvia	1.7	Latvia	2.8
Poland	1.3	Lithuania	2.5
Czech Republic	1.2	Czech Republic	2.3
Kazakhstan	1.1	Poland	2.1
Turkmenistan	1.0	Range 1.1-1.9	
Range 0.5-0.9		Hungary	1.9
Albania	0.9	Kazakhstan	1.8
Croatia	0.8	Armenia	1.5
Slovakia	0.6	Bulgaria	1.5
Slovenia	0.6	Romania	1.1
Kyrgyzstan	0.5		
Transition economies average = 0.5		Transition economies average = 1.0	
Range 0.3-0.4		Range 0.5-0.1	
Lithuania	0.4	Georgia	1.0
Republic of Moldova	0.3	Slovenia	0.9
Range 0.1-0.2		Republic of Moldova	0.9
Armenia	0.2	Kyrgyzstan	0.7
Bulgaria	0.2	Turkmenistan	0.7
Romania	0.2	The former Yugoslav	
Russian Federation	0.2	Republic of Macedonia ..	0.6
Tajikistan	0.2	Slovakia	0.6
Belarus	0.1	Albania	0.5
Georgia	0.1	Range 0.0-0.4	
The former Yugoslav		Russian Federation	0.4
Republic of Macedonia ..	0.1	Tajikistan	0.4
Ukraine	0.1	Ukraine	0.4
Uzbekistan	0.1	Belarus	0.3
		Uzbekistan	0.3

Source: UN/ECE secretariat calculations based on national balance of payments statistics and GDP(PPP) estimates.

TABLE 3

Ratio of FDI inflows and current account deficits, 1993-1999
(Per cent)

	1993-1996	1997-1999
Eastern Europe	58 ^a	86
Baltic states	97	64
CIS^b	45	77
of which:		
Asian CIS	66	84
European CIS^c	21	59

Source: UN/ECE secretariat based on national balance of payments statistics.

Note: The ratios are calculated as averages of cumulated FDI inflows to cumulated current account deficits.

^a Excluding Poland, which had a large current account surplus in 1995.

^b Excluding Russian Federation.

^c Belarus, Republic of Moldova and Ukraine.

TABLE 4

Coefficients of variation ^a of FDI inflows and other capital flows ^b
(Standard deviation divided by the absolute means)

	1990-1999		1993-1999	
	FDI inflows	Other flows	FDI inflows	Other flows
Eastern Europe^c	1.0	1.9	0.7	1.5
Albania	0.7	2.3	0.3	3.4
Bulgaria	1.2	1.6	1.0	2.6
Croatia	1.3	1.5	0.9	0.9
Czech Republic	0.9	2.9	0.7	1.7
Hungary	0.5	2.8	0.4	1.9
Poland (cash basis)	1.1	1.0	0.8	1.0
Romania	1.1	0.8	0.9	1.2
Slovakia	0.7	1.3	0.4	0.7
Slovenia	0.6	2.4	0.4	1.3
The former Yugoslav				
Republic of Macedonia ...	1.7	2.5	1.3	0.9
Baltic states .....	..	..	0.7	1.0
Estonia .....	..	..	0.6	1.5
Latvia .....	..	..	0.5	1.2
Lithuania .....	..	..	1.1	0.3
Total CIS .....	..	..	0.7	1.7
Armenia .....	..	..	1.3	0.5
Azerbaijan .....	..	..	0.8	0.7
Belarus .....	..	..	0.9	0.5
Georgia .....	..	..	1.2	0.5
Kazakhstan .....	..	..	0.4	1.4
Kyrgyzstan .....	..	..	0.6	0.5
Republic of Moldova .....	..	..	0.7	0.6
Russian Federation .....	..	..	0.7	2.3
Tajikistan .....	..	..	0.4	0.8
Turkmenistan .....	..	..	0.5	10.7
Ukraine .....	..	..	0.5	0.8
Uzbekistan .....	..	..	0.9	1.4
Total above .....	..	..	0.7	1.4
Memorandum items:				
CETE-5	0.8	2.1	0.6	1.3
SETE-7^c	1.2	1.7	0.9	1.8
Asian CIS	0.9	5.0	0.8	2.1
3 European CIS^d	0.8	0.8	0.7	0.6

Source: UN/ECE secretariat based on national balance of payments statistics.

^a Standard deviation divided by the mean, absolute annual dollar inflow.

^b Excluding errors and omissions.

^c Excluding Bosnia and Herzegovina and Yugoslavia.

^d Belarus, Republic of Moldova and Ukraine.

TABLE 5

Hungary: direct effect of FDI on the balance of payments, 1996-1999
(Million dollars; per cent)

	1996	1997	1998	1999
Current account items	-350	-155	184	556
Trade balance of FIEs	320	876	1 804	2 219
Exports	2 842	5 081	8 282	10 705
Imports	2 522	4 204	6 478	8 486
Income items	-670	-1 032	-1 620	-1 663
Direct investment income	-261	-438	-920	-863
Reinvested earnings ^a	-409*	-594*	-700*	-800*
Capital account item:				
Net FDI (adjusted) ^b	2 687*	2 336*	2 255*	2 495*
Total above	2 337	2 181	2 439	3 051
<i>Memorandum items:</i>				
Non FIE trade balance	-2 760	-3 010	-4 505	-5 215
Net FDI (cash basis)	2 278	1 742	1 555	1 695
Total current account/GDP (cash basis)	-3.7	-2.1	-4.9	-4.3
Total current account/GDP (adjusted) ^c	-4.6	-3.4	-6.4	-6.0

Source: UN/ECE secretariat based on national balance of payments statistics; for FIE exports and imports, K. Antaloczy and M. Sass, "Greenfield FDI in Hungary: is it better than privatization-related FDI?", UNCTAD seminar, *op. cit.*. For estimates of reinvested earnings; 1996-1997, IMF, *Hungary: selected issues*, Staff Country Report No. 99/27 (Washington D.C.), April 1999.

Note: The trade of FIEs is the trade of international free trade zones (IFTZ) only; see text.

^a Reinvested earnings estimates: 1996-1997 are IMF estimates. 1998-1999 outflows are assumed to be increased by \$100 million annually.

^b Net FDI on a cash basis plus estimates of reinvested earnings.

^c Includes estimates of reinvested earnings (outflows).

TABLE 6

Azerbaijan: direct effect of FDI on the balance of payments of the oil sector, 1995-2000
(Million dollars)

	1995	1998	1999	Jan.-Jun. 2000
Current account items	143	-228	258	467
Trade balance	227	78	476	702
Exports (oil and products)	257	434	801	777
Imports (oil sector)	-30	-356	-325	-75
Services	-68	-286	-189	-62
Income	-16	-20	-29	-173
<i>of which:</i>				
Compensation of employees ^a	-9	-20	-29	-20
Profit repatriation ^a	-7	-	-	-153
Capital account item:				
Net FDI ^b	130	757	350	11
Total above	273	529	608	478
<i>Memorandum item:</i>				
Total current account	-318	-1 363	-600	-49
Total net FDI inflows	282	1 024	510	85

Source: UN/ECE secretariat based on balance of payments data reported to the IMF.

^a Oil consortia.

^b Excluding signing bonuses paid to the government by foreign oil companies.

TABLE 7

FDI penetration and exports
(Per cent, ratios)

	Cumulative FDI/GDP ^a	Share of FIEs in manufacturing				Total exports growth ^b	Contribution of exports ^c to real GDP growth			
		Investment 1998	Sales 1998	Exports			(1) Exports 1996	(2) GDP 1997	1998	1999
Czech Republic	12.3	41.6	31.5	15.9	47.0	185	(1) 5.0	4.5	6.6	4.6
	..	..	..	..	..	..	(2) 4.8	-1.0	-2.2	-0.2
Estonia	16.9	32.9	28.2	32.5	35.2	366	(1) 1.6	21.6	10.5	-2.1
	..	..	..	..	..	..	(2) 3.9	10.6	4.7	-1.1
Hungary	17.8	78.7	70.0	77.5	85.9	280	(1) 3.1	10.4	8.0	7.0
	..	..	..	..	..	..	(2) 1.3	4.6	4.9	4.5
Poland	10.0	51.0	40.6	26.3	52.4	192	(1) 3.0	3.0	3.7	-0.4
	..	..	..	..	..	..	(2) 6.0	6.8	4.8	4.1
Slovenia	5.3	24.3	24.4	25.8	32.9	140	(1) 2.0	6.4	4.0	1.1
	..	..	..	..	..	..	(2) 3.5	4.6	3.8	5.0

Source: UN/ECE secretariat based on national balance of payments, trade and national account statistics. For penetration of FIEs in manufacturing, Gábor Hunya, *International Competitiveness Impacts of FDI in CEECs*, Research Reports No.268, August 2000,.

^a Cumulated FDI 1988-1999 and nominal GDP in 1999.

^b Ratio of the dollar value of total exports in 1999 to 1993.

^c Goods and services.

TABLE 8

Estonia: Obstacles to foreign direct investment, 1997 and 1998
(Index, range 0-5)^a

	1997	1998
Bureaucracy ^b .....	..	3.22
Corruption	2.86	3.05
Labour quality	3.09	2.89
VAT payments/rebates	3.19	2.81
Customs procedures	2.82	2.76
Project finance	2.69	2.69
Work and residence permits	2.70	2.69
Tax rates ^b .....	..	2.66
Gaps in legislation	3.08	2.62
Slow land reform	2.83	2.59
Unfair competition	2.79	2.41
Land acquisition	2.56	2.22
Raw material availability	2.10	1.95
Absence of tariffs	2.03	1.65

Source: T. Ziack, 'Foreign Investor 1997 and 1998 Surveys', *Discussion Papers 2000, No.3*, Bank of Finland Institute for Economies in Transition (BOFIT).

^a A one denotes 'no problem' and a 5 denotes a 'serious problem'.

^b Not included in the 1997 survey.

APPENDIX TABLE 1

Balance of payments components of FDI in the transition economies as reported by the IMF

	Equity capital	Reinvested earnings	Other capital
Albania	1992-1998	..	..
Bulgaria	1990-1998	1998	1997-1998
Croatia .....	..	..	..
Czech Republic	1993-1998	..	..
Hungary	1991-1998	..	1996-1998
Poland ^a	1990-1998	1990-1998	1991-1998
Romania	1991-1998	..	..
Slovakia	1994-1998	1995-1998	1995-1998
Slovenia	1992-1998	..	..
The former Yugoslav Republic of Macedonia	1996-1998	..	1996-1997
Estonia	1992-1998	1992-1998	1992-1998
Latvia	1992-1998	1996-1998	1996-1998
Lithuania	1993-1998	1995-1998	1995-1998
Armenia	1993-1998	1997-1998	1995-1998
Azerbaijan	1995-1998	..	1995-1998
Belarus	1993-1998	1997-1998	1996-1998
Georgia	1998	..	..
Kazakhstan	1995-1998	1996-1998	1995-1998
Kyrgyzstan	1993-1998	1996-1998	1995-1998
Republic of Moldova ...	1995-1998	1998	1995-1998
Russian Federation	1997-1998	1998	1997-1998
Tajikistan .....	..	..	..
Turkmenistan	1996-1997	..	1997
Ukraine	1994-1998 ^b	..	..
Uzbekistan .....	..	..	..

Source: IMF, *Balance of payments Statistics Yearbook*, Part 1 Country tables, 1999.

^a Accrual basis.

^b Total FDI.

APPENDIX TABLE 2

Inflows of foreign direct investment ^a in ECE transition economies, 1990-1999
(Million dollars)

	1990	1991	1992	1993	1994	1995	1996	1997	1998	1999
Eastern Europe ^b	558	2506	3518	5276	4904	11743	9732	11951	15502	18865
Albania ^c .....	..	–	20	58	53	70	90	48	45	41
Bosnia and Herzegovina .....	..	..	..	..	–	–	–	–	100	60*
Bulgaria ^c	4	56	42	40	105	90	109	505	537	806
Croatia	–	–	16	120	117	115	506	530	898	1 408
Czech Republic	132	513	1 004	654	869	2 562	1 428	1 300	2 720	5 108
Hungary	311	1 459	1 471	2 339	1 146	4 453	2 275	2 173	2 036	1 944
Poland (accrual basis)	89	291	678	1 715	1 875	3 659	4 498	4 908	6 365	7 270
Romania	–	40	77	94	341	419	263	1 215	2 031	1 041
Slovakia	18	82	100	168	250	202	330	161	508	330
Slovenia	4	65	111	113	128	177	194	375	248	181
The former Yugoslav Republic of Macedonia ^c	–	–	–	–	24	9	11	16	118	30
Yugoslavia .....	..	..	..	..	..	..	..	740	..	..
Baltic states .....	..	..	119	238	460	454	685	1 142	1 863	1 139
Estonia .....	..	..	82	162	215	202	151	267	581	305
Latvia .....	..	..	29	45	214	180	382	521	357	348
Lithuania .....	..	..	8	30	31	73	152	355	926	486
CIS .....	..	..	..	1 875	1 720	3 969	5 188	10 611	6 733	6 599
Armenia ^c .....	..	..	..	1	8	25	18	52	221	122
Azerbaijan ^c .....	..	..	–	60	22	284	627	1 115	1 024	510
Belarus .....	..	..	7	18	11	15	73	200	149	225
Georgia ^c .....	..	..	–	–	8	6	40	203	265	82
Kazakhstan ^d .....	..	..	100	228	635	964	1 137	1 321	1 151	1 584
Kyrgyzstan ^c .....	..	..	0	10	38	96	47	83	109	36
Republic of Moldova .....	..	25	17	14	12	67	24	76	81	34
Russian Federation	–	100	1 454	1 211	640	2 016	2 479	6 639	2 761	3 309
Tajikistan ^c .....	..	..	9	9	12	20	25	30	24	21
Turkmenistan ^c	–	–	11	79	103	233	108	102	64	60*
Ukraine .....	..	..	170	198	159	267	521	623	743	496
Uzbekistan ^c .....	..	..	9	48	73	–24	90	167	140	121
Total above ^b .....	..	..	..	7389	7085	16212	15604	23704	24137	26697
<i>Memorandum items:</i>										
CETE-5	554	2410	3364	4988	4268	11053	8725	8918	11877	15563
SETE-7^b	4	96	155	312	640	704	979	2 313	3 629	3 326
Asian CIS .....	..	..	..	435	899	1 605	2 092	3 073	2 998	2 535
3 European CIS^e .....	..	..	194	229	181	349	617	899	974	755
Poland (cash basis) ^c	10	117	284	580	542	1 132	2 768	3 077	5 129	6 471

Source: National balance of payments statistics; IMF.

^a Inflows into the reporting country.

^b Excluding Bosnia and Herzegovina.

^c Net of residents' investments abroad. Bulgaria, 1990-1994; Poland, 1990-1992.

^d Drawings less repayments.

^e Belarus, Republic of Moldova and Ukraine.

APPENDIX TABLE 3

Foreign direct investment inflows and selected indicators
(Billion dollars, per cent)

	Secondary education ^a		Corruption index 2000		Cumulative FDI inflows 1988-1999						FDI inflows / GDFCF ^c (per cent)		FDI inflows / current account (per cent)	
	1997	Rank ^b	CPI score	Billion dollars	Per cent of GDP	Rank	Per cent of GDP/PPP	Rank	Per capita dollars	Rank	1993-1996	1997-1999	1993-1996	1997-1999
Eastern Europe^e	80	51	3.8	84.4	22.8	..	9.6	..	789	..	12	17	58 ^d	86
Albania	38	..	..	0.4	11.8	18	4.1	16	126	16	..	..	104	28
Bosnia and Herzegovina .....	..	..	..	0.2	3.6	..	..	..	57	..	..	..	-	4
Bulgaria	77	52	3.5	2.3	18.5	14	5.5	11	279	12	6	39	26	488
Croatia	82	51	3.7	3.7	18.4	15	11.6	6	815	7	8	19	74	52
Czech Republic	99	42	4.3	16.5	31.1	7	12.3	5	1609	2	10	20	92	164
Hungary	98	32	5.2	19.8	40.9	3	17.8	2	1969	1	30	19	89	115
Poland (FDI: accrual basis)	98	43	4.1	32.1	20.6	12	10.0	7	830	5	14	17	-672	85
Romania	78	68	2.9	5.5	16.2	16	4.3	15	246	13	4	20	19	67
Slovakia	94	52	3.5	2.2	10.9	20	3.9	17	400	11	5	5	58	20
Slovenia	92	28	5.5	1.6	8.0	22	5.3	12	806	6	5	6	-88	88
The former Yugoslav														
Republic of Macedonia	63	..	..	0.2	6.1	24	2.1	21	103	19	2	9	7	23
Yugoslavia	62	89	1.3	0.7	4.2	..	1.7	..	70	..	..	..	-	21
Baltic states	91	42	4.4	6.1	27.7	..	12.0	..	805	..	18	26	97	64
Estonia	104	27	5.7	2.0	38.2	4	16.9	3	1361	3	23	28	104	86
Latvia	84	57	3.4	2.1	33.2	6	14.2	4	853	5	34	29	-255	75
Lithuania	86	43	4.1	2.1	19.4	13	8.4	9	557	8	6	24	19	51
CIS	86	74	2.5	38.7	14.1	..	2.7	..	137	..	4	11	..	..
Armenia	90	76	2.5	0.4	24.2	10	5.1	13	117	17	7	45	8	41
Azerbaijan	77	87	1.5	3.6	91.0	1	19.7	1	456	10	51	61	62	92
Belarus	93	43	4.1	0.7	6.6	23	1.0	25	68	22	1	6	6	30
Georgia	77	..	..	0.6	21.8	11	3.1	19	111	18	4	46	5	56
Kazakhstan	87	65	3.0	7.1	44.9	2	9.7	8	477	9	20	55	131	185
Kyrgyzstan	79	..	..	0.4	34.4	5	3.7	18	86	21	21	41	23	33
Republic of Moldova	81	74	2.6	0.3	30.1	8	4.9	14	96	20	12	20	22	29
Russian Federation	96 ^f	82	2.1	20.6	11.2	19	2.1	22	141	15	2	8	-15	-45
Tajikistan	78	..	..	0.2	13.8	17	2.4	20	24	25	12	..	12	39
Turkmenistan .....	..	..	..	0.8	24.5	9	5.7	10	165	14	9	24	-59	18
Ukraine	94 ^f	87	1.5	3.2	10.3	21	1.9	23	64	23	3	8	27	99
Uzbekistan	94	79	2.4	0.7	4.1	25	1.2	24	28	24	2	3	14	77
Total above^e .....	..	..	..	129.2	19.4	..	5.5	..	325	..	8	14	..	..
<i>Memorandum items:</i>														
CETE-5	96	39	4.5	72.2	24.3	..	11.1	..	1088	..	14	16	174	92
SETE-7^e	68	57	3.4	12.2	16.5	..	5.5	..	299	..	6	22	28	69
Asian CIS	83	77	2.4	13.9	29.8	..	6.7	..	191	..	14	29	66	84
European CIS^g	91	72	2.6	24.8	10.9	..	2.0	..	118	..	3	8	..	..
Poland: cash basis .....	..	..	..	20.1	12.9	..	6.3	..	520	..	5.6	13	21	59

Source: UN/ECE secretariat based on national balance of payments statistics. Transparency International, *Corruption Perceptions Index (CPI)*, <http://www.transparency.de>. For data on secondary education, The World Bank, *World Development Indicators 2000* (Washington, D.C.), 2000.

^a Per cent of the relevant age group.

^b Country rank out of 90 countries surveyed. The score ranges from 0-6, highest to lowest perceived corruption.

^c GDFCF - gross domestic fixed capital formation, converted to dollars at current exchange rates.

^d Excludes Poland, which has a large current account surplus in 1995.

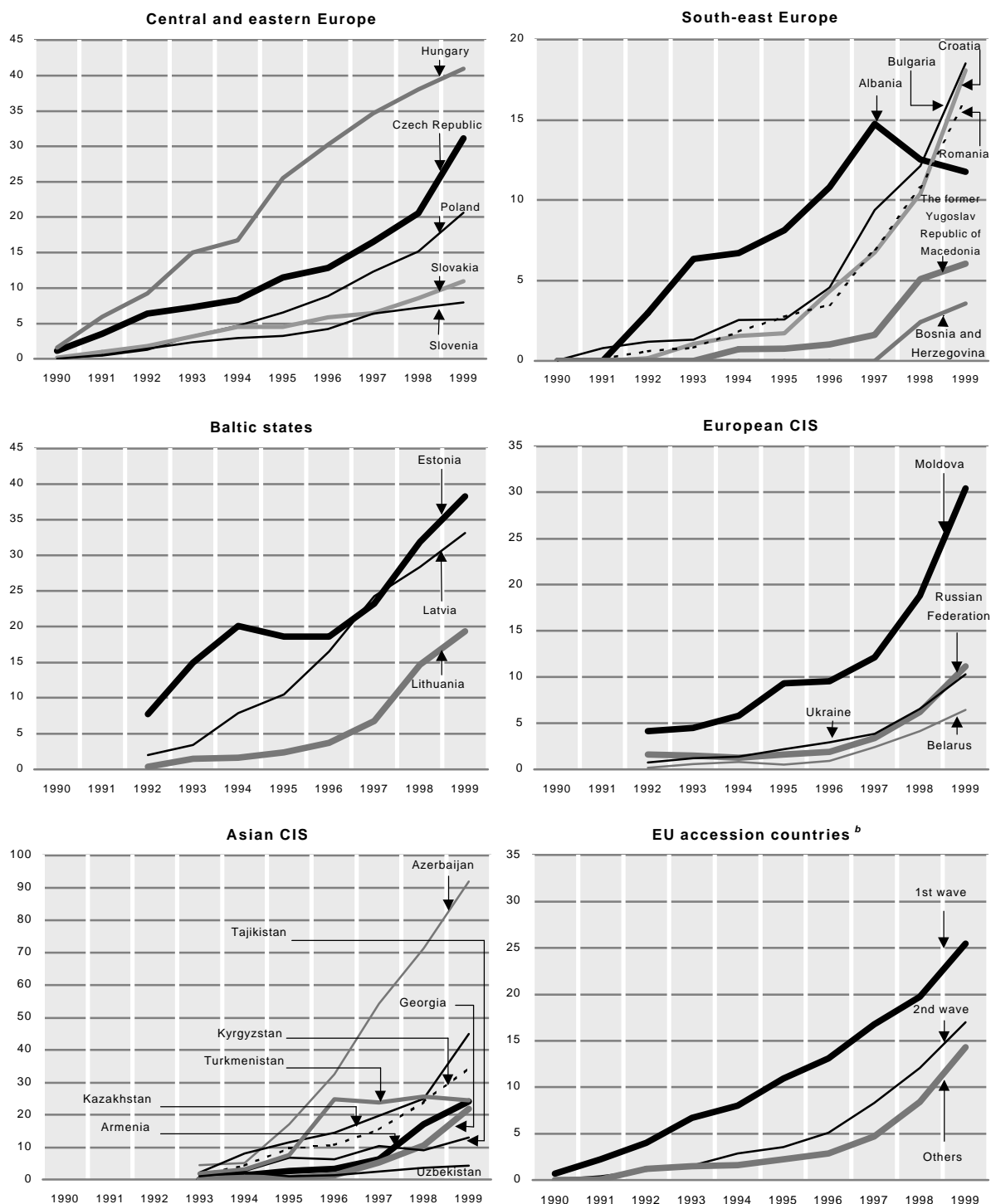
^e Excluding Bosnia and Herzegovina and Yugoslavia.

^f 1980.

^g Belarus, Republic of Moldova and Ukraine.

CHART 1

Cumulative FDI inflows as a percentage of GDP, ^a 1990-1999
(Per cent)



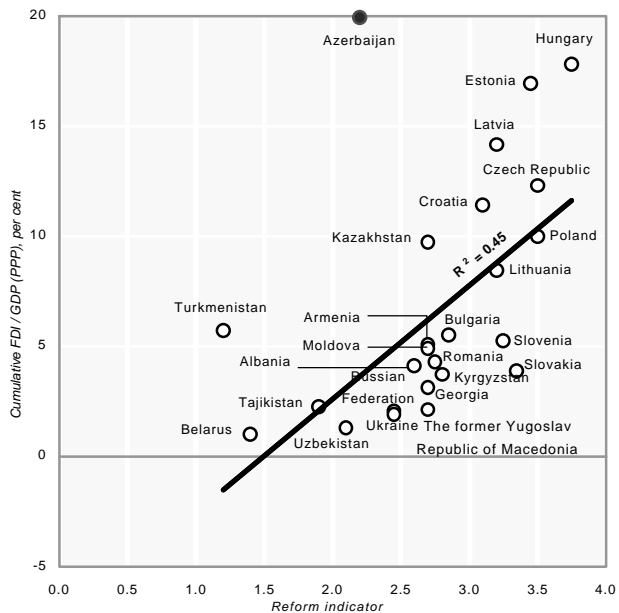
Source: UN/ECE secretariat based on national account and balance of payments statistics. FDI inflows are cumulated from 1988.

^a Nominal GDP, at current prices and exchange rates.

^b First wave: Czech Republic, Estonia, Hungary, Poland and Slovenia; Second wave: Bulgaria, Latvia, Lithuania, Romania and Slovakia.

CHART 2

Ratio of cumulative FDI inflows to GDP (PPP) and progress in transition
(Per cent)

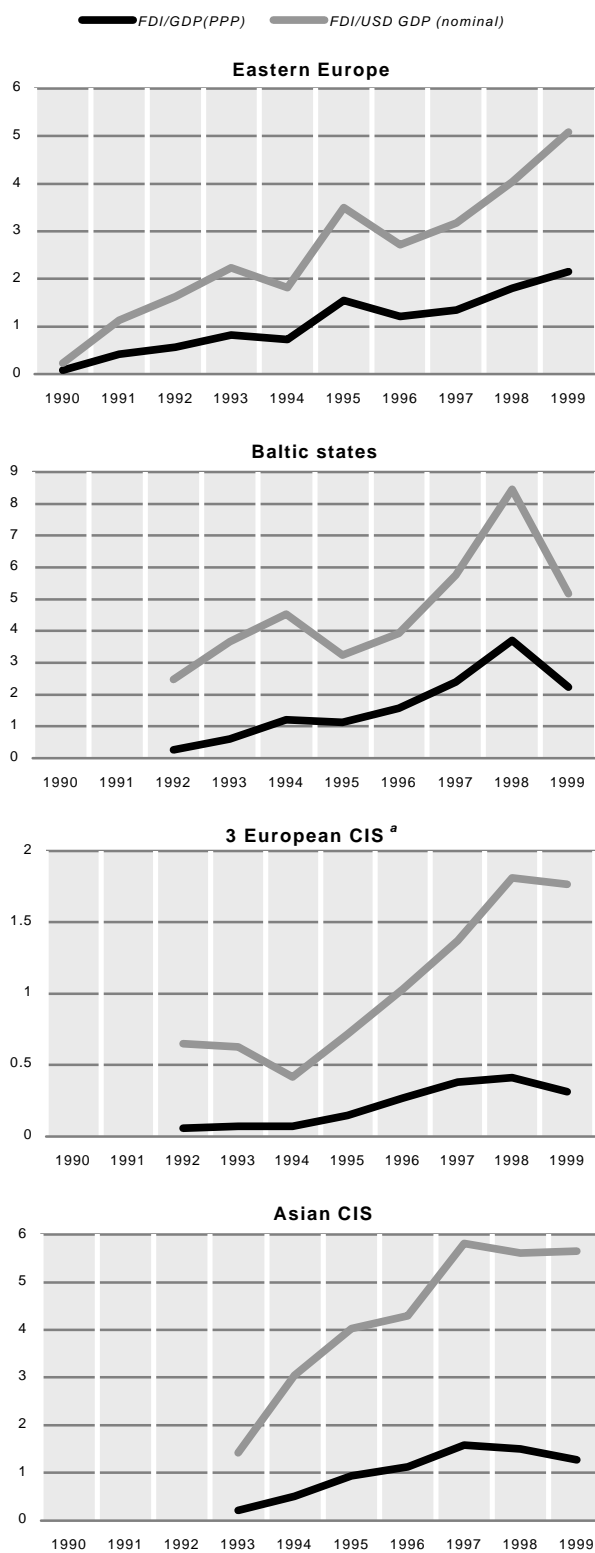


Source: National balance of payments statistics and EBRD (for the reform indicator).

Note: Azerbaijan is excluded from the regression.

CHART 3

FDI inflows as a percentage of GDP, 1990-1999
(Per cent)

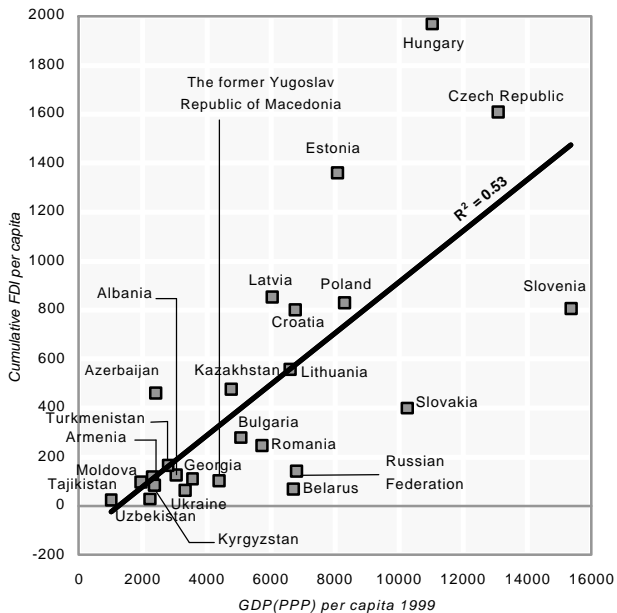


Source: National balance of payments statistics; UN/ECE secretariat for GDP(PPP).

^a Belarus, Republic of Moldova and Ukraine.

CHART 4

Cumulative FDI inflows per capita and GDP (PPP) per capita
(Dollars)

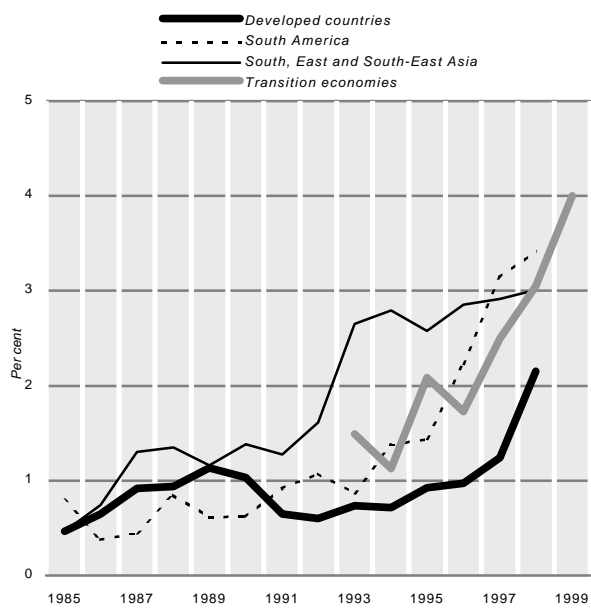


Source: National balance of payments statistics; UNECE secretariat for GDP(PPP).

Note: FDI inflows are cumulated from 1988-1999.

CHART 5

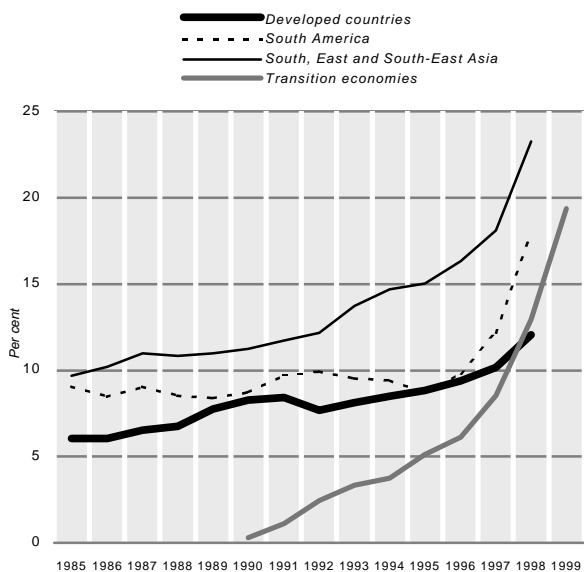
FDI inflows as a percentage of nominal GDP, 1985-1999
(Per cent)



Source: UN/ECE secretariat for the transition economies; UNCTAD, *World Investment Report 2000* (Geneva), for other areas.

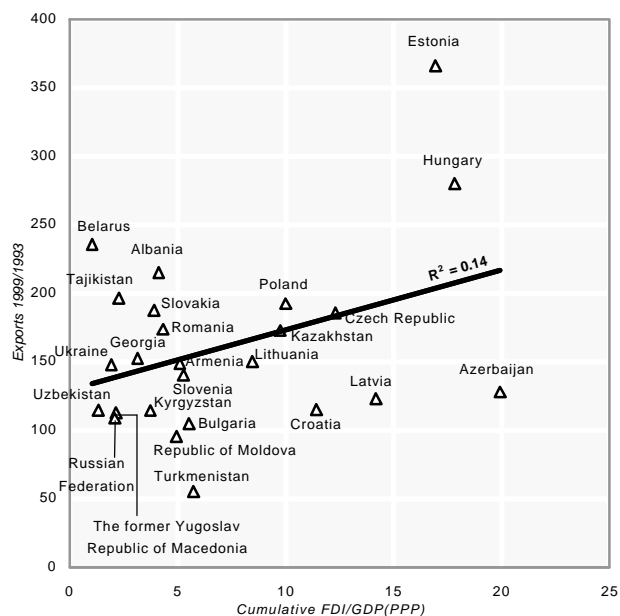
CHART 6

Cumulative FDI inflows as a percentage of GDP, 1985-1999
(Per cent)



Source: UN/ECE secretariat for the transition economies; UNCTAD, *World Investment Report 2000* (Geneva), for other areas.

CHART 7

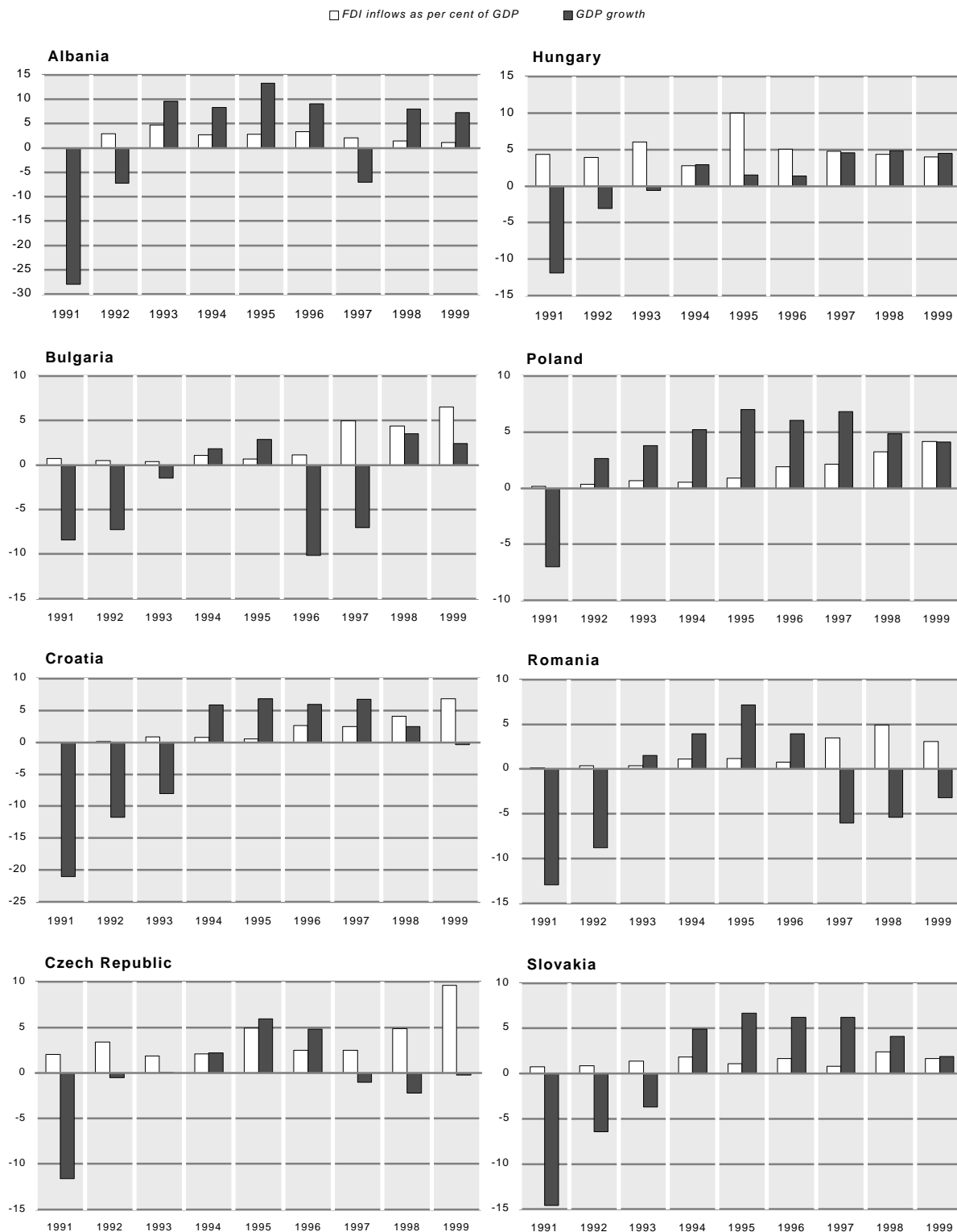
Export growth and ratio of cumulative FDI inflows to GDP (PPP)^a

Source: UN/ECE secretariat based on national balance of payments statistics and merchandise trade statistics.

^a Ratio of exports (in dollars) in 1999 relative to 1993. FDI is cumulated from 1988 to 1999.

CHART 8

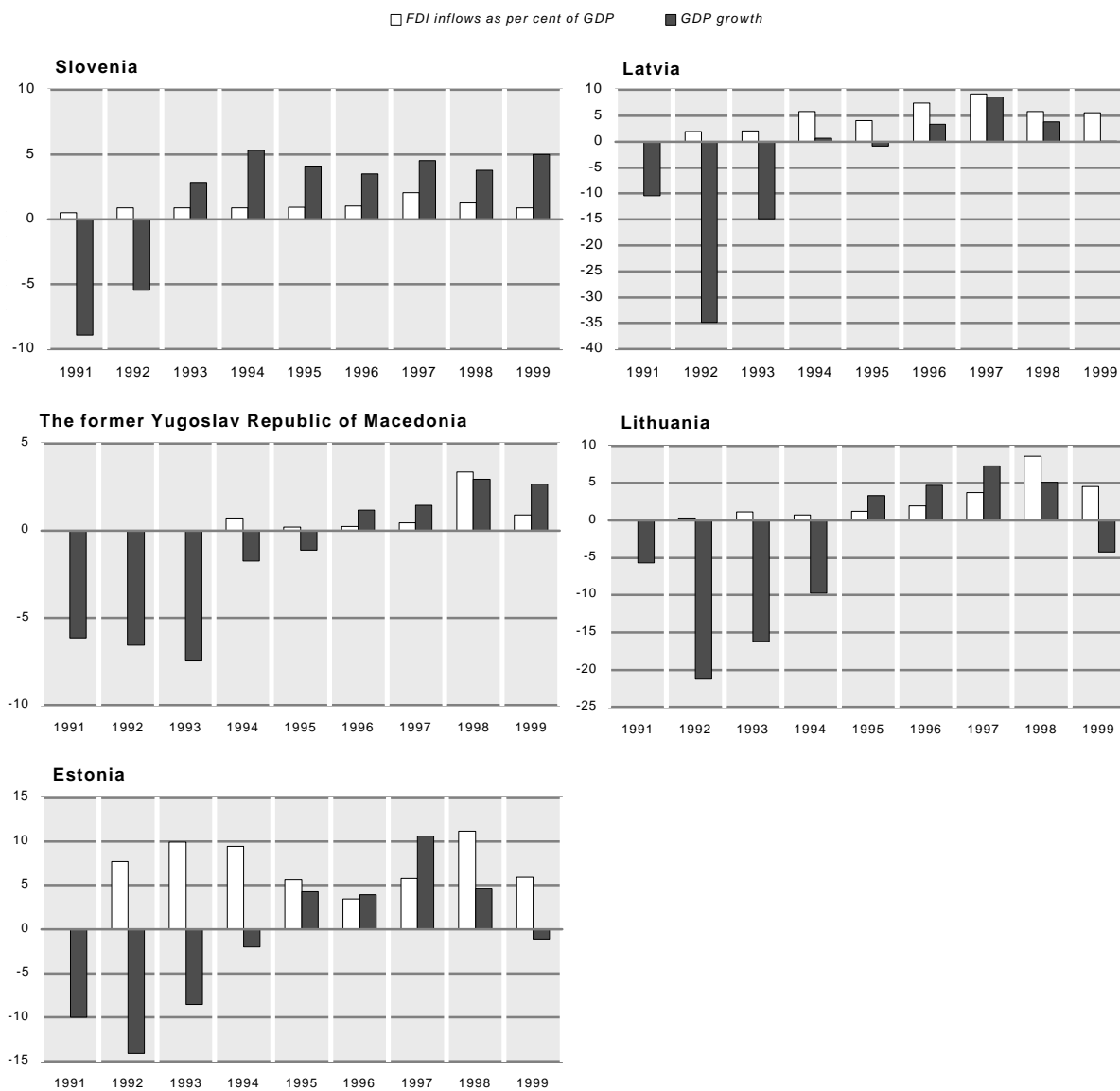
GDP growth and FDI inflows as a per cent of nominal GDP, 1990-1999
(Per cent)



(For Source see end of chart.)

CHART 8 (concluded)

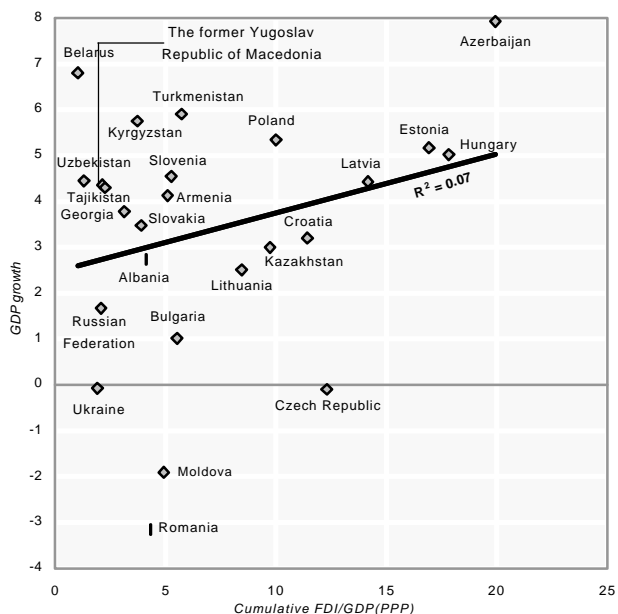
GDP growth and FDI inflows as a per cent of nominal GDP, 1990-1999
(Per cent)



Source: UN/ECE secretariat based on national account and balance of payments statistics.

CHART 9

Growth of GDP and ratio of cumulative FDI inflows to GDP (PPP)^a



Source: UN/ECE secretariat based on national account and balance of payments statistics.

^a Average growth of GDP, 1997-2000 (estimates). FDI inflows are cumulated from 1988 to 1999.