Addendum 13b

Seminar on the Promotion of Foreign Direct Investment to Southeastern Europe

Masahiko YOSHII,

Professor, Graduate School of Economics, Kobe University

English

8 November 2002, Tokyo, JIIA

Ministry of Foreign Affairs of Japan
The Japan Institute of International Affairs

Nov. 8, 2002

Seminar for Promotion of Investments in Southeast Europe
(Japan Institute of International Affairs)

Masahiko Yoshii
(Graduate Course of Economic Studies, Kobe University)

Southeastern European Countries need to improve their balances of payments by increasing the inflow of direct investment and cutting down on grant aid and debt in the short term, and they also need to improve their trade balances by promoting exports through the competitiveness improvement effect of direct investment in the long run. From this point of view, the incentives for foreign direct investment (FDI) in Southeastern European countries are not attractive enough. It would be difficult to compete with Central European countries over FDI without offering more attractive incentives. We anticipate competition over FDI incentives will take place to the extent permitted in the relationship with the EU. The comparative advantage of cheap labor currently enjoyed by Southeastern European countries is expected to diminish sooner or later. Establishing technological competitiveness over a short period before today's comparative advantage fades away is key to the FDI policies of Southeastern European countries.

1. Present Macroeconomic Condition of the Countries Participating in the Seminar

The present macroeconomic condition of the countries participating in the seminar (Southeast European countries) and Central European countries is shown in Table 1.

Southeast European countries experienced serious deterioration of macroeconomic performance owing to transitional recession or civil war in the 1990s. As shown in Table 1, however, the region started demonstrating favorable performance with GDP growth rates turning positive in almost all countries and inflation (the rate of increase in the consumer price index) dropping below the level of Central European countries in all countries except Romania and Yugoslavia.

There remain, however, several problems.

First, GDP per capita in Southeastern European countries, with the exception of Croatia, is on the level of 1,000 USD per year. This low income level is a negative factor for attracting FDI, as is shown in the next section.

Table 1 Macroeconomic performance

	Area	Population	GDP growth rates	GDP per capita	CPI	Export	Import	Trade balance	Current balance
	km^2	2000, thou	2000,%	2000, USD	2000,%		2000, mil USD		
Albania	28,750	3,401	7.8	1,094	0.1	256	1,070	-814	-260
Bosnia-Herzegovina			5.0	996	1.9	732	2,348	-1,616	-909
Bulgaria	110,910	8,170	5.8	1,476	9.9	4,812	5,988	-1,175	-701
Croatia	56,540	4,381	3.7	4,179	5.3	4,567	7,771	-3,204	-399
Macedonia	25,710	2,026	5.1	1,686	9.2	1,367	1,968	-601	-279
Romania	238,391	22,443	1.6	1,644	45.7	10,366	12,050	-1,684	-1,400
Yugoslavia	56,270	10,634	5.0	942	60.4	1,923	3,771	-1,849	-680
Czech Rep	78,860	10,272	3.1	4,797	3.9	29,052	32,183	-3,131	-2,273
Hungary	93,029	10,024	5.2	4,552	10.0	21,844	24,020	-2,176	-2,081
Poland	312,685	38,649	4.0	4,108	10.1	28,277	41,422	-13,145	-9,892
Slovakia	49,035	5,401	2.2	3,556	12.0	11,870	12,786	-917	-713
Slovenia	20,273	1,989	4.6	9,073	8.9	8,808	9,947	-1,139	-612

Eurostat, *Statistical Yearbook on Candidate and South-East European Countries 2002.*
EBRD, *Transition Report 2001*

The second problem is the balance of payments (Table 2). With the exception of Croatia, where the service balance surplus from tourism is high, the current balance of Southeast European countries is improving through current transfers, suggesting that grant aid plays a big role. In regard to the balance of payments, the inflow of direct investment has an effect in improving the international balance of payments in Bulgaria, Romania and Croatia but plays a small role in other countries. There are also countries where surplus from other investments plays a big role in improving the balance of payments, suggesting the existence of debt financing by government and other entities.

As for future direction, it will be necessary to improve the balance of payments by increasing the inflow of direct investment and cutting down on grant aid and debt in the short term while promoting export through the competitiveness improvement effect of direct investment to improve the balance of trade in the long term. Direct investment policies in the Southeast European countries will be discussed below from this point of view.

Table 2 Balance of Payments (2000, Mil EUR)

	Albania	Bulgaria	Romania	Croatia	Macedonia	Yugoslavia
Current account	-164	-761	-1,474	-466	-117	-22
trade balance	-882	-1,275	-1,827	-3,490	-604	-119
services, net	24	548	-276	2,470	-59	22
income, net	116	-348	-305	-404	-49	0
current transfers, net	577	314	933	958	596	74
Capital account	84	27	39	23	0	15
Financial account	218	809	1,123	974	43	7
direct investment, net	155	1,088	1,124	1,145	191	2
portfolio investment, net	-27	-194	111	756	0	0
other investment, net	-7	358	895	-297	107	21

2. Motivation of FDI

Potential motivations behind companies making foreign direct investment are as follows.

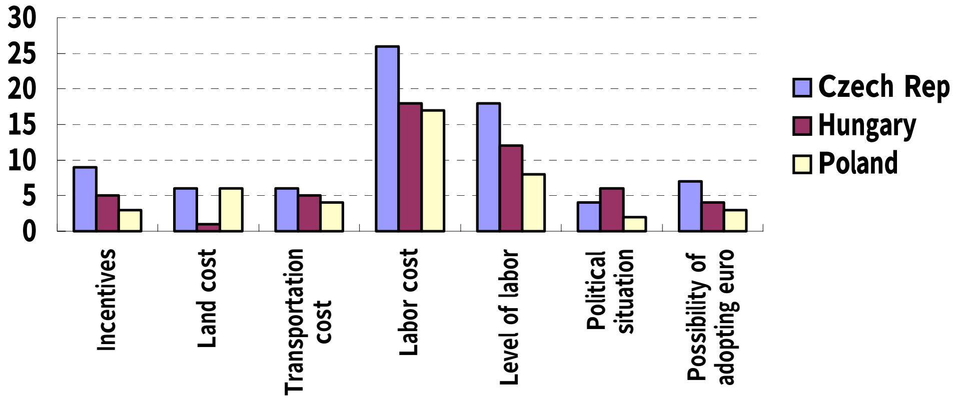
- Natural resources
- Market proximity
- Cost saving
- Avoidance of trade friction

Under which of these patterns do the current and prospective inflows of direct investment to Southeast European countries fall? We may safely exclude “natural resources” and “avoidance of trade friction” from our consideration in view of the scarcity of natural resources in Southeast Europe and the lack of major trade issues with the EU and other foreign countries (although investments for avoiding local content regulations may be made in the event such regulations are imposed).

Secondly, what is the market scale of Southeast European countries? As we have seen in the previous section, the national income of Southeast European countries remains at a low level. The percentage vis-à-vis the average GDP per capita for the current 15 member countries of the EU is as low as 7% and 28% in Bulgaria and 8% and 23.3% in Romania (current prices and purchasing power parity, respectively). Moreover, the small population of Southeast European countries — 22 million in the most populous Romania and 2.2 million in the least populous Macedonia — does not make the region an attractive market *per se*. In this respect, they are different from the Central European countries that have already reached 50 to 60% of the purchasing power parity average GDP per capita of the EU members.

For this reason, cost saving would provide the main incentive for companies in Europe as well as those in the U.S. and Japan to invest in a region neighboring the giant European market.

Table 3 Why Japanese companies have invested in Central European countries



The Nikkei, November 30, 2001

Since cost saving is the primary reason behind the expansion of Japanese companies into Central European countries, this aspect should become even more important in Southeast European countries (see Table 3). (While proximity to Russia, which may rank as a big market in the future, could provide an incentive for European and American companies to invest in Central Europe, Japanese companies are not likely to have this incentive.)

Cost-saving direct investment can be divided into horizontal labor specialization (to take advantage of economies of scale through specialized division of labor backed by advanced technology and know-how) and vertical labor specialization (or division of labor in production processes) based on low wages. Let us take a look at the level of competitiveness based on the present level of technology and know-how in Southeast European countries.

Firstly, since Southeast European countries are still proceeding with the transition to a market economy, let us see to what extent transition to a market economy has been achieved in the past 10 years by taking a look at the EBRD transition indicators (2001) (Table 4).

Table 4 EBRD Transition Indicators (2001)

	Private sector share of GDP	Enterprises: Large-scale privatization	Enterprises: Small-scale privatization	Enterprises: Governance & enterprise restructuring	Markets and trade: Price liberalization	Markets and trade: Trade and foreign exchange system	Markets and trade: Competition policy
Czech Rep	80	4	4+	3	3	4+	3
Slovakia	80	4	4+	3	3	4+	3
Hungary	80	3+	4+	3+	3+	4+	3
Poland	75	3+	4+	3+	3+	4+	3
Slovenia	65	3	4+	3-	3+	4+	3-
Albania	75	2+	4	2	3	4+	2-
Bulgaria	70	4-	4-	2+	3	4+	2+
Romania	65	3+	4-	2	3+	4	2+
Croatia	60	3	4+	4-	3	4+	2+
Macedonia	60	3	4	1	3	4	2
Bosnia-Herzegovina	40	2+	3-	2-	3	3	1
Yugoslavia	40	1	3	4	3	3	1

	Financial: Banking system	Financial: Securities & non-bank financial institutions	Infrastructure: Telecom	Infrastructure: Electric power and postal service	Infrastructure: Railways	Infrastructure: Roads	Infrastructure: Water and sewage
Czech Rep	4-	3	4	3	2+	2+	4
Slovakia	3+	2+	2+	3	2+	2+	2+
Hungary	4	4-	4	4	3+	3+	4
Poland	3+	4-	4	3	4	3+	4
Slovenia	3+	3-	3	3	3+	3	4
Albania	2+	2-	3+	2+	2	2	1
Bulgaria	3	2	3	3+	3	2+	3
Romania	3-	2	3	3	4	3	3
Croatia	3+	2+	3+	3	2+	2+	3
Macedonia	3	2-	2	2	2	2	2
Bosnia-Herzegovina	2+	1	3+	2	2+	2	1
Yugoslavia	1	1					

EBRD, *Transition Report 2001*

When seen as a whole, Southeast European countries have areas where transition is taking place to a degree comparable to Central European countries (e.g., small-scale privatization, price liberalization and liberalization of trade and foreign exchange systems). On the other hand, these countries lag in areas such as large-scale privatization, governance & enterprise restructuring, competition policy and finance. In addition, infrastructure improvement on par with Central European countries has been attained with regard to electric power and postal service while a slight lag can be seen in telecommunication, railroad and roads and a more significant one in water and sewage. By country, comparative slowness in transition to a market economy and in infrastructure improvement is conspicuous in Albania and the former Yugoslavian countries with the exception of Croatia.

One can easily imagine that lagging transition to a market economy and delays in infrastructure improvement—along with undeveloped legal systems—have the effect of limiting FDI from companies of the developed countries to Southeast European countries.

Table 5 illustrates the competitiveness indicators of Bulgaria and Romania. The list was created by giving up to 7.0 points to 20 growth engines in examining the competitiveness of 75 countries in the world in a manner similar to the competitiveness indicators the World Economic Forum calculates every year. (Unfortunately, this study was intended for obtaining the competitiveness of countries applying for EU membership and has not been conducted for other Southeast European countries.) Group 1998 consists of five countries that in 1998 started negotiations for joining the EU (Czech Republic, Estonia, Hungary, Poland and Slovenia) and Group 2000 consists of countries that in 2000 started negotiations for joining the EU (Bulgaria, Latvia, Lithuania, Romania and Slovenia).

As can be seen from these tables, the rankings for Group 1998 exceed those for Group 2000 in the majority of growth engines (18 out of 20) and the rankings for Romania and Bulgaria were lower than those of Group 1998 and Group 2000 in most cases. In other words, Southeast European countries, as represented by Romania and Bulgaria, do not possess industrial competitiveness based on technology and know-how, and must relay on price competitiveness based on low wages to compete in today's market.

Table 5 Competitiveness Indicators

	Macroeconomic stability	Start-up conditions	Financial sytem	Openness to international trade	Quality of government	Capital accumulation	Low taxes	Innovations	Technology transfer	New Economy
Bulgaria	4.4(55)	2.0(69)	2.8(62)	4.9(65)	3.7(24)	1.8(72)	2.2(64)	3.1(64)	3.8(70)	4.4(50)
Romania	4.5(53)	1.0(75)	2.6(64)	5.6(52)	1.7(66)	2.4(61)	2.0(69)	2.6(71)	5.8(44)	4.0(59)
Group 1998	5.1	3.9	3.8	6.5	3.1	3.7	3.3	4.0	5.3	5.4
Group 2000	4.7	2.3	3.0	6.1	3.0	3.0	2.7	3.3	4.8	4.7
EU average	5.8	4.8	4.8	6.7	3.8	3.2	2.6	5.1	5.2	5.9

	Education	Infrastructure	Rule of law	Red tape	Corruption	Competition	Local supplier	Workplace incentives	Labor market flexibility	Cluster development
Bulgaria	3.7(43)	3.7(63)	3.2(61)	4.0(54)	4.9(34)	4.0(70)	3.9(49)	3.4(66)	4.0(37)	1.0(74)
Romania	4.4(34)	3.1(69)	4.3(51)	4.5(43)	4.1(58)	4.7(42)	4.0(47)	4.6(39)	7.0(1)	4.0(21)
Group 1998	5.1	5.4	5.3	4.8	4.8	5.4	4.7	4.9	4.1	2.0
Group 2000	4.3	4.2	3.7	3.9	4.9	4.8	4.3	4.3	4.6	2.6
EU average	5.4	6.1	6.3	5.1	5.9	5.7	5.2	5.1	2.9	4.1

World Economic Forum, *The European Competitiveness and Transition Report 2001-2002*, Oxford University Press, 2002.

3. Incentives for Attraction of FDI

The important role FDI will play in the economies of Southeast European countries was explained in Section 1. FDI to Southeast European countries, as is shown in Table 6, remains low at present compared to Central European countries. For this reason, it will be crucial for Southeastern European countries to offer attractive incentives for promoting FDI. The incentives these countries can offer, as can be determined from the papers that have been presented, are summarized in the following.

Table 6 FDI in Eastern Europe

	Inflow (mil USD) mil USD			Inflow per capita, USD	Stock (mil USD) mil USD		Stock per capita USD
	2000	2001	2002 foreca	2001	2001	2001	2001
Czech Rep	4,986	4,916	3,500	478	21,644	26,764	2,604
Slovak Rep	2,075	1,475	3,500	274	4,504	6,000	1,115
Hungary	1,649	2,443	1,000	240	19,804	23,562	2,311
Poland	9,342	8,000	6,000	207	33,603	39,000	1,010
Slovenia	176	442	600	222	2,809	3,400	1,709
Central Europe	18,228	17,276	14,600	260	82,364	98,726	1,485
Albania	143	200	200	58	568	800	233
Bulgaria	1,002	689	600	86	3,309	3,997	504
Romania	1,040	1,137	1,000	51	6,561	7,698	343
Croatia	1,126	1,502	1,100	343	5,202	6,703	1,530
Macedonia	176	442	500	217	381	824	403
Bosnia & Herzegovina	150	130	200	35	340	470	125
Yugoslavia	25	165	500	20	990	1,155	139
South Eastern Europe	3,662	4,265	4,100	79	17,351	21,647	377

http://www.wiiw.ac.at/pdf/wiiw-wifo_fdi_June02_summary_eng.pdf

<u>Albania</u>

Relevant law: Law No. 7765, Nov. 2, 1994 “On Foreign Investments”

- -No permission or approval needed for investment
- -Not subject to expropriation or nationalization
- -All investment-related funds and goods can be transferred overseas

Incentives for investment are offered equally to domestic and foreign nationals.

- -Four-year tax holiday offered to all companies that will engage in economic activities for at least 10 years in the manufacturing sector
- -Sixty-percent tax refund offered to reinvested profit in the manufacturing sector
- -Five-year tax holiday offered to companies engaged in recommended activities in the tourism development zone
- -Tax incentives for companies that are doing business in the free zone or signing a concession contract
- -No restrictions concerning debt/equity ratio
- -Loss can be carried over for 3 years
- -No withholding tax charged on dividends sent out of the country

<u>Croatia</u>

Relevant law: Investment Promotion Act (2000)

- -Incentives are offered to newly established enterprises registered in the area that the incentives are offered.
- -Incentives

-Leasing, granting of construction rights and sale or usage of real estate or other infrastructure
-Creation of new jobs
-Vocational training or re-training
-Custom benefits to equipment that is part of the investment

Bosnia Herzegovina
Relevant law: Direct Foreign Investment Policy Law
-National treatment of foreign investors
-Free investment of assets and services in all sectors except weapon production and official information
-Tariffs waived for foreign investment

Bulgaria
-National treatment of foreign investors
-Investment protection
-Incentives

Macedonia
-National treatment of foreign investors
-Alleviation and exemption of taxes and other legal measures
-Partial exemption of corporate income taxes and tariffs

Yugoslavia
Relevant law: Law on Foreign Investment (Jan 2002)
-No restrictions in areas of investment with the exception of weapon production and distribution
-No restrictions in sending funds to home country and purchase of real estate
-Tariff exemption for equipment import with the exceptions of passenger cars and slot machines
-Preferential treatment on other taxes and tariffs

Romania
Relevant law: Law No.332/2001 Regarding the Promotion of Direct Investment with Significant Impact on Economy, etc.
-Exemption of tariffs and VAT
-Payment deferral for VAT
-Twenty-percent tax exemption on new investments
-Five-year carry-over of loss
-Utilization of accelerated amortization

Czech Republic

Incentives listed in the Act on Investment Incentives

-Tax incentives	Corporate tax relief for up to 10 years for new companies Partial tax relief for up to 5 years for existing companies
-Job creation grants	Financial support for creation of new jobs
-Retraining grants	Financial support for retraining new employees
-Site support	Provision of low-cost building land and/or infrastructure

The incentives are available singly or collectively and are designed to have maximum impact in the early stages of a project.

http://www.czechinvest.org/ci/ci_an.nsf/Links?OpenPage

Based on the information available in the seminar, the aspects commonly found among the FDI incentives of the Southeast European countries are as follows:

- National treatment of foreign investors (although purchasing land is possible in some countries and not possible in others)
- Investment protection and free remittance to home country
- Tax exemption available for tariffs and VAT

There are also following incentives that are offered by some countries but not referred to in others:

- Reduction and exemption of corporate taxes
- Use of free trade zone
- Preferential treatment for investment (e.g., accelerated amortization, tax reduction for reinvested profit)

As far as the information we obtained from the papers presented in the seminar is concerned, we could not help but gain the impression that investment incentives available in Southeast European countries were not attractive enough. With the Czech Republic presently offering preferential treatment to foreign investors for corporate income tax and almost all Central European countries offering similar or better incentives, it would be difficult for Southeastern European countries to compete with Central European countries over FDI without offering incentives that are much more attractive. We anticipate competition over FDI incentives taking place to the extent it is permitted in light of relationships with the EU.

4. From FDI to Competitiveness Gaining Policy

As we have seen in Section 1, FDI is desirable for Southeast European countries in improving the balance of payments in the short term. However, it is necessary to pay attention to several points concerning the inflow of FDI.

1) FDI has the effect of improving the balance of payments in the short term. In the mid- and long-term, however, it may have a negative effect on the balance of payments as a result of the remittance of profits to the home country and invested capital being withdrawn when FDI does not generate the anticipated profits.

2) Aside from the benefits mentioned in the foregoing paragraph, the benefits expected from FDI are as follows:

- Creation of employment
- Transfer of tangible and intangible technology and management resources to relevant companies and to other companies to improve the country's economic performance
- Increased competitiveness of products and services resulting from transferred technology or management resources to improve the country's balance of payments through the increase of exports
- Other effects (e.g., increased revenue)

However, there is no guarantee that these effects will be realized. In particular, the transfer of technology is often not realized in cases where the company in the home country simply limits FDI to building factories to take advantage of low-wage labor and withdraws this FDI as soon as it determines that this effect is becoming weaker, moving it to countries offering lower wages. For this reason, efforts and system-building for realizing the aforementioned effects are needed, particularly in the manufacturing industry.

Local content is often used to realize this. However, it is difficult to tighten the local content regulation as far as the EU—an entity based on the premise of the equality of domestic and foreign investors—is involved. It is therefore essential to step up policies for small and medium enterprises and create subcontractors and supporting industries with technical capabilities. Furthermore, it is necessary to have a clear notion of the industrial sectors that are to be developed in the future when fostering small and medium enterprises. In other words, it is necessary to establish priority industrial sectors and implement industrial policy, starting with education, for this sector.

The promotion of exports backed by cheap labor may work under the present framework in Europe. However, the comparative advantage from cheap labor currently enjoyed by Southeast European countries is expected to diminish sooner or later as a result of the EU's policy to incorporate Africa through the Lome Agreement, the expansion of subcontracting to former Soviet republics such as Russia, and the economic development of China, which is predicted to become the "world's factory" in the near future. Establishing a technological edge over a short period of time before the comparative advantage is lost is key to the industrial and FDI policies of Southeast European countries.

【Appendix】

Several participants from the Southeast European countries commented that the Southeast European countries as a region have an adequate market size, and that they hoped Japanese investors would invest in the region. I would like to respond to the comment here, as I was unable to do so in the seminar.

Table 7 shows the shares of exports and imports of each Southeast European country to other Southeast European countries and the EU. It is obvious that trade between Southeast European countries remains at a extremely low level with the exception of trade between Croatia and Bosnia & Herzegovina, and Yugoslavia and Macedonia.

Table 7a Share of exports to specific countries as a percent of total exports (2000)

To	Of							
	ALB	B&H	BUL	CRO	MAC	ROM	YUG	EU
Albania	-	0.1	0.5	-	1.3	0.1	0.1	0.0
Bosnia&Herzegovina	-	-	0.2	11.6	1.7	0.1	-	0.0
Bulgaria	0.0	0.0	-	0.1	1.8	1.8	2.4	0.1
Croatia	0.1	10.2	0.1	-	3.7	0.2	-	0.2
Macedonia	1.7	13.0	2.3	1.4	-	0.1	-	0.1
Romania	0.0	1.0	1.8	0.1	0.2	-	-	0.4
Yugoslavia	-	-	7.8	-	22.4	-	-	0.1
EU	85.4	67.2	51.2	54.9	46.4	61.7	75.9	60.8

Table 7b Share of imports to specific countries as a percent of total imports (2000)

To	Of							
	ALB	B&H	BUL	CRO	MAC	ROM	YUG	EU
Albania	-	-	0.0	-	0.2	-	0.1	1.1
Bosnia&Herzegovina	0.0	-	0.0	1.0	0.5	0.1	-	2.2
Bulgaria	2.5	0.4	-	0.1	5.4	0.6	14.3	0.1
Croatia	1.0	19.3	0.1	-	2.8	0.0	-	0.1
Macedonia	2.0	0.9	0.4	0.7	-	0.0	-	0.0
Romania	0.7	0.5	3.6	0.2	0.5	-	-	0.3
Yugoslavia	-	-	0.4	-	9.6	-	-	0.0
EU	77.8	44.5	44.9	56.0	47.1	63.7	61.5	58.0

V. Gligorov, "European Union Enlargement and the Balkans", in *The European Competitiveness and Transition Report 2001-2002*, *op.cit*.

First, according to the gravity model, the trade level of one country has a positive correlation to the income level of trade partners and a negative correlation to the distance. Hence the low income level of Southeast European countries keeps intra-regional trade at low level. It will take a long time before the income level of Southeast European countries goes up enough to regard these countries as a region.

Furthermore, the low income level alone cannot explain why the spoke-shaped trade of Southeast European countries with the EU as a hub and intra-regional trade remain at low levels. I can point out two other reasons:

1) Southeast European countries have a long history of bitter ethnic problems that have stopped a network-shaped trade structure from developing.
2) COMECON forced Southeast European countries to engage in spoke-shaped trade with the USSR as a hub. Despite the start of the transition to a market economy, the spoke-shaped trade has remained, although the hub has shifted from the USSR to the EU. The pattern is the same in Central Eastern European countries.

These factors developed over a long time cannot easily disappear even after FTAs remove the trade barriers. From this point of view, it will also take a long time to regard Southeast European countries as a region.