

STIMULATION OF FOREIGN INVESTMENT AND REGIONAL ECONOMIC COOPERATION

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Recent Trends of FDI Flows

The growth of international production has been facilitated by the growing liberalisation of trade and international investment in recent years. Global FDI in 1996 amounted to US\$350bn, 10% more than in the previous year, whilst the global stock of FDI reached US\$3.2trn. The bulk of this FDI went to a selected group of some 30 countries. The least developed countries, mainly in Africa, but also some FSU countries, have by and large been left out from international capital flows. As the environment for multinational business becomes more favourable, the knowledge of global business matures and the technical facilities for global operations improve, the expansion of international production is likely to continue in the future. The Central and East European countries (CEECs) have to improve both their market institutions and physical infrastructures to benefit more from these processes.

More advanced, stable and open transforming countries have been the most attractive FDI targets among CEECs in the 1990s. CEECs had a modest 4% share in 1996 world FDI inflows, the four smaller among them (Czech Republic, Hungary, Slovenia, Slovak Republic) received 1.1% and Poland alone almost 1%. The seven CEE countries listed in Table 1 attracted some US\$10bn in 1995 and about US\$9bn both in 1996 and in 1997. In the last three years, FDI flows into Hungary, Poland and, in some years also into the Czech Republic have been comparable in size to newly industrialised countries.

Initially most of the FDI in CEECs went into trade and manufacturing, later also into finance and telecommunications. The distribution of FDI by economic activities undergoes major changes in countries where new sectors are opened to foreign investment by the advance of privatisation. The most notable cases were the telecommunications sector in the Czech Republic and the gas and energy sector in Hungary in 1995. In both countries the share of the manufacturing sector in FDI stock decreased below 40%. In Slovakia and Slovenia FDI preferred trade, insurance, consulting and manufacturing, with other sectors lagging behind.

**Table 1 - Foreign Direct Investment in CEECs 1994 - 1997:
FDI Stocks at end 1997 (US\$ million)**

	1994	1995	1996	1996 as % of fixed capital formation	1997	Stock Estimate 1997	Stock 1996 as % of GDP
Czech Republic	869	2,562	1,428	8,4	1,000	8,000	12,6
Hungary ¹	1,300	4,570	2,100	21,8	2,200	17,500	34,1
Slovakia ²	185	181	666	9,6	200	1,500	7,0
Slovenia ³	377	414	190	4,6	600	2,600	10,4
CEEC-4	2,731	7,727	4,384	-	4,000	29,600	-
Poland ⁴	1,342	2,511	4,000	17,5	4,000	16,000	8,9
Bulgaria	214	164	283	23,7	600	1,400	8,8
Romania	650	323	614	7,4	1,000	3,400	6,2
CEEC-7	4,937	10,725	8,949	-	9,600	50,400	-

1) From 1996 including inter-company loans.

2) Since 1996 including banking.

3) Since 1993 new methodology.

4) Projects with more than US\$1m invested capital. Small ventures add US\$2,200m to stock. From 1996 includes reinvested profits.

Sources: Hunya, G. and J. Stankovsky (1997), Database of the Vienna Institute for comparative Economic Studies (WIIW) and the Austrian Institute of Economic Research (WIFO). Foreign Direct Investment in Central and East European Countries and the Former Soviet Union, WIFO and WIIW, December 1997

Promotion of FDI

At the outset of transformation, Hungary and Poland used special incentives to attract FDI, while Czechoslovakia and Slovenia did not offer them. However, according to company surveys, the absence of an incentive framework has only marginally discouraged investors in the Czech Republic and Slovenia. The direct stimulation of FDI with tax holidays and other economic policy instruments played some role in Hungary up to 1994, but there is no evidence either proving that Hungary's success in attracting FDI was due to tax allowances and investment subsidies provided by the government, or, especially in the case of large green-field investments, investors acknowledged the role of incentives. The free trade zone arrangement for export oriented investments has been a major success in terms of attracting FDI and generating an export surplus.

From 1998, all of the more advanced CEECs now refrain from positive discrimination of foreign investors, but all investors can benefit from investment promotion schemes. Accelerated depreciation of machinery investment has been allowed in the Czech Republic and Slovenia. Hungary lowered the corporate tax rate to 18% in 1996 which is now one of the lowest in Europe, although a dividend tax was also introduced. Job creation is stimulated in Slovakia,

Slovenia and Hungary whilst regional investment incentives are provided in Hungary. The role of regions and local authorities has been upgraded in Hungary and Poland in attracting foreign investors. Recent subsidy schemes have been formulated in accordance with EU rules and apply to domestic and foreign investors alike. The budgets for incentive programmes are generally too limited to have a widespread impact on investment decisions. In this respect, CEECs are in a disadvantaged position in the Europe-wide competition for FDI.

Foreign Penetration in CEEC Manufacturing

Foreign penetration is expressed as the share of foreign investment enterprises (FIEs) in the whole economy by various indicators (Table 2). Companies of any size of foreign ownership are involved, which overstates the significance of the foreign sector. It may, however, be assumed that in most cases companies with minority foreign ownership tend to differ significantly from entirely domestically owned companies.

Table 2: Shares of FIEs in Main Indicators of Manufacturing Companies (%)

		Equity capital	Employment	Investment outlays	Sales	Sales for exports
Czech Republic ¹	1996	21.5	13.1	33.5	22.6	-
Hungary ²	1995	60.0	38.0	80.0	55.0	67.0
Poland	1994	-	12.2	30.9	18.7	29.1
Slovakia ¹	1994	12.2	9.7	34.3	12.8	15.7
Slovenia ¹	1995	13.1	8.5	14.0	17.6	23.2
Austria ²	1995	24.8	32.9	-	45.0	-

1) Czech Republic, Slovakia: non-financial corporations with at least 25 employees;

2) Hungary, Slovenia, Austria: companies supplying tax declarations.

Source: IIW database on foreign investment enterprises, relying on data supplied by national statistical offices.

The penetration of FDI has improved the economic growth potential of several CEECs and FDI has contributed to the upgrading of economic structures. FDI expresses the advance of countries in the transformation process and reinforces economic behaviour patterns in conformity with EU standards.

Multinational companies have, to varying degrees, integrated these economies into the EU at the micro-economic level. The process has advanced the furthest in Hungary, followed by the Czech Republic, while Poland is catching up. Slovenian and Slovakian companies are less integrated, which is especially problematic in the case of Slovakia being backward in terms of legal as well

as political harmonisation. In view of these results, Hungary, the Czech Republic and Slovenia, together with the other two FDI favourites in the region, Poland and Estonia, have been selected to join the EU ahead of others.

Prospects for FDI in Countries Joining NATO

NATO membership can contribute to the attractiveness of a member country as a host for FDI by reducing the country's (perceived) political instability and risk in the eyes of foreign investors. Therefore, the real issue with respect to NATO membership and FDI inflows is the importance of a host country's political instability and riskiness for the investment decision of an investor from outside the EU.

Theory suggests that uncertainty in the form of political volatility adversely affects the economic viability of a firm's present or future value-adding activity, likely leading to a low level of FDI. Various country-risk analysts (such as those of *Euromoney*, *The Institutional Investor*, Frost and Sullivan, and so on) attach considerable importance to political risk. For instance, *Euromoney* assigns as weight to political risk within total risk of 25%, the same as its weight on economic performance.

However, the results of research on the impact of political instability and risk on FDI inflows are ambiguous. In 1993, John Dunning, a prominent expert on FDI, carried out a comprehensive overview of empirical studies on the influence of political instability and risk on FDI. He found that early field studies all suggested that political risk ranked very high among the variables taken into consideration by multinational enterprises (MNEs) in determining the location of their overseas operations. However, later statistical studies which have embraced political environment indicators have yielded more ambiguous results. (As a rule, these analysis studied the influence of political volatility on U.S. investors, which increases the relevance of their findings for our topic.)

In sum, empirical analysis suggests the following:

- political instability and risk are important for foreign investors when they consider their locational decisions, but their importance varies in time and across countries, with developing countries being under tighter scrutiny;
- foreign investors are especially adverse to drastic types of unfavourable international or domestic events which are especially likely to occur in less developed countries;
- for a promising investment opportunity, foreign investors seem prepared to take on a fair amount of political instability and risk.

The only empirical example of NATO's influence on FDI inflows occurred when Spain joined NATO in 1982; all the other member countries joined NATO before the mid-1950s when the role of FDI in international economic relations

was still rather weak. Data show that FDI inflows into Spain did not really increase after 1982, either in absolute terms or as a share of FDI inflows to OECD countries. Neither did the share of Spain in FDI outflows or stock from the US increase after 1982, although in the case of Japan there was a slight increase. All this hardly provides a basis for the conclusion that NATO membership plays a positive role in enhancing inward FDI in general, or that from on-EU countries in particular.

It is too early to analyse the affects of the Czech Republic, Hungary and Poland joining NATO on inward FDI flows to these countries. A possible illustration is *Euromoney's* assessment of political risk. In all three countries, political risk in the period March-September 1997, during which they were invited to join NATO, actually deteriorated. However, according to that magazine, political risk in comparable countries not invited to join NATO (Estonia, Slovakia, and Slovenia) worsened to an even greater extent.

Regional Cooperation

The Conference on Business Perspectives in Vienna has agreed on the so-called "Danube Recommendations 1998". I want to quote these Recommendations because they are also valid for this seminar:

"A graduated system" of partnership should be encouraged:

- Partnerships for Europe (twinning of all EU-member states as well as selected provinces or cities with counterparts in individual accession countries).
- Partnerships between countries of the region with the involvement of regional and local authorities in cross-border cooperation.
- Partnerships of public institutions with NGOs and private firms (consultants) which are already active in the region and have the necessary contacts and networks.
- Partnerships between more advanced transition countries and those less advanced for the provision of expertise and training.
- Partnerships of business sharing information and experience of development.
- Intra-regional trade and investment should be encouraged through deregulation and trade and investment agreements.
- Investors should be conceived as customers with agreements on investment conditions by public authorities being binding. Special zones with favourable investment conditions could be created.
- Certifications and norms should be harmonised to facilitate trade and investment flows.
- In order to improve cooperation opportunities, industrial organisations should introduce mutual information exchange and foster collaboration through trade missions, investment matching and networking of think tanks.

- Bilateral quotas for the mobility of professionals should be created immediately.
- Visa regulations and other entry restrictions should be simplified and eased for business and training purposes.
- With the aim of increasing transport speed and procedures at the frontiers, transnational initiatives need to be introduced to allow speedy transport in the region (example: international freight rail lines), non-tariff barriers to trade in the administrative area (customs) must be reduced (bilateral help in the training of customs officials), more frontier crossing points (twice as many within 10 years) among non EU members as well as on the Schengen exterior border should be set up.

References

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