

Chapter 1

Conditions for an investment revival in Central and Eastern Europe

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1. Sustainable economic growth hinges on investment

Following setbacks in the wake of the global financial crisis and the euro crisis, economic growth recovered in most Central and Eastern European EU (EU-CEE) member states in 2015. But was this a one-off event and what are the prospects for the future? The more general question is how to make economic growth more dynamic and sustainable under the 'new normal' of sluggish global demand and high perceived risk in the financial sector? Consumption was depressed in the aftermath of the financial crisis and negatively impacted investment, but started to recover in 2015 in several countries, with investment slowly following suit. While household consumption is currently the main growth driver in the EU-CEE (wiiw 2016), future economic growth depends on the ability to increase productivity and investment. Both foreign and domestic investment may make recovery sustainable and help the EU-CEE in its efforts to catch up with the EU15.

The main factors affecting investment levels include the size and dynamism of markets, the business environment and the terms for financing investments. Provided foreign markets and domestic household consumption expand, investment in extending production capacities will be necessary to meet increased demand. In the case of investment-generated growth, investment boosts productivity, allowing wages to increase and in turn boosting domestic demand. Further, investments may improve the infrastructural network and drive technological progress, allowing for further productivity increases. In addition, increasing external demand may pull investment, in particular if exports grow on the basis of improved competitiveness. FDI and multinational supply chains can play a specific role in this process. Production networks of multinational enterprises (MNEs) provide access to markets, enhancing the specialization and integration of EU-CEE economies. They can also drive technological progress and foster competitiveness.

Beside demand constraints, financial constraints are also important determinants of investment levels. Domestic and foreign companies can finance investments by tapping capital and credit markets or relying on retained profits. Before the financial crisis, capital was abundant in Europe and flowed generously to the CEE region in the expectation of high returns. Large FDI inflows functioned as growth engines in the host economies, meeting expectations and improving profitability. However, the financial crisis and the euro crisis shook the European banking system, cutting or even reversing the credit flows used to finance the investment boom. While cheap credits available in the wake of the ECB's policy of very low policy rates have made capital abundant again,

the risk aversion of investors in the real sector prevented any surge in investment until demand for goods and services increased, and no recovery of FDI inflows to EU-CEE economies was registered until 2016.

EU-CEE countries import capital not only in the form of FDI but also as transfers from EU structural funds, a source used to finance investments mainly in infrastructure but also in the private sector. This chapter compares these two major sources of foreign investment for financing projects in the EU-CEE. While EU transfers constitute public money for public and private investments, FDI represents solely private investment.

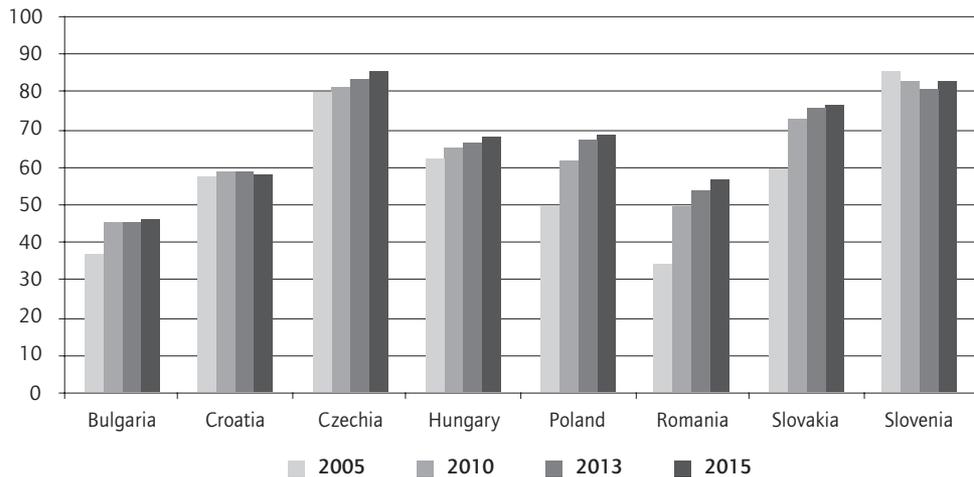
We take a macro-economic look at the foreign financing of investments (gross fixed capital formation). The approach is thus more limited than in those lines of research that explore the relationship between economic growth and capital inflows in general (Cardarelli *et al.* 2010, Ghosh *et al.* 2011). The findings of Aizenman *et al.* (2013) are especially insightful in this context: ‘The relationship between growth and lagged capital flows depends on the type of flows, economic structure, and global growth patterns. We find a large and robust relationship between FDI – both inflows and outflows – and growth. The relationship between growth and equity flows is smaller and less stable. Finally, the relationship between growth and short-term debt is nil before the crisis, and negative during the crisis.’ This and other econometric studies confirm that FDI and other equity inflows discussed in the current paper are the most important forms of capital inflows from a development point of view.

This chapter analyses one by one the main datasets on gross fixed capital formation, EU transfers, FDI inflows and cross-border greenfield investment projects (whereby EU transfers and FDI inflows feature in the balance of payments). As regards FDI, we use data based on the directional principle, as far as possible excluding transactions of special purpose entities and capital in transit in accordance with the IMF balance of payments manual BPM6. The chapter also explores the Financial Times FDI Market database to interpret greenfield investments.

The countries covered in this analysis are eight Central European EU member states (EU-CEE excluding the Baltics), namely Bulgaria, Croatia, Czechia, Hungary, Poland, Romania, Slovakia and Slovenia. While having several characteristics in common, they also have distinct ones. All are below the EU-28 average in terms of per capita GDP at purchasing power standards (PPS) (Figure 1). Six of them caught up with the EU average to various degrees between 2005 and 2015, while two fell back (Croatia and Slovenia). Croatia has been macroeconomically under pressure for a long time, while Slovenia became victim to the Euro crisis and only started recovering in 2015.

The analysis in this chapter mainly covers the 2010-2015 period. Considering the pre-crisis years as inconsequential, it focuses on the brief recent recovery period which was itself interrupted by the euro crisis. A forward-looking assessment of economic growth and investment based on preliminary 2016 data also allows certain future growth patterns to be forecast – with or without a recovery of FDI in the region.

Figure 1 GDP per capita at PPS in % of the EU-28 average



Source: Eurostat

2. The investment rate started to recover in 2015 after several years of decline

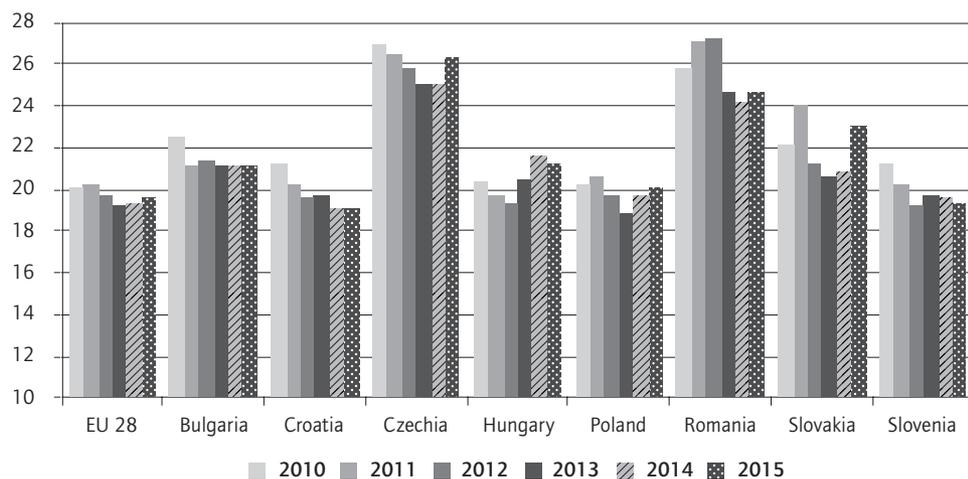
The gross fixed capital formation (GFCF) to value added (GDP) ratio indicates how much of total factor income is invested in fixed assets. It is given in gross terms as it includes both replacement investments (depreciation) and new additions to the capital stock. GFCF consists of resident producers' acquisitions, minus disposals, of fixed tangible or intangible assets. This covers in particular machinery and equipment, vehicles, dwellings and other buildings.¹ The change in the investment rate reflects the expectations of economic agents regarding future market developments. If economic agents are not confident about their future output, they will not invest in fixed assets. Expectations can be self-fulfilling, as less spending on fixed assets would dampen the market for the producers thereof.

GFCF as a share of GDP was relatively high in the EU and especially in the CEE region before the financial crisis, mostly in the range of 25-30% of GDP; it was somewhat lower than 25% in Hungary and Poland and above 35% in Bulgaria and Romania in 2008. The investment rate declined to about 20% during the 2009-2013 crisis period, with only Czechia and Romania above 25%; it has since moved slightly upwards in some countries (Figure 2). The lowest rates, just below 20%, were found in Croatia, Hungary, Poland and Slovenia. With rates in Poland and Hungary recovering recently, only Croatia and

1. Eurostat definition; in detail: 'Gross fixed capital formation - GFCF (ESA95, 3.102) consists of resident producers' acquisitions, less disposals, of fixed assets during a given period plus certain additions to the value of non-produced assets realised by the productive activity of producer or institutional units. Fixed assets are tangible or intangible assets produced as outputs from processes of production that are themselves used repeatedly, or continuously, in processes of production for more than one year. Disposals of fixed assets are treated as negative acquisitions.' http://ec.europa.eu/eurostat/cache/metadata/en/nama_esms.htm

Slovenia under-performed, with investment rates below 20% in 2015. This pattern of change is in line with the boom-or-bust cycle of economic growth, indicating that investment levels react more to a crisis-related drop in demand than to the production of value added.

Figure 2 Gross fixed capital formation in % of GDP



Source: Eurostat

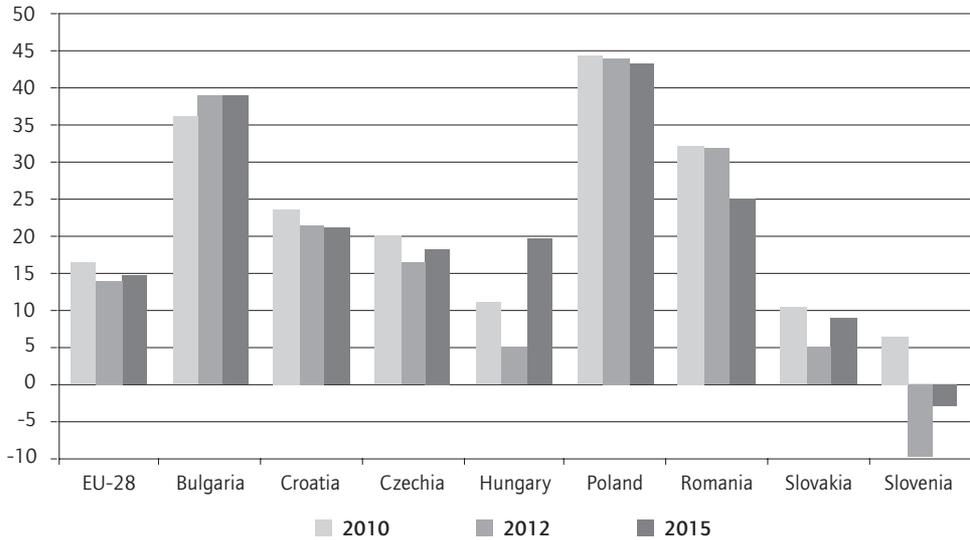
The majority of countries reported higher investment rates in 2015 than the year before, mainly on account of higher EU transfers. Hungary reported a recovered rate in 2014 on account of a jump in EU transfers, though a marginal correction took place in the subsequent year. The recovery did not persist in the following year, when the inflow of EU funds dropped throughout the region. Access to funds from the 2007-2013 financing period became unavailable in 2016, while access to funds under the 2014-2020 financial framework was only at its inception.

Typical long-term country differences between investment levels are noted. Czechia and Romania have had the highest investment rates in each year since 2010, the reason for which is not obvious. High investment rates can be associated with high saving rates of the Czech population and savings transferred by Romanians working abroad. The persistently low investment rate in Poland did not hinder positive economic growth throughout the post-crisis period, while similar rates in Hungary can be interpreted as crisis symptoms contributing to sluggish economic growth.

Deducting consumption of fixed capital (depreciation) from the GFCF, we arrive at net fixed capital formation (Figure 3). The higher the share of net versus gross, the more investment is spent on expanding capacity. While only 15% of GFCF was spent on net capital formation in the EU in 2015, the figure was close to 40% in Bulgaria, above 40% in Poland, well above 20% in Romania and at around 20% in Croatia, Hungary and Czechia; however, rates were below the EU average in Slovakia. Typically, higher investment rates and higher net investment ratios occur in countries with

lower development levels and more stable economies, indicating solid future growth prospects from an investment perspective. While these rates have been quite stable in some countries, crisis-related setbacks and recent recovery characterised Hungary and Slovakia. Slovenia was the only EU-CEE country with a negative ratio (-3%) of net investments in GFCF (i.e. depreciation higher than investment) in each year between 2012 and 2015. Not replacing worn-out capital stock entails its degradation, possibly to the detriment of recovery.

Figure 3 Share of net fixed capital formation in GFCF (%)



Source: AMECO

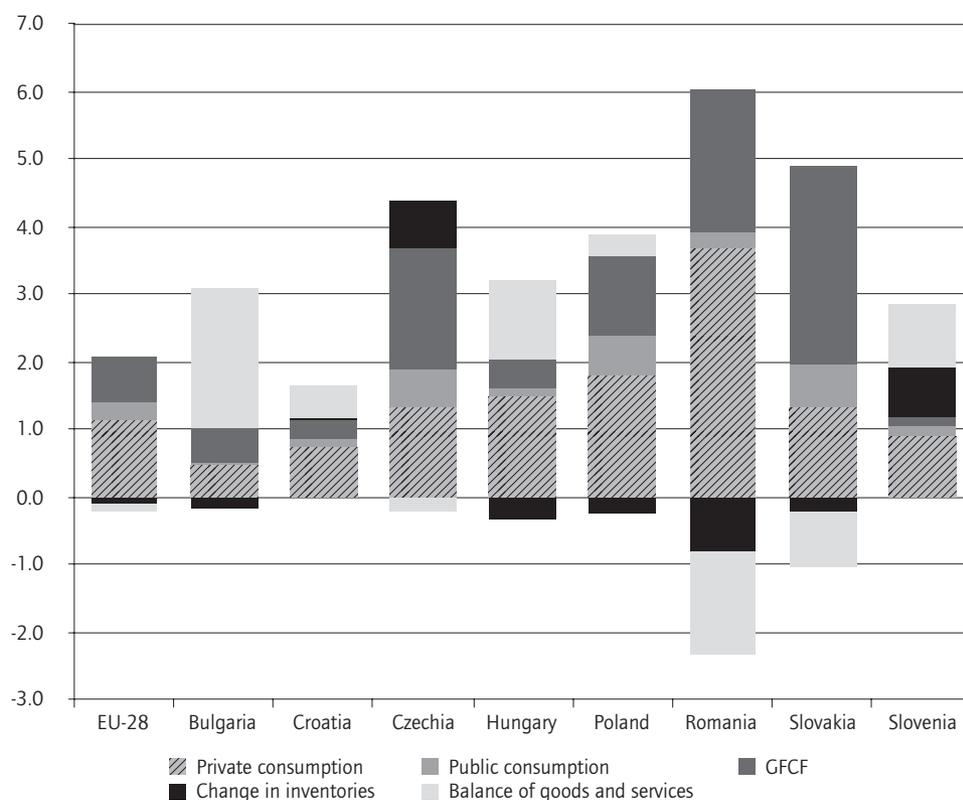
Even the multiple efforts of national governments, the EU and/or the EIB cannot close the gap between pre-crisis and current investment rates (Dauderstädt 2015). Most likely, pre-crisis investment activity had been overheated, one of the reasons for the crisis (Gros 2014). The current lower rate of potential growth may result in less investment to attain the same investment rate. In addition, the quality of investments may matter more than their quantity for long-term development. While any investment growth contributes positively to the GDP of a given year, the longer-term income generated by these investments will determine whether it promotes sustainable growth.

3. Contribution of investments to economic recovery

Assessing the role of GFCF in the demand side of GDP reveals the extent of investment-based economic growth. We measure the contribution in percentage points, whereby private consumption, public consumption, GFCF, changes in inventories and the balance of goods and services together determine the rate of growth (Figure 4). In half of the countries surveyed, the main driver of economic growth has been private consumption, the component with the highest share of GDP. High private consumption

usually coincides with a negative external balance, and vice-versa, a characteristic of specialized open economies where any increase in demand generates imports. Similarly, a high GFCF often coincides with a negative external balance, meaning that most investment funding is imported. The impact on growth of increasing GFCF is positive. Countries where GFCF was the most robust contributor to growth, namely Czechia, Romania and Slovakia, experienced the most dynamic growth from 2010 to 2015. However, in Romania the GFCF contribution was lower than that of private demand when growth peaked in 2015. Slovenia, a country engaged in external stabilization, experienced a downturn in domestic demand components (including GFCF), meaning that the adjustment of the external balance was the main driver of the country's meagre economic growth.

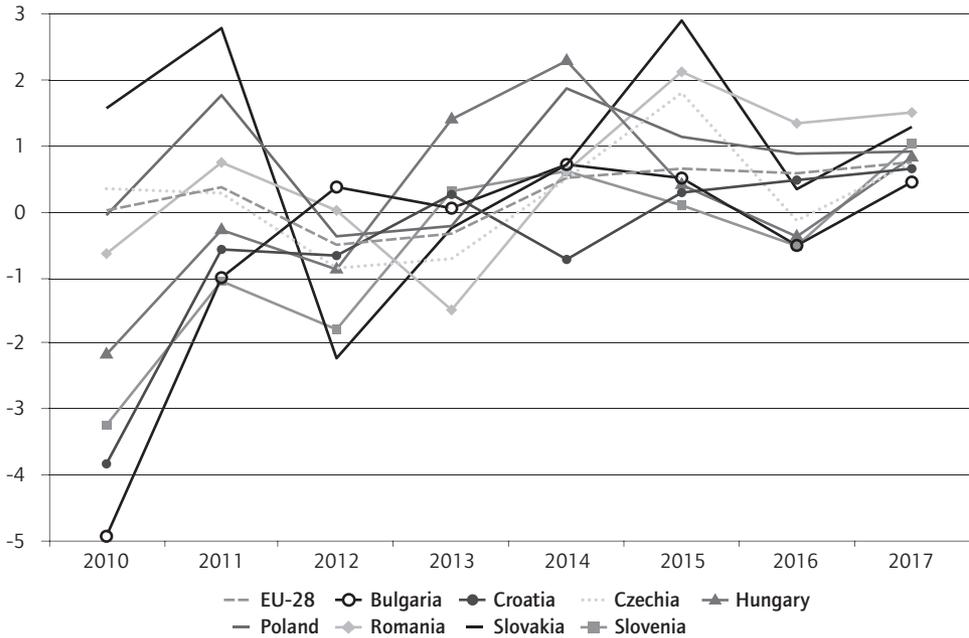
Figure 4 Contribution of individual demand components to GDP growth in percentage points in 2015



Note: Components add up to the rate of economic growth

Source: AMECO

Figure 5 Contribution of GFCF to GDP growth, 2010-2015 and EC forecast 2016-2017



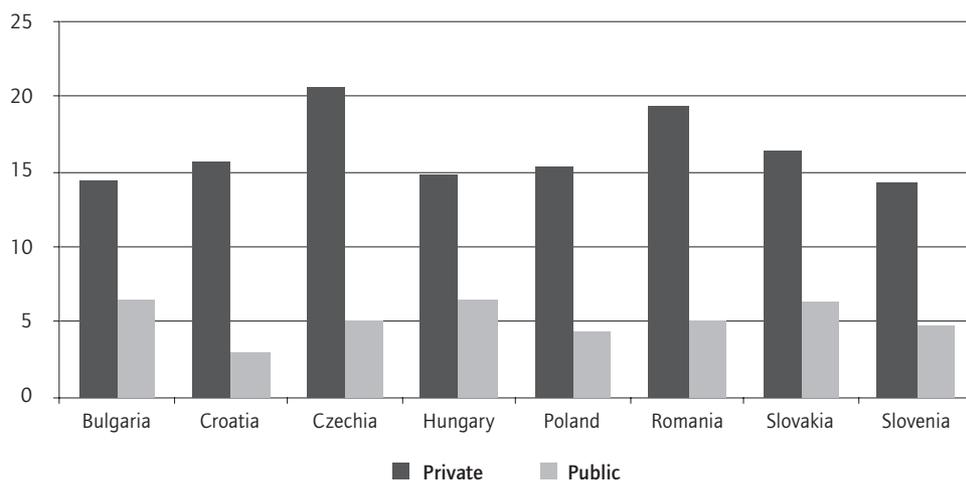
Source: AMECO

The contribution of GFCF to economic growth was negative in most of the economies under survey in 2012 due to the uncertainties triggered by the euro crisis. Subsequent recovery peaked in 2014 or 2015 and was fuelled by the investment boom marking the final EU transfers under the 2007-2013 funding period. Investments declined in 2016 due to lower EU transfers (Figure 5). The European Commission expects investment to play an increasing role in driving economic growth in the coming years when EU funds allocated for the 2014-2020 funding period start flowing at a high pace. While GDP is expected to grow by around 3% annually, the contribution of investments will be in the range of 0.5-1.5 percentage points. Higher values may again occur in countries with the most robust rates of economic growth, i.e. Romania and Slovakia, depending on their ability to tap EU funds.

4. Who invests - the private or the public sector?

On average, close to 80% of gross fixed capital formation derives from private-sector investment, making it much more important than government investment. Country-specific differences (see Figure 6) have been quite stable over time; countries with larger government sectors (viz. Hungary and Czechia) have a smaller share of private-sector investment in total gross fixed capital formation.

Figure 6 Share of public and private GFCF investment in GDP (%), 2015



Source: National and Eurostat statistics, wiiw estimations, own calculations

Conditions for financing private investments have improved in the latest post-crises years due to companies' better financial situation. Most of the investments are financed via retained profits, with credit funding playing only a secondary role. Falling input prices and increasing capacity utilisation in the manufacturing sector have generated higher profits. Private-sector indebtedness has declined and new credit has become more readily available on less restrictive terms. EU-CEE banks have largely finished restructuring their portfolios, reducing the volume of outstanding credits and the number of non-performing loans. Over the past few years, the stock of private-sector bank loans declined at a particularly rapid rate in Hungary and Romania, mainly due to working out non-performing loans. The size of the latter nonetheless remained a problem, as bank financing in terms of GDP in both countries has shrunk to the lowest level of all EU-CEE countries. Banking sector profits have since recovered and approvals of new credits were up in 2016. Slovenia and Bulgaria were two other countries set on a path towards deleveraging. Poland and Slovakia, however, found themselves in a completely different situation; loan volumes have been rising while non-performing loans are at a very low level, conditions conducive to business expansion. All these factors constitute an improvement over the credit conditions prevailing two or three years earlier, without entailing a return to the lax banking practices of the pre-crisis era which are unlikely to return.

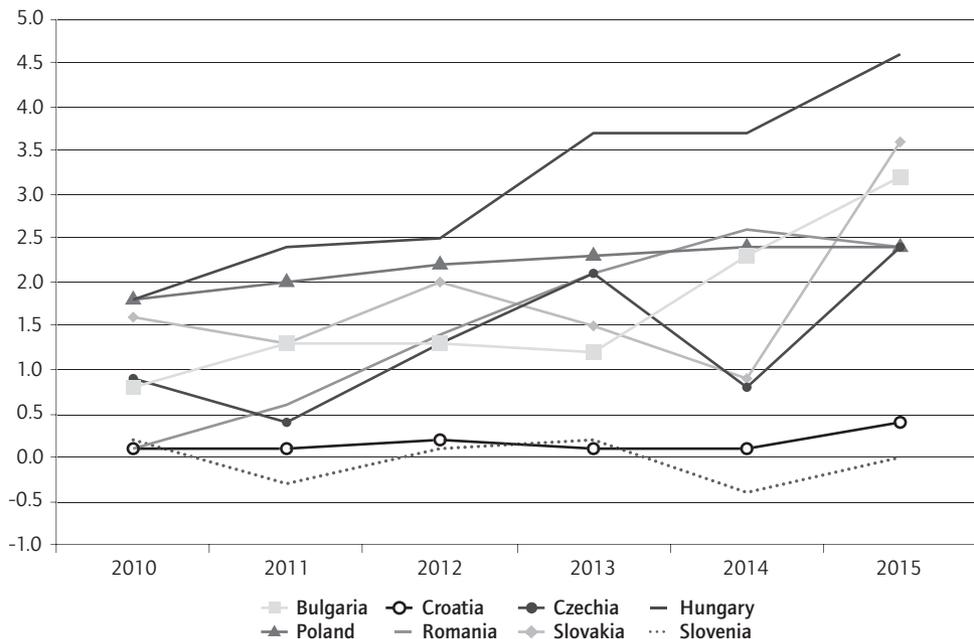
Conditions for public investment depend on fiscal constraints and policy choices. Fiscal policy is a tool for stimulating growth and structural change that governments often ignore. Eurozone countries and countries with a fixed exchange rate can only use fiscal policy, whereas other countries may also resort to monetary and exchange rate policies. In terms of scope, fiscal policy is often not a matter of choice. Its use is restricted in countries with high debts and onerous debt-service burdens or simply by virtue of EU regulations. Nevertheless, even countries with high government debt can structure their budgets to attain their economic or social goals, instead of being guided by inertia and vested interests.

The scope for fiscal expansion has recently widened. Government consumption made a minor, but positive contribution to growth in 2015, signalling the end of fiscal austerity in the EU-CEE. Highly indebted countries, including Croatia and Hungary, have recently managed to adopt a neutral fiscal stance, while most other countries have further room for government consumption as a positive contribution to growth. Well-balanced and low-debt countries, including Czechia and Poland, could well pursue a fiscal policy contributing 0.4–0.6 pp. to GDP growth. Most other countries are using the opportunity provided by low-cost debt financing and are not restricting government spending. The only country to embark on an expansionary path in 2016, Romania achieved a high rate of economic growth, albeit with signs of overheating.

5. External investment financing – a balance of payments analysis

In this section, we discuss the balance of the capital account and that of FDI as recorded on the financial account². The capital account contains EU transfers and transfers from other international donors (e.g. World Bank) for capital investments. The FDI balance, the difference between assets and liabilities³, refers to the net financing flows of direct investments, a good share of which finance real investments.

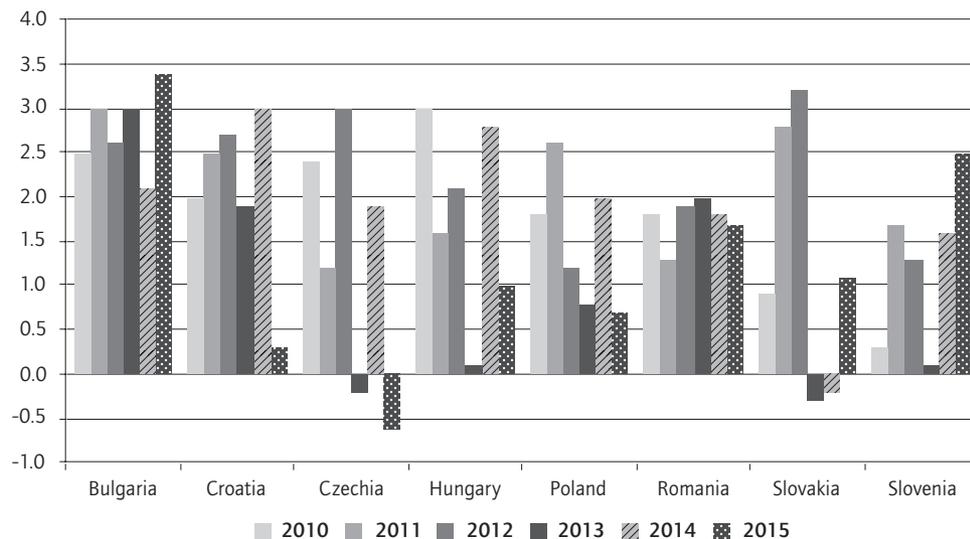
Figure 7 Capital account net in % of GDP 2010-2015



Source: Eurostat

- Balance of payments data according to the asset-liability principle is used for both indicators. Net FDI is, in principle, identical both according to asset/liability and directional principles, though deviations exist in practice. Portfolio and other external resources are ignored due to their high volatility.
- Net FDI by the asset/liability and the directional principle are principally of the same amount.

Figure 8 Net FDI in % of GDP, 2010-2015



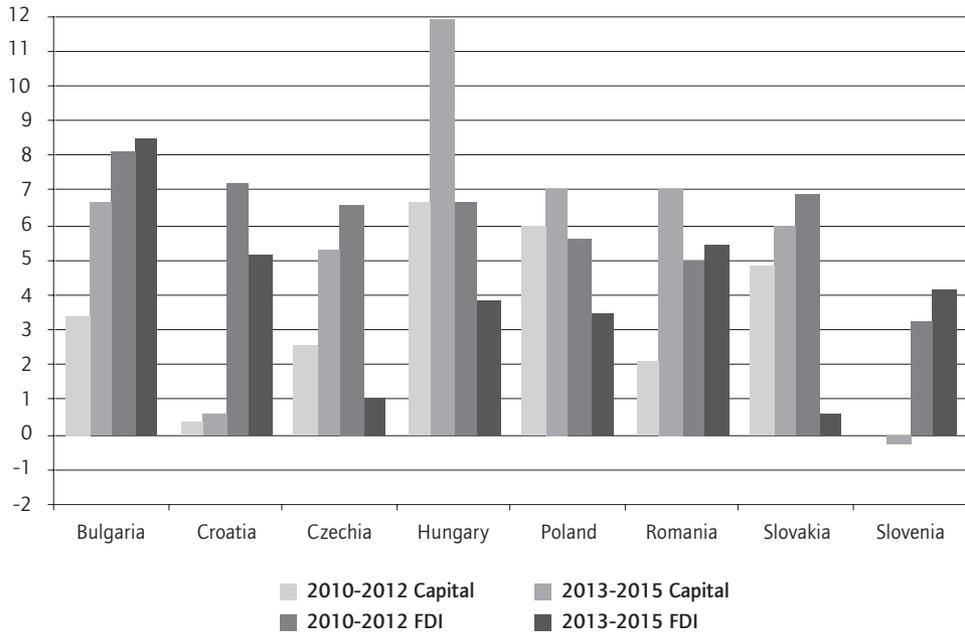
Source: Eurostat

Annual data on capital transfers (Figure 7) reveals a rising trend over the period, except in Croatia which joined the EU later than the other countries and Slovenia which had relatively high per capita GDP from the start, making it less eligible for funding. FDI net inflows (Figure 8) were flat (in the range of 1-3% of GDP) over the same period, but with noteworthy country-specific fluctuations. A detailed comparison of the two time series allows us to discuss the changing relationship between capital and FDI inflows.

Prior to the financial crisis, the EU-CEE was the target of soaring FDI inflows while EU transfers remained rather small. The relationship between the two external financing channels changed after the crisis, with FDI decreasing and EU transfers allocated for the 2007-2013 financing period starting to flow. The decline in FDI got worse as a result of the 2013-2015 euro crisis. At the same time, capital transfers moved in the opposite direction as the disbursement of EU funds peaked, fuelled by access to the funds of the 2007-2013 financing period (2014-2015).

Figure 9 shows the size of the two types of capital inflows as a percentage of GDP, revealing which of the two items was higher, capital transfers or FDI. It also shows the change between the two periods (before and after the euro crisis) corresponding to the middle and the final stage of receiving EU funds under the 2007-2013 financial framework.

Figure 9 Net capital account and net FDI as a % of GDP cumulated for 2010-2012 and 2013-2015



Source: Eurostat

Net FDI inflows were lower in the 2013-2015 period⁴ than earlier in five countries and higher only in three, while capital transfers increased in all countries except Slovenia. In the first period, capital transfers were higher than FDI inflows in Poland, and equal in Hungary. In the second period, capital transfers surpassed FDI inflows in all countries but Bulgaria, Croatia and Slovenia. Thus, the two sources of external financing have swapped places, with EU and other multilateral funds taking over the position of private direct investments in external investment financing. FDI inflows thus dropped, with public and multilateral external financing making up for the loss.

Net FDI fell the most in Czechia and Slovakia, to less than 2% of GDP in 2013-2015. Bulgaria, Romania and Slovenia reported higher net FDI in the second period than in the first, with Slovenia switching from negative to positive. Capital account inflows accounted for less than 2% of GDP solely in Croatia which only joined the EU in 2015 and in Slovenia, a country too advanced in terms of per capita GDP to receive regional development funds in any substantial amount. The other countries received capital transfers accounting for 2-6% of GDP in the three-year period 2010-2012 and 4-12% of GDP in the 2013-2015 period, i.e. such transfers doubled. The increase was especially high in Hungary, Romania, Czechia and Bulgaria.

4. 2015 data are preliminary, subject to revision. Revisions for Hungary indicate very low net inflows.

The two types of external financing differ a lot in their content. Capital transfers primarily finance infrastructure and other public investments or support SME development. FDI funds, on the other hand, generally flow to large private businesses. Capital transfers typically finance sectors with low direct profits, long-term and indirect income generation, while FDI finances businesses with good profit expectations. The two are thus more complementary than substitutes. A shift in external financing thus also means a shift in the sector of investment. After a transfer-funded boom in infrastructure investments, a revival in FDI-financed private investments is even more necessary, and infrastructure and SME development projects funded by capital transfers are expected to trigger private investment.

To what extent future investments come from foreign investors depends of the size of the foreign sector in a country and its attractiveness for new FDI projects. The next section therefore looks at the relative size of the foreign sector, while the following one analyses the characteristics of new FDI projects.

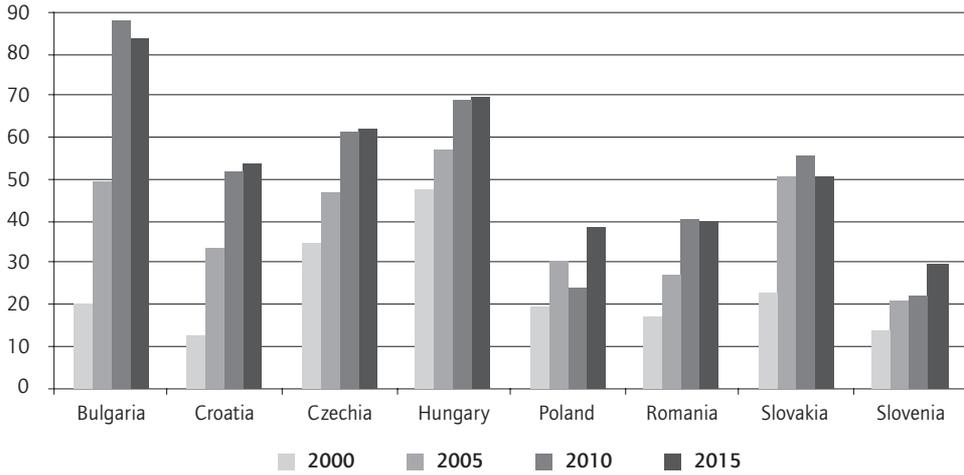
6. Characteristics of the foreign sector

Two indicators, the size of the accumulated FDI stock as a percentage of GDP (based on the international investment position) and the contribution of foreign controlled enterprises to GDP and various other economic indicators (based on the foreign affiliates statistics, FATS), measure the size and importance of the foreign sector in an economy. The two approaches lead to somewhat different results because of the different definition of the foreign sector – more than 10% foreign ownership in the case of FDI stock and 50% ownership in case of the FATS. Moreover, the structure of FDI may also matter as FDI in the financial sector and real estate are not covered by FATS.

The amount of FDI stock as a percentage of GDP indicates a country's exposure to FDI (Figure 10). Among the eight countries under survey, this indicator is the highest in the Bulgarian and Hungarian economies, followed by Czechia and Slovakia. Slovenia has the lowest FDI stock per GDP, meaning that FDI has little importance for this country.

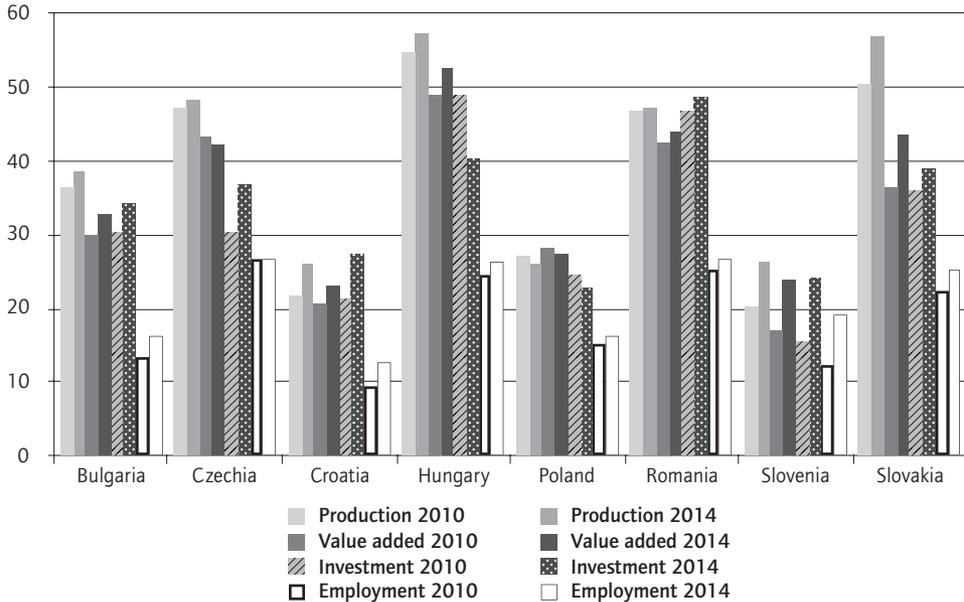
Developments over the past five years have been subject to separate changes in GDP and FDI, with each following its own dynamics. Nevertheless, the overall trend was that countries previously with a relatively low foreign penetration such as Poland and Slovenia experienced rising penetration, while the FDI to GDP rate hardly changed in countries with an already high penetration. Slovenia was the only country to change its policy, privatizing public property under the pressure of the fiscal crisis while GDP declined. FDI stock per GDP declined in some countries (e.g. Bulgaria) where the value of assets (mainly of banks and real estate) decreased even though inflows were positive.

Figure 10 FDI inward stock as a percentage of GDP, 2000-2015



Source: wiiw FDI database relying on national bank statistics

Figure 11 Share of foreign-controlled enterprises in production, value added, investments and employment in 2010 and 2014



Source: Eurostat FATS

FATS, the other indicator of foreign penetration, measures the contribution of majority foreign-owned enterprises (foreign affiliates) to various economic indicators in the non-financial business economy (Figure 11). Data from the most recent survey (2014) shows that foreign penetration in terms of value added reached 53% in Hungary, more

than 40% in Czechia, Romania and Slovakia, and less than 30% in Croatia, Poland and Slovenia. The low rate of foreign penetration in Poland indicates that economic growth is less dependent on FDI, as the country has a strong domestically owned corporate sector. In Croatia and Slovenia, economic policy was for long not FDI-friendly in terms of privatization and the business environment. However, in the wake of the economic crisis, both countries changed tack to allow greater foreign investment with a view to promoting restructuring and increasing efficiency. As a result, the share of foreign affiliates increased rapidly in Slovenia. Foreign penetration increased in all countries except Poland between 2010 and 2014.

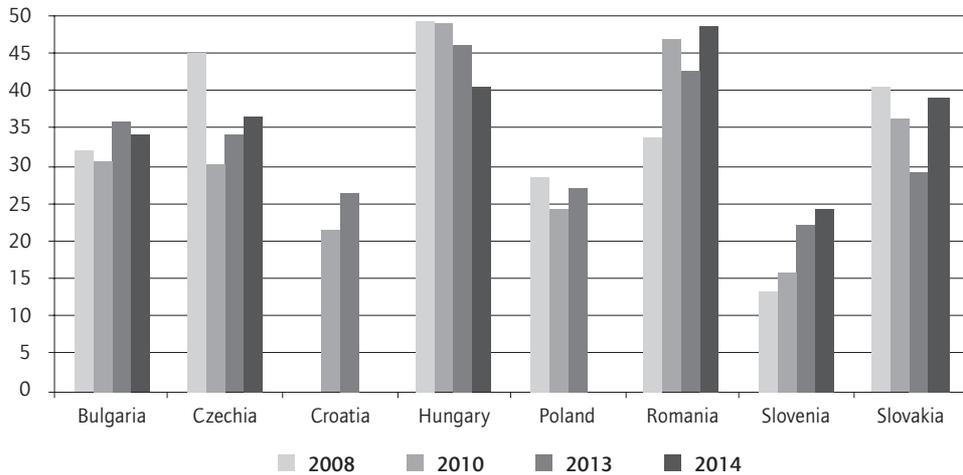
Compared with the FDI stock per GDP data, the size of the foreign sector measured by FATS is relatively small in Bulgaria (33%). This may be due to the absence of real estate and financial sector investments in the FATS data, two areas which have high shares in the Bulgarian FDI stock. In the case of Romania, the FATS statistics show higher foreign penetration (second to Hungary) than the FDI stock per GDP ratio suggests. One explanation could be the relatively low amount of FDI in sectors not covered by FATS (for example real estate). Nevertheless, such differences are not only due to the partly different coverage of FDI and FATS data.

What is more important is to compare the four foreign penetration indicators used in FATS. In terms of production value, Slovakia has a similar share of foreign affiliates as Hungary, namely close to 60%. But in terms of value added the Hungarian figure is 10 percentage points higher. In fact, Slovakia has the biggest discrepancy between the shares in terms of production and value added, indicating that it specializes in assembly work with a high imported content. In Poland, foreign shares in value added are higher than in production, making it the most diverse economy with much domestic sourcing.

The share of foreign affiliates in value added is generally higher than the foreign employment share, indicating that labour productivity in foreign subsidiaries is higher than in domestic companies. This can be explained by better technology and higher capital intensity in foreign affiliates but also by their narrower specialization on selected production processes. Domestic companies have full-fledged corporate structures including many labour-intensive activities such as management and marketing, areas which, in the case of foreign affiliates, are mostly concentrated in the parent companies.

The share of the foreign sector in corporate investments is similar or somewhat smaller than the foreign share in value added. It has changed only modestly in most surveyed countries over the past five years (Figure 12). A big decline in Hungary in 2013 and 2014 indicates the rising investment activity of domestic companies, which enjoyed preferential treatment in the distribution of EU funds. By contrast, special taxes levied on part of the foreign sector (retail and utility companies) decreased profitability and thus the funds available for investments.

Figure 12 Gross investment in tangible goods, share of foreign affiliates in the non-financial business economy



Source: Eurostat FATS

A high foreign penetration in an economy indicates both strength and weakness. It is certainly an advantage for a country to be attractive for foreign investors, enabling it to rely on all the benefits of FDI for development. But a foreign-capital-dominated economy will also have to live with the fact that a large part of profits are transferred abroad. Moreover, the relative strength of the foreign sector also highlights the relative weakness of the domestic sector. Imbalance appears where the domestic sector cannot keep pace with the foreign sector.

As the benefits of FDI are to a large extent attributed to technological spillovers from the foreign to the domestic sector, the size and efficiency of the domestic sector are of major importance. The domestic sector must be large enough and its productivity should not be too different from the foreign sector to allow spillovers to happen (for a summary of the literature on absorptive capacity and technological gap determining spillovers, see Crespo and Foutoura 2007). As in most sectors foreign subsidiaries tend to be larger and more productive than domestic companies, policy should attempt to maintain a balance between SME support benefiting mainly domestic companies and FDI incentives.

Fiscal and other benefits accorded to large investment projects due to increased international competition for greenfield investment projects impose a burden on the government budget, while other companies are disadvantaged if paying the standard corporate income tax rate. In principle, investment policies strengthening locational advantages should be equally beneficial for foreign and domestic investors, whatever their size and whatever the sector. While most countries subsidize large projects, small companies enjoy a number of facilities under EU programmes.

Alone among the countries under survey, the post-2010 Hungarian government has introduced several measures negatively discriminating against various foreign dominated economic sectors engaged in non-tradable services. Sensitivity to the profits or even assets of such companies made some investors leave the country, and domestic ownership now dominates in the financial sector and utilities. At the same time, multinational companies signed so-called strategic agreements stipulating government support for additional investments in manufacturing and business services, for R&D activities and job creation. Selective benefits provided to certain domestic companies have engendered market segmentation and are giving rise to increasing cronyism. Mihályi (2015) and Szanyi (2016a) have documented this increasing nationalism. Nevertheless, the figures on foreign penetration do not show a decreasing role of foreign affiliates in the Hungarian economy as a whole. It does show up, however, in individual economic activities such as electricity, gas and water supply, the primary targets of re-nationalisation. In fact, the main economic issue in these activities was not the foreign ownership but the lack of competition and quasi-monopolistic prices. Total centralization and politically motivated price-setting have not cured the problem but instead have eroded the quality of the capital stock and of services.

7. Preferred greenfield FDI locations

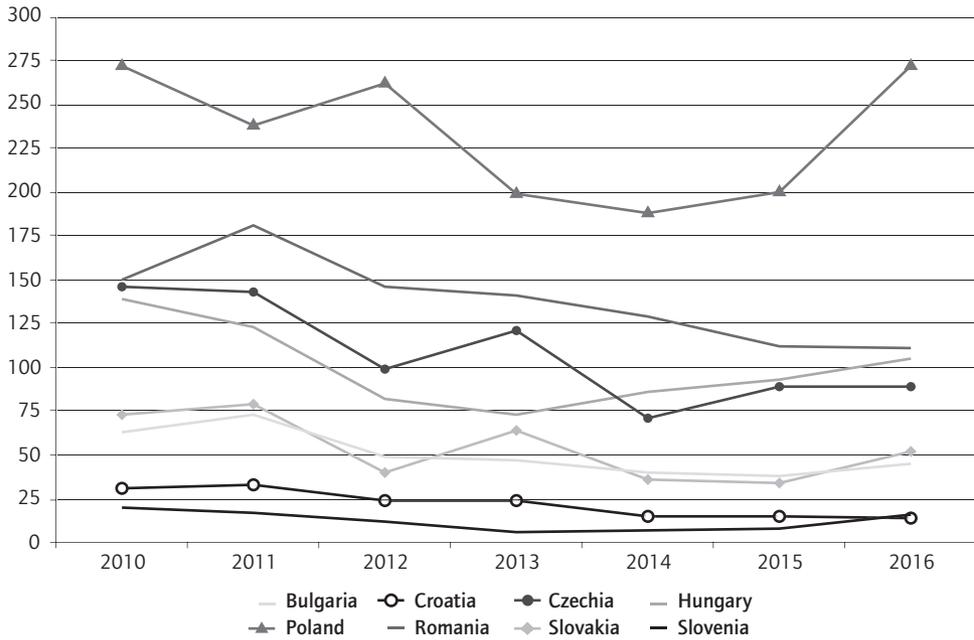
FDI can enter a country in two main forms: mergers and acquisitions (M&As) or greenfield investments. M&As do not initially bring new capital into the country and thus do not contribute to gross fixed capital formation. However, foreign investors entering by M&A usually make additional investments and increase efficiency and competitiveness. Greenfield investments, by contrast, bring in new capital and create new workplaces, making them the targets of public FDI policy and promotional activity.

Greenfield investors are sensitive to changes in demand conditions and production costs in home and host economies, to business legislation and investment incentives in host economies, and to the general perception of investment risk and the financing costs of investments. Conditions for greenfield investments deteriorated following the financial crisis due to the decline in overall demand and increasing investment risks and financing constraints in both home and host countries. EU-CEE economies are thus not per se responsible for the decline in greenfield FDI, being hit by the same factors as other locations.

Database on greenfield FDI projects

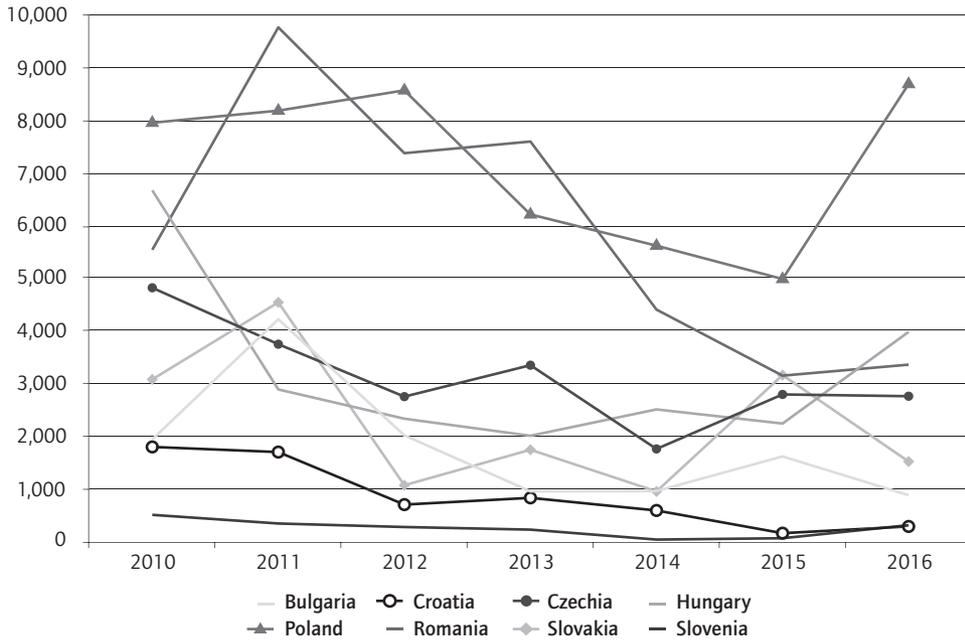
The data from fDiMarkets (www.fdimarkets.com, fDi Intelligence, a division of Financial Times Ltd) used in this report is based on media reports on individual investment projects. The database contains information on the number and value of investment commitments and the number of jobs to be created. Compared with the balance of payments, which records financial flows in a given period, fDiMarkets data refers to real investment projects that are to be realised over a longer period. The forward-looking character of this data may support forecasts, but there is a good deal of uncertainty, as realisation timeframes of individual projects may differ substantially. The database does not include financial sector investments, and we also exclude individual retail outlets and shops from the coverage. The investing country is the final home country of the investor, thus tax havens do not show up. Projects have been recorded by fDiMarkets since 2003 and are continuously updated.

Figure 13 Number of reported greenfield investment projects, 2010-2016



Source: fDi Intelligence, from the Financial Times Ltd 2016

Figure 14 Capital investment pledged in greenfield projects, 2010-2016, EUR million



Source: fDi Intelligence, from the Financial Times Ltd 2016

The number of greenfield projects and pledged investment capital declined after 2011, though a modest recovery occurred in several countries in 2015 and/or 2016 (Figures 13 and 14). The overall number of projects was about one third lower in 2014-2015 than in 2010-2011. There was a pronounced decline in pledged investment capital, on average halving between the two periods. As a result, average project size has become smaller over time. The Slovak figure was exceptionally high compared with previous years due to the announced car assembly plant planned by Jaguar. Poland attracted more and higher value projects in 2016 due to large new projects in construction and business services. Correcting for country size, the value of announced FDI projects in 2015 was the highest in Slovakia, followed by Czechia, Bulgaria and Hungary.

As greenfield commitments are volatile, it makes sense to look at the average of the past three years. Combining the number of projects and investment commitments, we can identify the most attractive greenfield locations as Slovakia and Czechia, followed by Romania and Hungary. Looking at fluctuations again, Hungary displayed the most even attractiveness to greenfield projects despite the government’s selective policies deterring investors in certain economic sectors. Slovenia was the least attractive greenfield FDI destination by all indicators. Recovering FDI inflows in this country were the result of M&As triggered by the banking crisis while greenfield investors were deterred by the economic and political risk at least until 2016 when economic growth resumed.

8. European policies to stimulate investments

The low investment rate throughout the European Union gave rise to various stimulating measures both at national and EU level. The monetary policies of the ECB and various national investment banks or even central banks are providing cheap financing via low interest rates and extra liquidity. However, abundant liquidity has been ineffective overall, with companies saving instead of investing. The banking system is still sitting on bad debts and commercial credit conditions are tight. Companies' appetite for investments is also curtailed by low European and global economic growth rates. At the same time, fiscal restrictions have remained tough and fiscal prudence prevailed throughout 2015. Fiscal stimulus and public investments were thus unavailable in most EU member states until recently.

In 2015, the European Commission launched an investment subsidy programme, the European Fund for Strategic Investments (EFSI) – the so-called the Juncker Plan. Established under the auspices of the European Investment Bank (EIB), its aim is to generate EUR 315 billion of additional investment in the EU-28 over the 2015-2017 period⁵. Its mission is to make better use of public money and attract additional private investors. The EU provided for a loan guarantee of EUR 16 billion in its budget and the EIB committed an additional EUR 5 billion, with the rest supposed to come from private investors. The expectation was that the EFSI would add EUR 330-410 billion to EU GDP and create 1-1.3 million new jobs through (a) mobilising investment finance without creating new public debt; (b) supporting investment in infrastructure, education, research and innovation; and (c) removing sector-specific and other financial and non-financial barriers to investment. For the EU-CEE, a project funded via the EFSI under near-market conditions may be less advantageous than taking out a grant from the European structural and investment funds (ESIF), although, admittedly, the latter might involve a delay of one, two or three years. As of mid-July 2016, there was just one signed EFSI project in the EU-CEE (a motorway in Slovakia), but 6 in Spain⁶. Of the EU-CEE projects approved but not yet signed, Poland has six, Lithuania two, and Croatia and Romania one each. Project approval gained momentum in the following 11 months, adding four more projects in Poland and two in Latvia and Lithuania.⁷

Monetary policy has been relaxed in the US and all over Europe including the NMS. In the euro area, monetary policy has become even more accommodative than in the US. In March 2017, the ECB refinancing rate was set at 0% and the deposit rate at -0.4%, while the ECB's quantitative easing programme launched in March 2015 involves monthly purchases of government bonds worth EUR 80 billion. Extremely lax monetary policy helped bring down inflation, but deflation was not the goal. Increasing the pace of economic growth and investment would require a more accommodative fiscal policy, a view which gained prominence in 2016 not only in the IMF and OECD but also in the EU Commission. A positive fiscal stance is possible due to low interest rates to finance

5. https://ec.europa.eu/priorities/jobs-growth-and-investment/investment-plan_en and <http://www.eib.org/efsi>

6. <http://www.eib.org/efsi/efsi-projects>

7. *Ibid.*

government debt⁸. Currently EU-CEE national budget deficits do not exceed the 3% 'Maastricht benchmark' and thus formally comply with EU rules. Similarly, public debt is not excessively high except in Croatia, Hungary and Slovenia. This means that fiscal loosening could indeed fuel economic growth. For the last two years, Romania has been the only country using fiscal stimuli, albeit excessively, i.e. beyond those necessary to achieve a high economic growth rate. Cutting taxes and increasing expenditure on wages fostered GDP growth, but may prove unsustainable in the long run.

9. Conclusions and prospects: more balanced investment financing follows FDI-led growth

Economic growth in the EU-CEE region declined only modestly in 2016 compared with the previous year to an estimated 3%, mainly on account of growth coming down to a 'normal rate' in Czechia. Investment declined as both EU transfers and FDI inflows decreased. With a GDP growth rate of 4.8%, Romania was the 'star performer' in the EU-CEE region – primarily due to fiscal stimuli (VAT cut and minimum wage hike). The main driving force was strong consumer demand in connection with declining unemployment, rising wages, less restrictive fiscal policies and zero inflation. Low growth and low investment countries, i.e. Croatia and Hungary, were the exception in 2016. First quarter results for 2017 show that economic growth is accelerating in all countries under survey.

Household demand in the EU-CEE is fuelling a relatively fast rate of economic growth, in turn spurring investment in the private sector financed by retained profits rather than new credits. Restricted credit-taking for financing consumption and investments has reduced the risk of another 'boom-and-bust' development. Profit-making companies can invest while upcoming businesses can hope for public subsidies. Start-up and R&D financing via EU funds is abundant in most countries and the EFSI SME line provides loans at conditions unavailable on the market. Similarly, foreign investors are reporting higher profits, part of which are destined for reinvestment.

FDI inflows recovered in 2016, reaching their highest level since 2008, primarily on account of high inflows to Czechia, Hungary, Croatia and Romania (Hunya 2017). Although inflows may not necessarily reflect investors' locational preferences and may fluctuate due to adjustments of loans and assets within multinational conglomerates, the 2016 recovery is in line with generally improving business sentiment and demand conditions throughout the European Union. The trend is set to continue in 2017 when economic growth, investments and FDI are expected to grow more rapidly than before.

Capital shortages are no longer a major impediment to growth in the EU-CEE, as indicated by the small current account deficits (or surpluses). Economic growth is more demand-constrained than capital-constrained. If recovering European demand becomes more robust in the future, EU-CEE economies are set to prosper.

8. http://europa.eu/rapid/press-release_MEMO-16-3711_en.htm

The current new wave of economic growth in the EU-CEE relies on more than just FDI. Domestic private and public investments have gained strength and EU transfers are bound to flow more abundantly in 2017 and beyond. Domestic investors have become wealthy and skilled, and they are now in a position to initiate and finance large projects and win public procurement tenders. In addition, partly state-owned companies have become international investors, such as power companies in Czechia and Hungary.

Economic nationalism and patronage are on the rise, with diverse public policies supporting domestic champions. Certain governments have started distancing themselves from the interests of foreign investors or EU recommendations and are listening more to the domestic business elites that they try to control while representing their interests. The role of domestic business has increased in several sectors including banking (RZB 2017), construction, real estate and the media (the exception here is Slovenia which earlier had a low foreign penetration and is recovering from the banking crisis through privatisation to foreign investors). The development of economic nationalism has been most rapid in Hungary, resulting in growing cronyism (Szanyi 2016b).

It seems that the current investment mix can support average economic growth of about 3-4% in the EU-CEE, higher than in the past ten years, though still far below that preceding the financial crisis. Although more capital inflows – and especially FDI – may further accelerate growth, there is also a risk of them undermining the external balance. The pre-crisis years have taught the lesson of overheating. EU-CEE will be on a more balanced albeit slower growth path in the years to come.

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