

RECENT DEVELOPMENTS IN FDI IN THE NEW EU MEMBER STATES IN CENTRAL EUROPE

The new EU Member States in central Europe (the Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Slovenia and Slovakia; together known as the EU8) are currently experiencing a period of relatively strong growth, above the level of the euro area. Foreign direct investment (FDI) is commonly considered to be an important driver of economic growth, as the internationalisation of production helps enterprises and countries to make better use of their advantages, improves competitiveness in markets and stimulates technology transfers and innovative activity. Furthermore, FDI can complement domestic financial sources, which may sometimes be scarce in catching-up countries. Against this background, this box provides some more details on recent developments in FDI in the EU8 countries.

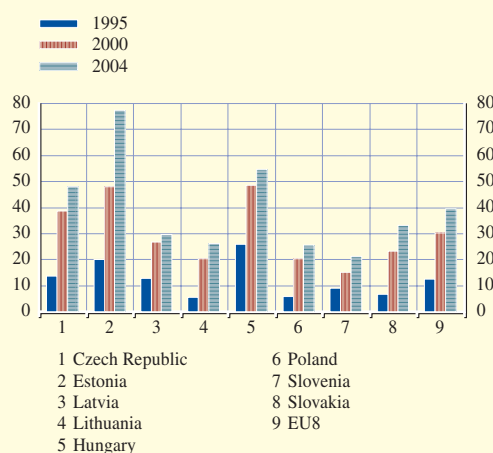
The EU8 countries have accumulated substantial FDI inflows since the early stages of their transition. Annual FDI inflows have ranged on average between 2% and 6% of GDP since 1995, though the pattern has varied strongly from country to country.¹ Overall, FDI inflows in the EU8 picked up significantly between 1995 and 2000, to 6.2% of GDP, but decelerated somewhat at the beginning of the new decade. In 2004 FDI inflows in the EU8 amounted to 3.3% of GDP (€15 billion). In line with the strong FDI inflows, FDI stocks have been growing fast in most EU8 countries, reaching an average of 40% of GDP in 2004 (see Chart A). Estonia has experienced the highest accumulation of FDI relative to its GDP (close to 80%), followed by Hungary and the Czech Republic. In Latvia, Lithuania, Poland, Slovenia and Slovakia, FDI inflows have been more moderate and FDI stocks remain below the EU8 average.

Various factors have shaped FDI accumulation in the EU8, EU accession prospects and privatisation being among the main drivers. Particularly during the 1990s privatisation was a major factor. Indeed, differences in the timing of privatisation and the degree of openness to foreign investment help to explain country-specific differences in FDI positions.² More recently, other determinants of FDI, such as cost factors, the size of the market and the location, overall political and macroeconomic stability, and FDI policies, have gained in importance.

The services sector has received the majority of FDI inflows in the EU8. Services sectors, in particular financial intermediation, trade, real estate and transport, comprise around 55% of the total FDI inward stock, while manufacturing comprises around 40%. FDI in the services sector is

Chart A Inward FDI stock

(as a percentage of GDP)



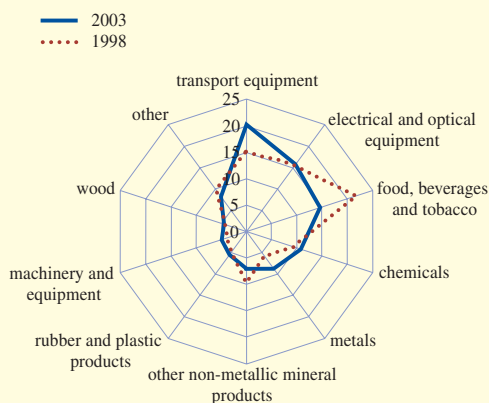
Sources: WIIW and ECB.

1 The FDI data used are from the database of the Wiener Institut für Internationale Wirtschaftsvergleiche (WIIW); data on FDI stocks for all EU8 countries are currently available for 1994-2004, flows for 1995-2004 and a breakdown of FDI stocks by sector, industry and investing country for 1998-2003.

2 For FDI restrictions, see OECD (2003), World Economic Outlook, Paris. See also Golub, S., *Measures of restrictions on inward foreign direct investment for OECD countries*, OECD Economic Studies No. 36, 2003.

Chart B Inward FDI stock in the EU8 by manufacturing sector

(as a percentage of total)



Source: WIIW.

Chart C Inward FDI stock in the EU8 by country of origin

(percentages)



Source: WIIW.

Note: Data relate to December 2004, with the exception of the Czech Republic, Hungary, Poland and Slovenia, for which data relate to December 2003.

usually motivated by market seeking, although outsourcing and FDI in export-oriented services also seem to have become important factors recently.

In the manufacturing sector, available data suggest that foreign investors' activity has been concentrated in a few industries, notably in transport equipment, electrical and optical equipment, and food, which have received around one-half of the FDI in manufacturing (see Chart B). Transport equipment has gained in importance in recent years (together with the metal industry), which may indicate the creation of "manufacturing export platforms" in these industries. In contrast, FDI in the food industry has become relatively less important, as this has mostly related to privatisation and the buying of existing firms and less to relocation. Other major industries have broadly retained their shares in FDI.

The EU8 countries have on average received the majority of their inward FDI from the euro area, with the euro area's share in inward FDI stock in the EU8 gradually increasing from 64% in 1998 to 71% in 2004. The most active countries have been Germany and the Netherlands, together accounting for more than 40% of total FDI inward stock, followed by Austria and France with shares of 8-9% each. The varying shares of individual countries highlight the importance of geographical factors, although some countries may act as channels for other countries' investment, owing, for example, to favourable financial and tax environments.³

Looking ahead, privatisation has largely ceased to be one of the main drivers of FDI in the EU8 countries, which is also reflected in the deceleration of FDI inflows to most EU8 countries over the last few years. Against that background, the institutional and business environment, as well as economic features that attract non-privatisation-related FDI, will become increasingly important for the EU8 countries in order to maintain high levels of FDI inflows. In particular, a stable macroeconomic environment, a favourable cost structure, the availability of skilled labour and a sufficiently developed infrastructure are needed to secure future FDI inflows.

³ The FDI outflows from Luxembourg and the Netherlands partly reflect their role as a channel for investment originating from outside the euro area, since a number of multinationals channel FDI through special purpose entities (SPEs) in these two countries (ECB Occasional Paper No. 30, June 2005, p. 58).