Foreign Direct Investment and Regional Attractiveness

in Southeastern European countries

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Abstract:

The aim of this paper is to analyse the relationship between the inward Foreign Direct Investment in South-eastern European countries in relation with the factors which determine the ability of a country to attract foreign investment capital.

The paper begins with the definition of the main terms related with Foreign Direct Investment and literature review related with the factors which determine the regional allocation of the FDI flows. Specifically, the article focuses on the definition of the Foreign Direct Investment flows, regional attractiveness, as well as the factors which affect the location of FDI activities within and across countries and regions.

Then, the article presents a comparative analysis of the relative position of the South-eastern European countries, as far as FDI is concerned, in order to form a relationship between FDI and a selection of potential determining factors. The paper is completed with reference to prospects regarding the implementation and planning of an effective FDI attraction policy aiming at economic development and cohesion.

Key Words: Foreign Direct Investment flows, Regional attractiveness, Development

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1. Introduction

During last two decades, regional development and convergence of the lagging regions within the enlarged European Union has been one of the main objectives of the European development strategy, focusing on achieving regionally balanced development levels. Due to Eastern enlargement, regional disparities have broadened, whereas within South-eastern European countries, the bulk of the economic activity is concentrated in a limited number of regions, mainly the capital cities and surrounding areas.

There are major differences in level of prosperity, economic performance, output, productivity and employment, reflecting continuing structural weaknesses. These disparities arise due to structural deficiencies in key factors of competitiveness—inadequate endowment of physical and human capital, as well as lack of innovative capacity and effective business support, which restrain the growth of new economic activities and overall development. South - eastern European regions suffer from structural weaknesses, such as low productivity, low employment and social exclusion, which bound their competitiveness and prevent them from achieving sustainable economic growth. Development problems are more intense in lagging regions which lack the necessary endowments to compete with other regions in intra – and inter – country level. Lagging countries and regions pursue policies to promote economic development, using a variety of means and diverse targets. They include, among others, assistance for technology and innovation, help for restructuring industries facing difficulties, support for entrepreneurial activities and incentives to inward investment.

The success of these political operations is linked to the ability of economic agents to support integration with appropriate levels of productive investments. Among others, emphasis was put on the ability of these countries to attract foreign direct investment. The importance of structural reforms leading to a stable and working market economy, the implementation of an appropriate and transparent legal framework for the business environment, the restructuring of the industrial base through privatisation programmes are all issues stressed by the enlarged European Union, since these factors are all likely to lead to an increased volume of foreign investments, and hence to rapid integration (Altomonte and Guagliano, 2003).

2. Definition of F.D.I. term

Foreign direct investment (FDI) is a category of international investment involving a long-term relationship and reflecting a lasting interest in and control by a resident entity in one economy (foreign direct investor or parent enterprise) of an enterprise resident in a different economy (FDI enterprise or affiliate enterprise or foreign affiliate)[3]. Capital transferred from the parent firms add to local stock and contribute to increase the host country's production base and productivity through a more efficient use of existing resources. Foreign investments promote the diffusion of new technologies, know-how and managerial and marketing skills through direct linkages or spillovers to domestic firms. Finally FDI may also contribute to improve external imbalances due to their greater propensity to export with respect to domestic firms

3 This definition is based on the FDI concept as presented in the IMF Balance of Payments Manual (BPM 5, 1993)

(Altomonte and Guagliano, 2003)[4]. The main aspects of the benefits that FDI confers on the recipient country can be summarised to the following points[5]:

- FDI brings in financial resources
- FDI can attract and support the transfer of managerial skills and advanced technical expertise (know-how).
- FDI introduces improved and adaptable skills and new organisational techniques and management practices in the host economy.
- FDI bring in modern technologies, which could contribute in raising the efficiency
- FDI trans-national activities may provide improved access to export markets
- FDI cause spillovers of technologies, management experience and skills

3. Importance of F.D.I.

Foreign direct investment is considered to be an important feature of economic growth. This is because the internationalisation of production helps to better utilize the advantages of enterprises and stimulate technology transfer and innovative activity, raising a country's technological level. Furthermore, Foreign Direct Investment (FDI) can potentially play a key role in reducing regional disparities in economic performance not only as a source of income and jobs but as a means of transferring technology and know-how to lagging regions, It is particularly important for the accession countries, in need of substantial restructuring of their economies in order to increase their productivity and competitiveness. Moreover, a stable and capable inflow of FDI may strengthen the efficiency of related productive areas. Increasingly, FDI has been acknowledged as an influential and major medium to achieve development, growth and global cohesion process. Many countries are therefore actively trying to attract foreign investors in order to advance their economic development[6] (Markusen and Venables, 1998, Resmini and Altomonte, 2002).

F.D.I. is considered to be one of the most important elements of the strategy of national economies regarding growth and development[7]. For this reasons countries continuously try to attract foreign investment capital by adopting a favourable attitude towards F.D.I. During the last decades, most countries worldwide have released their corresponding policies so that they attract investment capital from multinational corporations. Hoping that F.D.I. will increase employment, exports, tax income and

[4] See Dunning (1992, 1998) for a general presentation of the theory of multinational enterprises, Caves (1996) for an application to developing countries, and Markusen (1995, 2002) for some hints on the relationships between the theory of MNEs and the new international trade theory. Altomonte (2000) provides a survey of the literature on MNEs in the CEECs, while Reiffers (1997) and Resmini (2002) do the same for the MED region.

[5] OECD, *Official development assistance and FDI: Improving the synergies*, by Vangelis Vitalis, Global forum on International Investment, Attracting FDI for development, Shangai, December 2002

[6] Modern growth theory emphasizes endogenous technological change as the engine of growth. A policy implication for developing countries that has been drawn from this theory is that foreign direct investment increases growth. However, welfare assessments must recognize that investment returns may be repatriated. Reis (2001) showed that foreign investment may decrease national welfare due to the transfer of capital returns to foreigners. Taking into account all the relevant effects, Reis (2001) asserted that welfare does not change monotonously with FDI and characterized the conditions that imply a positive or a negative welfare effect of foreign investment.

[7] Balasubramanyam et al (1996), Barrell and Pain (1997), Ramirez (2000), Buckley et al (2002)

the distribution of knowledge in the economy, a lot of governments all over the world have also adopt various types of investment motives, so that they encourage the foreign enterprises to invest in their country and their economy.

Based on the argument that F.D.I. may strengthen economic growth and development, a lot of countries have incorporated a spectrum of investment motives in order to convince foreign enterprises to invest in their economy. During last decade, a lot of countries have limited the capital flows controls and the restrictions of foreign exchange have been decreased or suppressed, while the cost of capital transfer has been decreased worldwide. As a result of these changes, in combination with the continuously increasing perception regarding the importance of F.D.I. in the economic growth of nations, a lot of national governments have advanced aggressive policies of providing investment motives so that they attract foreign investments (Simmons, 2003).

Table: Amendments to national legislations regarding F.D.I attraction in O.E.C.D. countries, 1991-2003

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Countries with amendments	35	43	57	49	64	65	76	60	63	69	71	70
Amendments, of which:	82	79	102	110	112	114	151	145	140	150	208	248
▪ More favorable to F.D.I.	80	79	101	108	106	98	135	136	131	147	194	236
▪ Less favorable to F.D.I.	2	-	1	2	6	16	16	9	9	3	14	12

Source: UNCTAD, World Investment Report, 2004

The promotion of a modern frame of attracting F.D.I. (with particular focus on the investment policy motives), its effective application (institutions and policy tools) and the promotion of the investment potential of a host country are three interrelated actions.

4. Attraction Motives of F.D.I.

Motives refer to economic advantages provided to foreign enterprises by a government, so that they are encouraged to locate in the specific potential host country[8]. A more general approach defines the provided motives as government owned energies or actions that have been planned aiming to affect the decision-making, to increase the rate of attribution of investment or to reduce the uncertainty of the potential investor[9]. The motives of location choice can be categorized in four general categories: motives related to the expected demand in a certain region, motives related to the factors of cost, motives related to the number the domestic and

[8] United Nations conference on Trade and Development, (1996), 'Incentives and foreign direct investment', United Nations series, A. N. 30, Geneva.
[9] O.E.C.D., 1989, Investment Incentives and Disincentives: Effects and International Direct Investment.

foreigner enterprises in the same region, and the motives related to the public policies of attracting investment capital[10].

Attracting F.D.I. constitutes one of the more important development activities worldwide. National economies make a wide use of investment motives so that they influence the decisions of location of foreign investors and the competition in national and regional level it is increased continuously. A general categorisation of motives of attracting of investments[11] distinguishes in tax motives, that refer to the profits of enterprise, its capital investment, the workforce, the raw material, the sales, the intermediary products, the financing motives, subsidies, loans, guarantees, attendance in investments of high commercial danger, and other motives, government owned attendance in the infrastructure, preferential prices of government services, governmental contract of market of products in low prices, benefits of advisory services. The motives of attracting F.D.I. may, according to Basile (2004), be categorized in categories, depending on the form that can have, such as a) financing motives, v) tax motives, c) motives of promotion of work, and d) indirect government contribution, for example the government investments[12]. The magnitude and the type of motives varies and includes tax exemptions, tax credits, advantages in enterprises that are installed in developmentally disgraced regions, subsidies of capital and infrastructure. Moreover, there are specific motives, so that are attract specific investors.

5. Localization factors of F.D.I.

Tinbergen (1962) and Linnemann (1966) connected economic flows between regions with certain determining factors, such as market size or market potential, distance, and barriers to international activity. According to UNCTAD (2001), the main traditional factors driving FDI location around the world, such as the large markets, the tenure of natural resources, and the access to low-cost labour are diminishing in importance. Instead, other factors are increasingly affecting the setting of trans-national corporations, such as policy liberalisation (i.e. favourable regulatory changes), technical progress (i.e. local conditions facilitating efficient operation of multinational corporations' technologies), and managerial and organisational factors (i.e. efficient management practices). Moreover, main location advantages refer to the access to good information and communication technologies, an appropriate institutional infrastructure and the availability of productive and well-trained personnel at competitive costs. According to Cheng and Kwan (2000), there is a set of five variables: access to national and regional markets; wage costs adjusted for the quality of workers or labour productivity, and other labour market conditions such as unemployment and the degree of unionisation; policy toward FDI including tax rates; availability and quality of infrastructure, and economies of agglomeration.

The political, economic and legal environment is also identified as a key factor for foreign investors. Lankes and Venables (1996) and Bevan and Estrin (2000) confirm the importance of institutional determinants and suggest that announcement of progress towards EU membership has a positive and significant influence on FDI inflows. Disdier and Mayer (2004) point out that location decisions are influenced

[10] Crozet et al. (2004)
[11] Guisinger (1986)
[12] Basile (2004)

significantly and positively by the institutional quality of the host country. Location choices are also overviewed by Fujita et al. (1999), Neary (2001) and Fujita and Thisse (2002). Stirboeck (2002) provided evidence on the importance of regional size, gross domestic product, population density, the number of patents, economic openness, capital market integration, and the peripheral or central location of the region in the explanation of the even or uneven allocation of investment[13]. More recently, Redding and Venables (2004) examine the situation under which individual firms choose their location. This decision seems to be associated negatively with production costs and positively with market access. Moreover, according to Disdier and Mayer (2004), location decisions are influenced significantly and positively by the institutional quality of the host country. Disdier and Mayer (2004) assert that the location choice of individual firms is determined also by market access and production costs. Investors avoid areas in which the cost of production is high and locate in central places that guarantee good access to the markets targeted. This market access effect is summarized in the market potential of firms' profits presented by Head and Mayer (2004).

According to Hoover and Giarratani (1985) location theory examines the spatial distribution of economic activity. They assert that one of the main characteristics of economic activities is their tendency to occur in spatial clusters and the lower cost of production resulting from agglomeration economies is an important cause of specialization and regional competitive advantage. Since Krugman (1991), the new economic geography has focused on the belief that specialization need not develop according to the comparative advantage of regions, but can be the result of historical conditions and macroeconomic processes. Thus, even similar regions can develop differently and the resulting patterns of growth may be different. A number of empirical studies on sectoral agglomeration tendencies as well as regional specialisation have emerged in the last years. An overview on recent descriptive and econometric studies on the named topics is given by Stirboeck (2001, 2002).According to McCann et al (2002) the process of economic diversification is driven by changes in production patterns, consumption patterns, and trade patterns (Schuh and Barghouti 1988; Barghouti et al. 1990; Petit and Barghouti 1992). In particular, variations in local information externalities, labour hysteresis effects and location-specific input sources can generate conditions under which not only is economic growth localized, but also different locations are consistently specialized in different activities[14]. Under these kinds of conditions, factor price adjustments are not sufficient to ensure that all areas are equally attractive as investment locations, either for a single sector, or for all sectors. The possibility for a firm to locate in an area according to classical location arguments asserts that the location decision is determined by considering the various local investment costs: such as those associated with the quality and availability of local labour, allowing for variations in efficiency wages and ease of labour acquisition; the level of local land prices; the distance-transactions costs involved in the shipping of goods; and the distance-transactions

[13] In an analysis of the determinants of the level of relative investment specialisation, Stirboeck (2002) provided evidence on the importance of regional size, gross domestic product, population density, the number of patents, economic openness, capital market integration, and the peripheral or central location of the region in the explanation of the even or uneven sectoral allocation of gross fixed capital formation investment.

[14] McCann et al 2002.

costs involved in the acquiring and transmission of market and input supply information[15]. MNE location behaviour can be considered either with respect to traditional location theories, or with respect to the organizational issues typical of international business research and is essential to consider the relationship between firm internalization issues and the institutional characteristics of cluster[16].

The empiric studies regarding the motives of attracting F.D.I. suppose that the foreign investors, as each domestic investor, seek the region which has the probability of higher rate of profit. The rate of profit is faced as a result of the combination of the characteristics of each region, as the cost of productive factors, the cost of transport, the size and the characteristics of local market, and the level of infrastructures[17]. Helpman and Krugman (1985), as well as Markusen and Venables (1998) provide the theoretical background for the undertaking of F.D.I. and Dunning (1993) describes the motives which lead to F.D.I. undertaking and to the cross-border investment activity. Lucas (1993) and Jun and Stogh (1996) support that the total stability and the general economic and social environment of a country determine to a large extent the attractiveness of a country as a host country, Haufler and Wooton (1999) focus on the size of market, the tax imposition of profits, the duties, and the indirect and direct taxation, while Bevan and Estrin (2000) support the importance of motives, as the cost of labor, the size of market and the general investment dangers. Cheng and Kwan (2000) found that the large regional markets, the level of infrastructure, and the preferential policy have a positive effect in the F.D.I., while on the contrary the level of cost of work had a negative effect. The effect of level of education was positive, but no statistically important. Moreover, there was also a powerful effect of F.D.I. on itself. Moreover, Chakrabarti (2003) develops a theory with regard to the territorial distribution of F.D.I. and the relative location factors. Among the main factors, Chakrabarti (2003) distinguishes the size of market and size of competitive markets, the cost of work, the duties, the height of interest-rates, the exchange parity, the political stability, the cost of transports, and political and economic characteristics of competitive host countries.

Globerman and Shapiro (2002) support that the economic success of a country depends to a large extent on its political, legal and institutional environment, that is the institutional infrastructure of a country. Furthermore, they examine the role of other forms of infrastructure, as the natural environment and the human capital and they assert that the institutional infrastructure constitutes the main factor of influence of investment decisions in F.D.I. [18]. Investments in institutional infrastructures not only attract investment capital, but also, create the conditions under which the domestic enterprises are developed and invest in other markets and economies (Lucas, 1990). Moreover, the empiric approach tends to shows that the inter-country and inter - regional differences on the growth and productivity rates are related with various institutional infrastructures (Mody and Srivasan, 1998 Hall and Jones, 1999 Altomonte, 2000 Bevan and Estrin, 2000 Morisset, 2000 Stevens, 2000 Roll and Talbott, 2001). Lucas, 1993, Jun and Singh, 1996, Holland and Pain, 1998, Resmini, 2000 focus on the macroeconomic stability (economic enlargement, inflation,

[15] McCann et al (2002).
[16] McCann et al (2002)
[17] Basile (2004)
[18] Dunning, 1981, Beckman and Thisse, 1986, Vickerman, 1990, Puga and Venables, 1996, Fujiita et al, 1999, Head et al, 1999, Castellani and Zanfei, 2003, Basile et al, 2004

exchange parity), the institutional stability (tax system, transparency of institutions), and the political stability. Coughlin, Terza and Arromdee (1991) consider motives such as income per capita, wages and the geographic degree of concentration, while Woodward (1992) the force of market and the low force of working trade unions.

Further studies determine the different aspects and combinations of the provided motives of F.D.I. attraction. Dunning (1993) reports the importance of natural resources in low cost, the improvement of effectiveness with exploitation of comparative advantages, the growth of market and increase GNP, the strategic objectives, as the acquisition of share of market.

Andersen (OECD, 1994) determines as main motives the access to the domestic market, the increase of share of market, prospect of purchase, the low cost of production, the sources of raw material, the geographic proximity, the bureaucracy, the administrative and legislative problems, the economic climate, the lack of operational infrastructure, the political instability, and cultural resemblances. Vincentz (1995) writes for the motives of market and motives of offer, particularly the low cost of work. Meyer (1996) focuses on the size of domestic market, the factors of cost, the purchasing force, the cost of work, the geographic proximity, the working force, the political and economic stability, and the lack of local competitors. Respectively, Lankes and Venables (1997) determine as motives the size of market, the political and economic stability, the geographic proximity, the natural resources, the regulating environment, the access to other markets, the low cost of specialized and unskilled work. Pye (1997, 1998) focuses on the size of market, the prospect of growth, the share of market, the advantages of cost of work, the total stability, the profitability, the access in the local market, the geographic proximity, the access to the markets, and the specialized working force. Kurz and Wittke (1997) study the effect of motives of offer, as the presence of natural resources in low cost and motives of market, as the growth of market and prospects of new sales. KPMG International (1998) in a relative study refers to the specialized working force, the cost of work, the existing enterprising contacts, the geographic locality, the proximity with domestic activities, the tax motives, the legislative system, the bureaucracy, the purchasing force, the taxation, the infrastructure, the stability economic and enterprising environment. In another study, Southeastern European Cooperative Initiative (SECI, 1998) recognized the importance of the stability of the overall environment, the infrastructure, the enterprising environment, and the F.D.I. policy. Altzinger (1999) reports as important motives the possibilities of purchase, the cost of wage, the creation of export base, the geographic proximity, and historical and cultural bonds.

More recently, Iammarino and Pitelis (2000) study the effects of motives as the economic growth, the geographic locality, the motives of investment, the cost of work, the share of market, the sources of raw material, the cultural resemblances, the bureaucracy, the enterprising infrastructure, the economic climate, the legislative system, the enterprising danger, the rights of property, the political certainty, and the level of exchange parity in regard to the domestic currency. Benacek V. et al (2000) determine as main motives the size of market, the possibility of increase and growth of market, the advantages of cost, as well as the macroeconomic and political stability.

A lot of other studies have also analyzed the factors of location of F.D.I. and have focused on the concentration of F.D.I. in the most developed regions in a country (Glickman and Woodward, 1988 bagchi-Sen and Wheeler, 1989 Coughlin et al., 1991 Hill and Munday, 1991 Woodward, 1992 Freidman et al., 1992 Geese, 1996 O'hUallachain and Reid, 1997 Chunlai, 1997 Devereux and Griffith, 1999 Head et al., 1999 Wei et al., 1999 Belderbos and Carree, 2000). Palaskas and Stoforos (2002) assert that rather important motives are the size of market (GNP), the cost of work, and the F.D.I. inflows in competitive host countries. Moreover, Palaskas, Pexlivanos, and Stoforos (2004) consider as the most important motives the political and economic stability, the dynamism of economy, the enterprising environment, the commercial completion, the cost of work, the privatizations, the geographic proximity, and the access in new markets.

Market mechanisms are mediated via a range of different types of institutions, which can be of an economic, political or legal nature. In situations where institutional environments differ significantly between countries, the overcoming of such differences may incur non-trivial transactions costs. From the perspective of international business, the existence of such transactions costs leads to reduced firm efficiency, and where such costs are very significant, they can lead to missing markets and an absence of trade. In order to encourage economic growth and efficiency, the harmonization of institutional environments between countries is therefore one of the fundamental strategies used in the development of areas of economic integration, such as is the case with the EU (Rosamond and Addison). The long run effect of these institutional changes will be a convergence in the economic performance of the various countries within the zone of integration (Barro & Sala-I-Martin, 1992) and an equalization of factor proportions across these countries[19].

6. F.D.I. trends in South-eastern European countries

The position towards inward foreign direct investment has changed significantly over the last decades, as most nations, including South - eastern European countries, have liberalised their policies to attract investment capital from multinational corporations. Expecting that FDI will raise employment, exports, tax revenue, and knowledge spillovers in the host country, many governments have introduced various forms of investment incentives, to encourage foreign owned companies to invest in their economy. These developments, coupled with the recently increased importance of FDI to the economic health of individual nations, have encouraged many national governments to be more aggressive incentive policy to attract this investment (Simmons, 2003). The combination of relatively low wages, low corporate tax rates and access to EU subsidies – enhanced by a favourable investment climate and free access to the rest of the EU market, makes the accession countries attractive locations for FDI, both from other EU countries and from third countries[20].

As far as the south-eastern European economic and development policy is concerned, during the last decade, it was characterized by a series of strategic plans, the aim of which was mainly the creation of business incentives, in order to assist the economic reconstruction and the regional development of the countries. In order to deal with the

[19] McCann et al (2002)
[20] 2004 Competitiveness report

arising changes and pursue the investment and regional development, states reformed the development laws, comprising the need to attract foreign investment capital. The investment laws posed, in fact, the regional development issue and helped the investors to extract capital through significant fiscal and financial provisions introduced by the government incentive policy.

Reforms affecting world trade and the increasing pace of globalisation, affected South – eastern European FDI since the mid – 1980s. Expanded access to foreign markets resulted to increased flows of goods and services and capital across national borders, to the extent that, since the mid-1980s, FDI has experienced faster growth than world trade and the activities of foreign affiliates have continued to accelerate in recent years. During last two decades there was a major entrepreneurial activity, in both trade and foreign direct investment (FDI), in the countries of Central, Eastern and South-Eastern Europe. (Petrochilos, 1997, 1999; Salavrakos, 1997). An increasing number of neighbouring firms have acquired in recent years firm-specific advantages in the form of patents, own technology, etc., which have enabled them to upgrade their operations and enhance their productivity. In addition, the rapid changes brought about by the end of the Cold War and the break-up of the former Soviet Union have helped to create the conditions for extending the influence of the free enterprise system throughout the former command economies. As a consequence, the countries of south-eastern Europe welcomed the foreign presence as a useful means towards achieving their aims of a closer economic integration with Western economic structures (Salavrakos and Petrochilos, 2003). As a result, there was a significant increase in the F.D.I. level in all the countries of the south-eastern Europe region during the last decade, as it is demonstrated in the following table.

Table 1: FDI Inflows in constant 1995 prices
(mill. US Dollars)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Czech Republic	8683	2561.9	1428.2	1301.1	3716.4	6326.2	4980.2	5644.6	8483.5	2591.6
Estonia	214.4	201.5	105.2	266.2	580.5	305.0	387.0	542.0	284.0	891.0
Greece	1166.1	1197.7	1196.4	1088.6	73.9	561.5	1108.6	1589.5	50.1	661.8
Spain	9275.8	6285.1	6820.6	6387.8	11798.4	15758.8	37530.2	28010.1	35939.8	25649.3
Italy	2235.6	4816.2	3534.9	4962.5	4279.8	6911.4	13377.3	14873.4	14558.2	16979.2
Cyprus	:	:	:	:	:	685.0	804.0	652.0	614.0	830.0
Latvia	214.5	179.6	381.7	521.1	356.7	347.0	411.0	163.0	384.0	360.0
Lithuania	313.0	72.6	152.4	354.5	925.5	486.0	379.0	446.0	732.0	179.0
Hungary	1143.5	5101.9	3300.4	4170.9	3337.1	3313.1	2763.0	3936.0	2844.6	2470.0
Malta	:	:	:	:	273.0	822.0	622.0	281.0	428.0	380.0
Poland	1875.0	3659.0	4498.0	4908.2	6364.9	7269.6	9341.0	5713.0	4131.0	4225.0
Portugal	1254.6	660.1	1488.5	2478.8	3143.5	1233.5	6788.6	5893.7	1846.3	962.5
Slovenia	128.1	177.4	194.0	375.2	247.9	106.0	137.0	369.0	1606.0	181.0
Slovakia	272.9	241.4	395.7	230.6	706.8	428.5	2383.1	1584.1	4126.5	593.8
Bulgaria	105.4	90.4	109.0	504.8	537.3	819.0	1002.0	813.0	905.0	1419.0
Romania	341.0	419.0	263.0	1215.0	2031.0	1041.0	1037.0	1157.0	1144.0	1566.0

Source: Eurostat, 2004

During mid- 1990s to 2001, almost 70% of FDI inflows to these countries go to just three of them — Poland, which alone accounts for 35% of the total, the Czech Republic and Hungary. In Poland, therefore, FDI amounted to an average of 4½% of GDP over the three years 1999 to 2001 and in Hungary, to just over 4%, less than in most other countries. Although in the Czech Republic, FDI was higher than anywhere else relative to GDP (over 9%) other than in Malta (16%), it was also relatively high in Estonia and Bulgaria, countries with relatively low levels of GDP per head even within the region. At the same time, it was relatively low in Slovenia, in which GDP per head is relatively high.

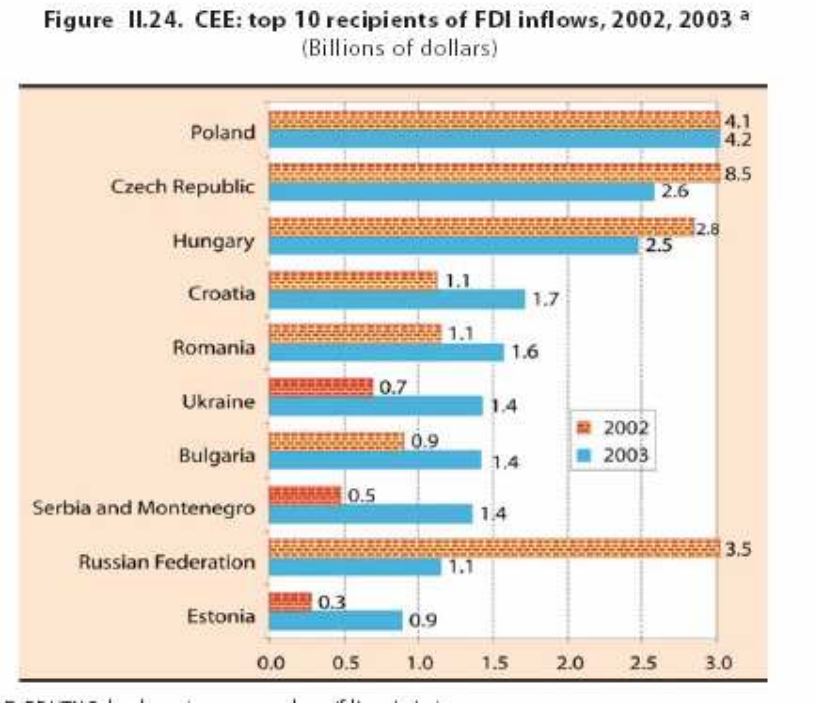
The Czech Republic and Poland increased the level of FDI inflows due to large privatisation projects. Together with Hungary, they are still on the net receiving end of the FDI spectrum, as the companies in each country have been able to invest only negligible amounts abroad. At this point, it is worth looking at the macroeconomic indicators of these south-eastern European countries. During last decade, these countries presented a rather significant improvement, as far as the main economic indicators are concerned.

The Czech Republic, even though it had relative increases and decreases of the G.D.P. level since 1994, the overall GDP level increased to 71.1% of the EU-25 average level, one of the highest levels in the region. In addition, the country presented rather significant improvements regarding the general economic environment. For example, inflation level dropped from 9.1 in 1996 to almost zero in 2003 and trade flows increased from 42,272 million US dollars in 1995 to 50,931 million US dollars in 2004, together with a significant increase in labour productivity (during the last five years, the labour productivity per person increased from 55.9 to 61,9, and the labour productivity per hour from 42,6 to 48,5). Poland experienced a rather significant increase in its GDP level, from 40.8 in 1995 to 47.4 of the EU-25 average level in 2004 along with a rather significant increase in the inflation rate, from almost 17% in 1995 to 0.7 in 2003. Moreover, the economy openness improved and the trade flows increased from 103,948 in 1995 to 150,056 million US dollars in 2004. There was also an important development regarding the labour productivity level (the labour productivity per person increased from 40.6 in 1995 to 51.7 in 2004. Furthermore, Hungary improved its macroeconomic situation, experiencing major increase in the GDP level from 49.6 in 1995 to 61.7 of the EU-25 average level in 2004. The same development was also in the trade flows, from 33,614.4 in 1994 to 47,798.4 million US dollars in 2004 and in the labour productivity level (labour productivity per person increased from 53.8 in 1995 to 64.2 in 2004).

During 2002 – 2003, FDI inflows into South-eastern European countries declined from a record $31 billion in 2002 to a low of $21 billion in 2003. This was almost entirely due to the end of privatization in the Czech Republic and Slovakia. Inward FDI in the rest of the region declined only marginally, from $19 billion to $18 billion. Overall, FDI inflows rose in ten countries and fell in nine, with Poland replacing the Czech Republic as the top recipient. The share of inward FDI in gross fixed capital formation fell from 17% in 2002 to 10% in 2003. No large-scale diversion of FDI from the older EU members to South-eastern European countries occurred during 2003. In contrast, at $7 billion, FDI outflows from South-eastern European countries reached a new record in 2003, up from $5 billion in 2002. Despite the decline in

2003, the medium-term prospects for growth of FDI in South-eastern European countries are favorable[21].

Picture 1: CEE, top 10 recipients of FDI inflows, 2002, 2003



Source: UNCTAD, World Investment Report, 2004

Outside the Czech Republic and Slovakia, the decline in FDI inflows was small, leading to the re-establishment of Poland, the Czech Republic and Hungary as the three top locations for inward FDI in the region. The group of eight CEE countries that joined the EU in May 2004 – the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovenia, Slovakia – saw its FDI inflows shrink from $23 billion in 2002 to $11 billion in 2003. In the other 11 countries of the region, including Bulgaria and Romania, FDI inflows rose from $8.6 billion in 2002 to $9.5 billion in 2003, representing an increase in their share of total FDI inflows from 28% in 2002 to 45% in 2003. In the South-Eastern European part of this group, a proportion of the high FDI can be explained by privatization deals, although these do not yet match the size of previous privatization deals in countries such as the Czech Republic, Hungary and Poland. The distribution of FDI inflows by range and country is presented in the following table:

Table 2: CEE: country distribution of FDI inflows by range, 2003

Range	Country
More than $ 1 billion	Bulgaria, Czech Republic, Hungary, Poland, Romania,
Less than $ 1 billion	Estonia, Latvia, Lithuania, Slovakia, Slovenia

Source: UNCTAD, World Investment Report, 2004

[21] 2004 Competitiveness Report

The overall FDI performance during the last years is presented in the following tables, which present the low and high performers of the south-eastern Europe region and the country ranking.

Table 3: Matrix of inward FDI performance and potential performance

	2000 - 2002	
	High FDI Performance	**Low FDI Performance**
	Front runners	**Below potential**
High FDI potential	Bulgaria, Croatia, Cyprus, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Malta, Poland, Portugal, Slovakia, Slovenia, Spain,	Greece, Italy,
Low FDI potential	**Above potential**	**Under performers** Romania,
	1993 - 1995	
	High FDI Performance	**Low FDI Performance**
	Front runners	**Below potential**
High FDI potential	Czech Republic, Estonia, Hungary, Malta, Poland, Slovakia, Spain,	Bulgaria, Cyprus, Greece, Italy, Portugal, Slovenia,
Low FDI potential	**Above potential** Latvia,	**Under performers** Lithuania, Romania,
	1988 - 1990	
	High FDI Performance	**Low FDI Performance**
	Front runners	**Below potential**
High FDI potential	Cyprus, Greece, Malta, Portugal, Spain,	Hungary, Italy, Poland,
Low FDI potential	**Above potential**	**Under performers**

Source: UNCTAD, World Investment Report, 2004

Table 4: Rankings by inward FDI Performance Index, 2001 – 2003

Ranking	**Country**
10	Estonia
12	Slovakia
13	Czech Republic
21	Bulgaria
24	Cyprus
33	Hungary
36	Spain
41	Latvia
53	Slovenia
55	Lithuania
62	Romania
68	Poland
71	Portugal
81	Malta
98	Italy
127	Greece

Source: UNCTAD, World Investment Report, 2004

On the other side, according to 2004 FDI Confidence Index[22], despite entry into the European Union, global investors expressed slightly lower levels of interest in new EU member markets. Poland dropped from fourth to 12th place, the Czech Republic from 13th to 14th place and Hungary from 17th to 19th most attractive global investment environment. Among the leading perceived threats to the competitiveness of the ten new EU members, global investors cited poor infrastructure (67% of investors), corruption (60%), and the erosion of low-cost advantage (53%). While they are expected to bring infrastructure investments and regulatory stability within the EU single market, the economic and social costs of adjustment remain high. EU law will likely add a new layer of bureaucracy and may undermine new members' relative FDI advantages in areas such as favourable tax and labour conditions. However, according to global investors, among the top ten countries and regions with the greatest positive outlook, half are in Eastern Europe: Poland, the Czech Republic, Russia, Hungary and the Baltic states.

On the other hand, within the countries there is a high degree of concentration of FDI in and around capital cities. In spite of the FDI inflows enhancement in south-eastern Europe, FDI inflows tend to go disproportionately to the economically stronger regions both within and across countries. Within Europe, inward investment went disproportionately to the more prosperous regions and relatively little goes to lagging areas. Within countries, however, the data available indicate a relatively high degree of concentration of FDI in and around capital cities, as well as the most developed areas. In Hungary, over two-thirds of inward investment in 2001 went to the region in which Budapest is located; in the Czech Republic, 60% went to Prague and the surrounding region. In Slovakia, some 63% went to Bratislava. In Poland, on the other hand, where there are a number of large cities apart from Warsaw, FDI inflows are less concentrated[23].

As far as the sectoral FDI distribution is concerned, a shift towards services brings about structural change service-related FDI inflows into CEE have followed the trend of growth in services (in GDP, employment, FDI) worldwide and in the region itself. In the CEE region, services had been largely neglected under the centrally planned economic system. With EU enlargement and the integration of the market for services, pressures have increased to upgrade services to the level of the old EU members and to attract FDI into higher value-added services, including export-oriented services. In the largest host countries of the region (the Czech Republic, Hungary, Poland, the Russian Federation), the industry composition of inward FDI is gradually shifting from manufacturing towards services, and within services, from network industries privatised in earlier years towards business services. In the Czech Republic, Hungary and Poland, services had already become dominant in FDI in the late 1990s.

[22] The FDI Confidence Index, (2004) is based on an annual survey of CEOs, CFOs and other top executives of Global 1000 companies, conducted by the Global Business Policy Council of A.T. Kearney.
[23] Third Report On Economic And Social Cohesion, 2004

7. Conclusion

The challenge facing South-eastern European countries is to strengthen competitiveness over the long-term in order to sustain high rates of economic growth while at the same time increasing employment rates. The challenge for cohesion policy is to help them bring their infrastructure up to date, modernise their education and training systems and create a business environment favourable to investment so that they can sustain the high rates of growth required for them to converge towards employment and income levels. While it is instructive to consider the performance of the EU economy overall, it is important not to ignore the wide disparities in output, productivity and employment which persist between countries and regions. These disparities stem from structural deficiencies in key factors of competitiveness—inadequate endowment of physical and human capital (of infrastructure and work force skills), a lack of innovative capacity, of effective business support and a low level of environmental capital (a blighted natural and/or urban environment).

If South-eastern European countries are to realize their economic potential, then all regions need to be involved in the development process. The cost of not pursuing a vigorous cohesion policy to tackle disparities is, therefore, measured in economic terms, in a loss of the potential real income and higher living standards. Given the interdependencies inherent in an integrated economy, these losses are not confined to the less competitive regions but affect every activity in the country.

Moreover, incentive policies should include macroeconomic, political and social stability, economic liberalisation, competition conditions, amenable investment environment, people, improved infrastructure, strategic location, strong competition, linkage creation, and technical networks. In addition, government, enterprises, and society as a whole can favour FDI flows and their positive impact on the economy through public and corporate governance. They should focus on improving the micro- and macro-economic functioning of the economy and strengthening commercial and judicial institutions that provide stability to investors, domestic as well as foreign. The incentives should not be of an *ex ante* type that is granted prior to the investment, but they should instead promote those activities that create a potential for spillovers. In particular, these include education, training, and R&D activities, as well as linkages between foreign and local firms.

Strengthening regional competitiveness throughout the countries and helping regions fulfil their capabilities will boost the growth potential of the economy as a whole to the common benefit of all the regions. The challenge for cohesion policy is to invest in the competitiveness factors so that Member States and regions can overcome their structural problems.

The challenge ahead for structural policy is to classify the structural deficiencies in each region which have the most negative consequence on competitiveness and growth potential and to give priority to deal with these first; to create a long-term development strategy for each region in line with its comparative strengths and weaknesses, which recognizes that all requests cannot be undertaken at the same time and which orders investment projects in the light of the contact between them and the growth path it is intended to follow over the long-run; to avoid disproportionate concentration of investment in the present growth centers where the impact on

economic activity might be greatest in the short-term but which may be at the expense of balanced development over the long-run; to assist reinforcing the administrative capacity for designing, implementing and managing development programs at regional level.

From a policy perspective, for regional development to be sustained requires favourable conditions at the national level, in particular a macroeconomic environment conducive to growth, employment and stability and a tax and regulatory system which encourages business and job creation. At the regional level, two complimentary sets of conditions need to be satisfied. The first is the existence of a suitable endowment of both basic infrastructure (in the form of efficient transport, telecommunications and energy networks, good water supplies and environmental facilities and so on) and a labour force with appropriate levels of skills and training. The second set of conditions, which directly relates to the factors of regional competitiveness which are important in the knowledge-based economy, is that innovation should be accorded high priority, that information and communication technologies (ICT) should be widely accessible and used effectively and that development should be sustainable in environmental terms. They include the capacity of a regional economy to generate, diffuse and utilise knowledge and so maintain an effective regional innovation system; a business culture which encourages entrepreneurship; and the existence of cooperation networks and clusters of particular activities. It is widely accepted that good governance and an effective institutional structure are an important source of regional competitiveness through facilitating cooperation between the various parties involved in both the public and private sectors. In particular, they can improve collective processes of learning and the creation, transfer and diffusion of knowledge and transfer, which are critical for innovation. In addition, they can cement networks and public-private partnerships and so stimulate successful regional clusters as well as regional innovation strategies and policies. They are important for less-favoured regions which tend to have deficient systems of governance and inadequate understanding of science and technology policy issues yet face significant economic, technological and social change.

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