

Foreign Direct Investments: A Comparison of EAEU, DCFTA and Selected EU-CEE Countries

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The paper is based on the authors' contribution to a larger study on FDI between the EU and EAEU conducted by IIASA during 2017. That study also provides insights into the relevant regulatory environment and focuses on the specifics of FDI in the energy sector. It is available at <http://pure.iiasa.ac.at/id/eprint/15273/>.

Abstract

Foreign direct investment (FDI) has been the main driver of restructuring and modernisation in Central and Eastern Europe. This paper looks into FDI stocks and flows in a dynamic and cross-country perspective, comparing the key EAEU countries (Belarus, Kazakhstan and Russia) as well as DCFTA countries (Georgia, Moldova and Ukraine) with selected EU-CEE peers (Hungary, Poland, Romania and Slovakia) in the neighbourhood. The study shows that EAEU and DCFTA countries have not been particularly attractive for foreign investors: taking out round-tripping inflows from offshore destinations, the accumulated FDI would be even lower. This explains a lot why restructuring in the region stalls. This pattern can change only with marked improvements in the domestic regulatory environment and investment climate.

Keywords: foreign direct investment, FDI flows and stocks, Eastern Europe, Belarus, Georgia, Kazakhstan, Moldova, Russia, Ukraine, FDI by key partners and sectors

JEL classification: C82, F13, F14, O57, P23

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1. Overview of recent FDI developments

Foreign direct investment (FDI) has been the main driver of restructuring and modernisation. In the countries of Central and Eastern Europe which became members of the EU in 2004, 2007 and 2013, respectively (termed EU-CEE countries in the following), FDI has been instrumental in both the privatisation of state-owned enterprises and the launching of new greenfield investment projects. After initial hesitance in some EU-CEE countries toward foreign investors' participation in the privatisation of state-owned assets in early 1990 and the presence of foreign capital in general (e.g. in the Czech Republic, Poland and Slovenia), more recently there has been a competition among countries for attracting foreign investors. Before EU accession, the Central and East European countries were competing for investors not only by offering low labour costs, but also by providing various investment incentives such as tax holidays, infrastructure and job-related investment support subsidies, etc. Since the countries' EU accession, foreign investors have to be treated the same as domestic ones (equal treatment). Most recently, however, renewed economic nationalism has resulted in selective treatment of investors by activities, in some countries de facto restricting foreign investment in banking, trade, etc.¹

Costs, tax regimes and targeted subsidies still represent important elements of FDI policies which affect investors' decision-making processes, but other factors such as geographical proximity to markets, and the quality of physical and legal infrastructure – the investment climate in general – are important for investment decisions as well. Foreign investors' motives – the profit gain in general – may differ largely according to the priorities given to local market access and to generating export capacities. Obviously, both varying investors' motives and host countries' characteristics (costs, infrastructure, market size, etc.) affect specific investment decisions.

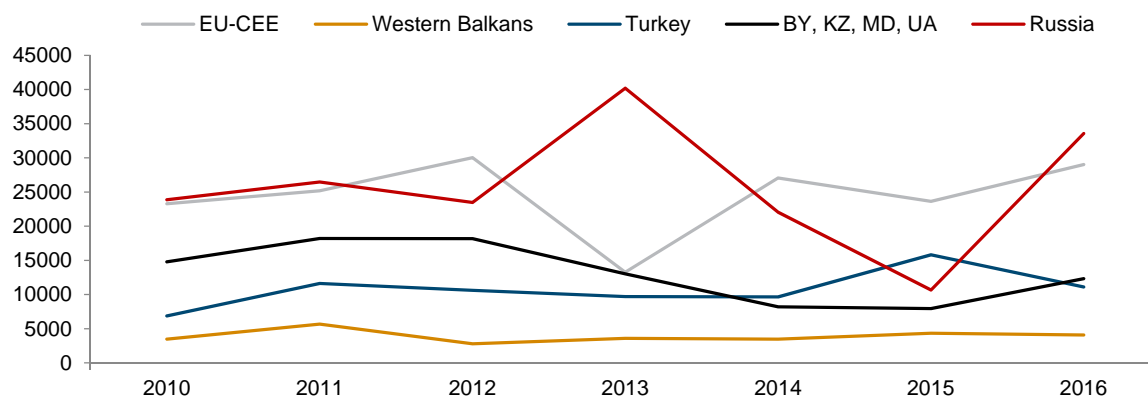
From the FDI host country's perspective, the motives for attracting investors are also manifold: these range from acquiring the foreign exchange badly needed to fill empty government coffers, to getting access to new technologies, marketing and management know-how, to obtaining access to new markets and the integration in global value chains. There have been also differences between export-oriented FDI projects and domestic market-penetration motivated FDI, as well as other important sectoral characteristics. In general, FDI flows in manufacturing have been beneficial in creating modern competitive export-oriented industries and generating corresponding export revenues whereas FDI flowing into services sectors (including finance, insurance but especially retail trade and real estate) have been more problematic since they generate import demand rather than creating appropriate export capacities. FDI inflows in these sectors may thus aggravate balance of payments problems and potentially cause financial bubbles. Investment promotion policies represent an important component of industrial policy, which has recently become popular again, in particular in the context of transition and restructuring.

There is an extensive literature related to various aspects of FDI and we shall provide just a brief overview in this paper. Next, we will analyse FDI stocks and flows in a dynamic and cross-country perspective, comparing the key EAEU (Eurasian Economic Union) countries (Belarus, Kazakhstan and

¹ See Liebscher et al. (2007) and Szanyi (2017) for more details.

Russia) as well as DCFTA (Deep and Comprehensive Free Trade Area) countries (Georgia, Moldova and Ukraine) with selected EU-CEE peers (Hungary, Poland, Romania and Slovakia) in the neighbourhood, as well as with selected West European countries (Austria, Germany, France, Italy and the Netherlands) which are the main investors in Eurasia. We shall look at various indicators related to the FDI performance of individual countries in relation to GDP growth, export revenues and FDI-related incomes. We will also discuss investors' motives such as labour costs and also other indicators, assessing the investment climate in a cross-country perspective. In addition, we will look at the sectoral composition of FDI stocks. A more detailed analysis will be provided for Russia, Belarus and Ukraine. Last but not least, we will also provide conclusions and policy recommendations related to the varying FDI performance in the EAEU, DCFTA and EU-CEE groups of countries. The main source of data in this study is the wiiw FDI Database, which is based on official statistics provided by the respective central banks.²

Figure 1 / FDI inflows in the main regions, EUR million



Source: wiiw FDI Report 2017; wiiw FDI Database.

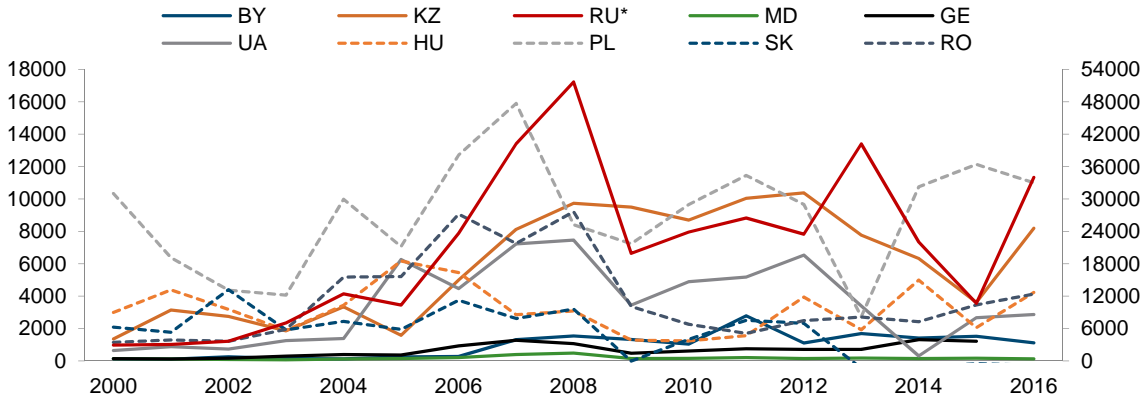
FDI flows have been highly volatile and there is no straightforward explanation for such fluctuations either in the region or globally (UNCTAD, 2017). Moreover, data may differ in the various sources and have been frequently revised even several years backwards.³ In 2015, for example, Russia and Kazakhstan received unusually low inflows due to a combined effect of sanctions, oil price collapse and subsequent domestic currency devaluations. In 2016, FDI to Russia went up sharply, not least owing to a single large transaction (see below for details); inflows to Kazakhstan recovered as well (Figure 2a). FDI inflow into Ukraine also increased in 2016, primarily due to bank recapitalisation and the privatisation of some companies with the participation of institutional investors such as the EBRD. FDI inflows to Georgia were high during the whole 2014-2016 period (about EUR 1.5 billion per year), presumably thanks to the implementation of the DCFTA with the EU. A similar trend, albeit at a much

² See Annex for methodology. The wiiw FDI Database, based on official statistics published by the respective central banks, is available online (<https://data.wiiw.ac.at/foreign-direct-investment.html>).

³ Another source of FDI data is UNCTAD and its World Investment Report published annually. Data on greenfield projects are available from fDiMarkets (www.fdimarkets.com, a division of Financial Times Ltd). The EDB Centre for Integration Studies uses a similar methodology in monitoring and analysis of FDI (EDB, 2016).

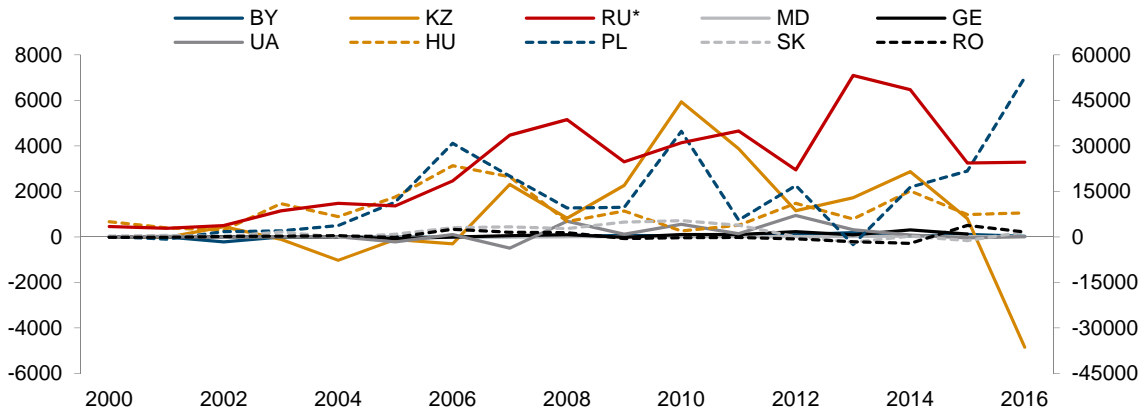
smaller scale, has been observed in Moldova. A similar volatility can be observed in FDI outflows, especially in Kazakhstan, Russia and Poland (Figure 2b).⁴

Figure 2a / FDI inflows in selected countries, EUR million



* Russia (RU): right scale.

Figure 2b / FDI outflows in selected countries, EUR million

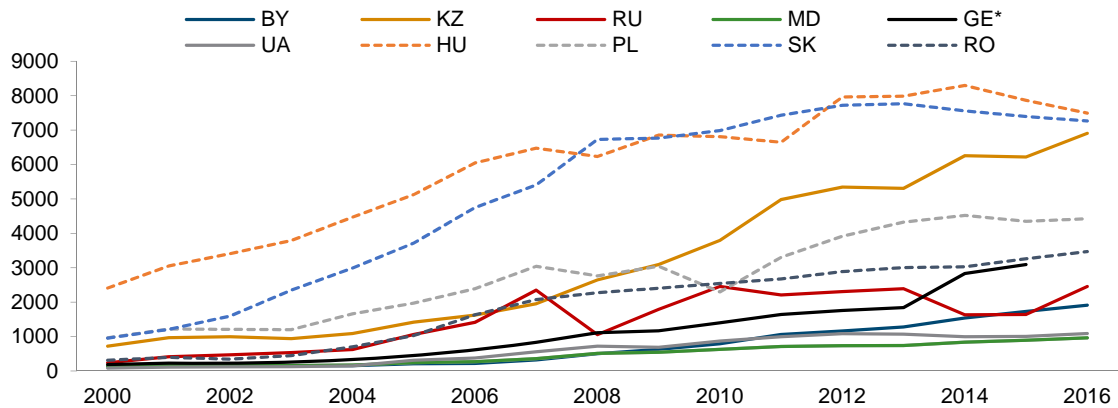


*Russia (RU): right scale.

Source: wiiw FDI Database. Georgia: UNCTAD, World Investment Report, wiiw calculations.

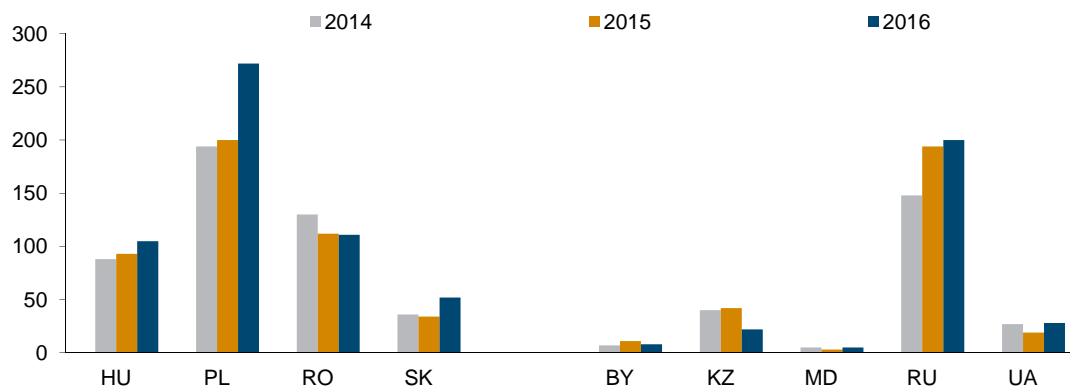
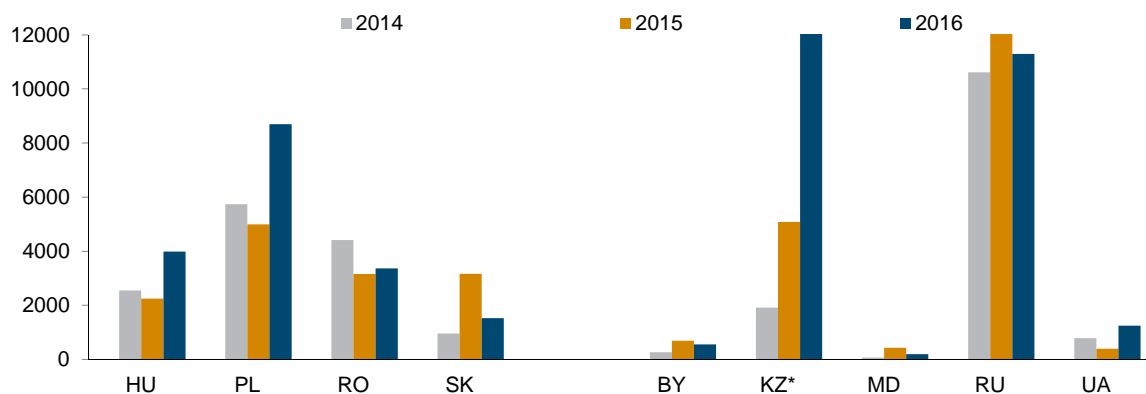
A better tool for international cross-country FDI comparisons is data on per capita stocks/flows (or in % of GDP) since it eliminates the effect of the country size. Figure 3 shows that, apart from Kazakhstan, all EAEU and DCFTA countries accumulated, on aggregate, much less FDI than EU-CEE peers, not to mention West European EU countries. As will be shown below, there are other structural FDI features which distinguish EAEU and DCFTA countries in terms of varying FDI performance from EU-CEE peers.

⁴ In addition, methodological issues affect the volatility (and comparability) of FDI data. Especially assets/liabilities accounting and directional principle, as well as changes in the balance of payments methodology (BPM5 until 2012 and BPM6 since 2013), provide widely different results (e.g. for Cyprus, Austria and the Netherlands). For Austria see: <https://www.oenb.at/isaweb/report.do?report=9.3.04>.

Figure 3 / FDI inward stocks per capita, in EUR

* Georgia: Excluding Abkhazia and South Ossetia.

Source: wiiw FDI Database. Georgia: UNCTAD, World Investment Report, wiiw calculations.

Figure 4a / Number of announced greenfield FDI projects in selected countries, 2014-2016**Figure 4b / Investment capital pledged in greenfield projects by country, 2014-2016, EUR million**

* KZ 2016: EUR 35,122 million.

Source: www.fdimarkets.com (adapted from wiiw FDI Report 2017).

The number and value of newly announced greenfield FDI projects in an economy is another indicator that may express the faith of investors in the host country, as well as their overall sales prospects (Figure 4). Information on these new investment decisions reflects preference for location choice more accurately than FDI flows. Controlling for the size of the country and measuring the number of greenfield projects per thousand inhabitants, we find that Russia and Ukraine were among the least attractive countries during 2014-2016, together with Belarus and Kazakhstan. Nevertheless, the number of announced greenfield projects in Russia was high, especially given the sanctions regime. Main investors were China, Germany and the United States which, paradoxically, may seek market entry and exploit the official Russian import substitution policy especially in food processing and the consumer goods sectors.

Table 1 / Overview of foreign direct investment (FDI) in 2016

	Inflow EUR mn 2016	Inflow growth p.a. in %	FDI net EUR mn	Inflow per capita, EUR	Inward stock	Inflow as % of GFCF	Inward stock as % of GDP
Bulgaria	702	-72.3	530	98	5,632	7.8	84.5
Croatia	1,577	547.5	1,959	378	6,304	17.6	57.6
Czech Republic	6,104	1355.8	5,214	578	10,333	14.2	62.7
Estonia	787	573.1	354	598	13,817	17.1	87.1
Hungary ¹⁾	4,226	105.4	3,171	431	7,490	21.1	65.3
Latvia	114	-81.0	-47	58	6,923	2.5	54.0
Lithuania	-188	. ²⁾	-65	-66	4,586	-2.6	33.8
Poland	11,000	-9.4	4,000	286	4,424	14.4	40.1
Romania	4,134	19.4	3,917	210	3,458	10.8	40.2
Slovakia	-267	51.4	-491	-49	7,263	-1.6	48.8
Slovenia	831	-43.3	742	403	5,850	11.3	30.4
EU-CEE	29,020	22.7	19,283	280	5,643	12.3	49.5
Albania	983	10.4	958	342	1,980	33.7	52.8
Bosnia and Herzegovina	258	5.8	247	68	1,703	9.7	43.4
Kosovo	216	-30.1	176	182	1,953	14.0	57.5
Macedonia	358	65.4	354	172	2,309	17.2	48.6
Montenegro	205	-67.6	372	327	7,039	22.0	116.6
Serbia	2,078	-1.8	1,861	294	4,079	34.2	84.4
Turkey	11,115	-29.7	8,264	140	1,583	4.8	16.3
Western Balkans + Turkey	15,212	-24.8	12,233	157	1,842	6.2	21.1
Belarus	1,122	-26.2	1,097	118	1,911	10.9	42.4
Kazakhstan	8,196	126.5	13,046	460	6,907	30.0	101.6
Georgia	1,500	10.0		405	4050		115.1
Moldova	129	-21.3	121	36	964	9.5	56.2
Russia	33,568	314.0	9,232	229	2,447	13.9	31.1
Ukraine	2,871	7.5	2,857	67	1,087	22.5	55.0
CIS-4 + Ukraine	47,000	150.0	26,508	220	2,500	15.7	39.1
Total region	92,000	45.9	58,000	220	3,159	11.6	38.2

Remarks:

Data refer to BPM6 directional principle, unless otherwise stated.

Moldova: BPM5. Georgia: estimates from GeoStat.

Data exclude special purpose entities (SPEs).

FDI net: inflow minus outflow.

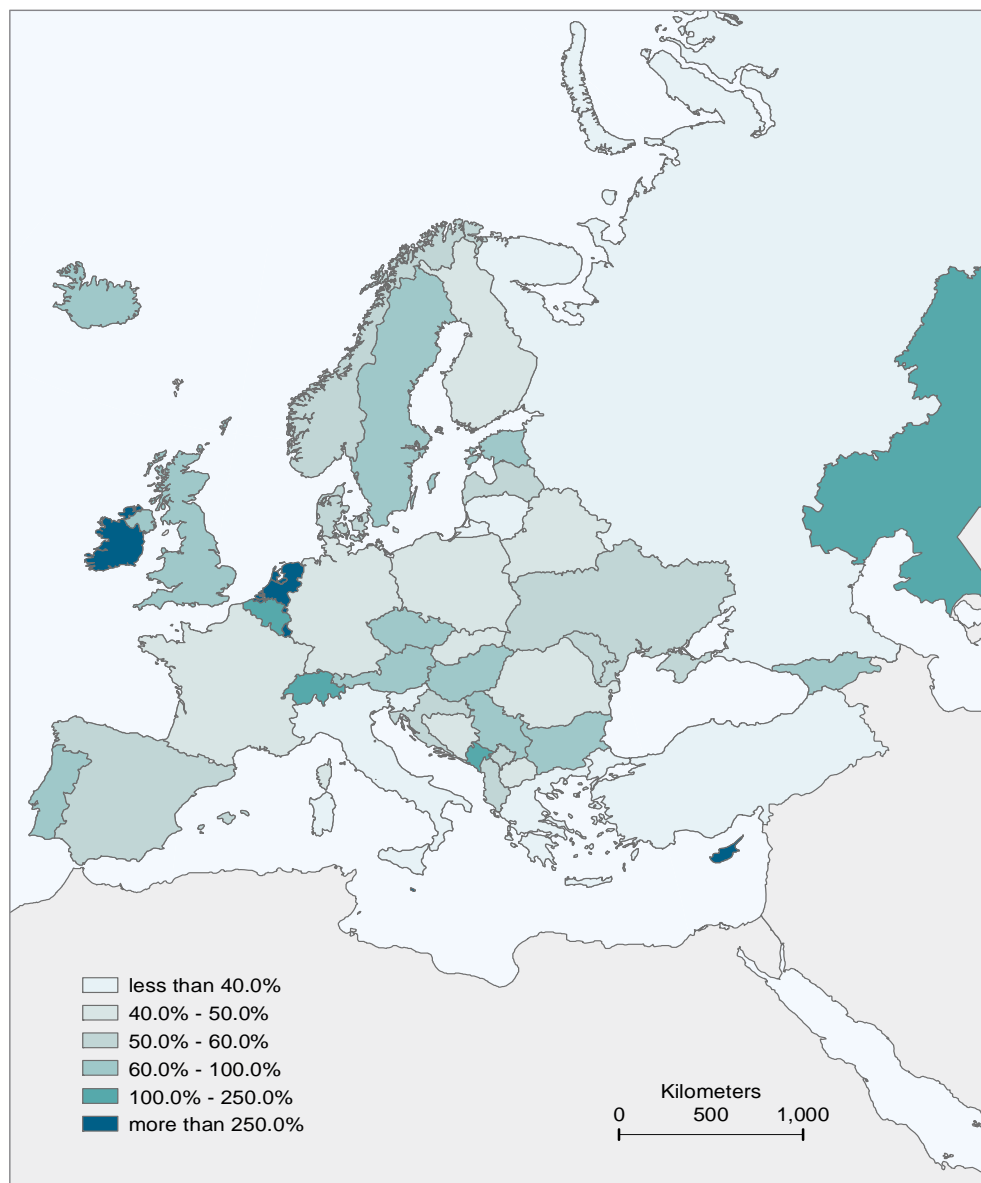
GFCF: Gross fixed capital formation.

1) Inflow and outflow excluding capital in transit and restructuring of asset portfolios. 2) No growth rate given, due to change from positive to negative value.

Sources: wiiw databases incorporating national and Eurostat statistics; adapted from wiiw FDI Report 2017.

Table 1 provides an overview of the key FDI characteristics for selected countries of Central, East and Southeast Europe (CESEE) for the year 2016. For an international comparison, relative indicators (e.g. FDI per capita or FDI in % of GDP) should be used in order to eliminate the effects of varying country size. One can see that, compared to CESEE, both EAEU and DCFTA countries have attracted much less FDI than EU-CEE⁵ (with the possible exception of Kazakhstan where the bulk of FDI is concentrated in mining and basic metals industries). Moreover, a significant part of FDI in both EAEU and DCFTA countries flows via off-shore tax havens (Cyprus) and thus most likely represents just a recycling of domestic flight capital (see more details above).

Map 1 / FDI inward stocks in Europe, in % of GDP, 2016



Source: wiiw Handbook of Statistics 2017 incorporating national statistics and Eurostat.

⁵ For comparison, FDI stock per capita on average for the European Union amounted to EUR 12,800 in 2016 according to Eurostat – twice as much as the average for EU-CEE. Per capita FDI stock (from extra-EU) in Cyprus reached nearly EUR 50,000 in 2015, in Austria EUR 14,300, and in Germany EUR 2,400.

Map 1 illustrates another aspect of FDI stocks in Europe as a whole. Apart from Ireland, the Netherlands, Cyprus and other tax havens which are outliers (see below), it is only Georgia, Kazakhstan and Montenegro which attracted more FDI than their respective GDP. A relatively high FDI penetration in Moldova and Ukraine can be explained by their low GDP.

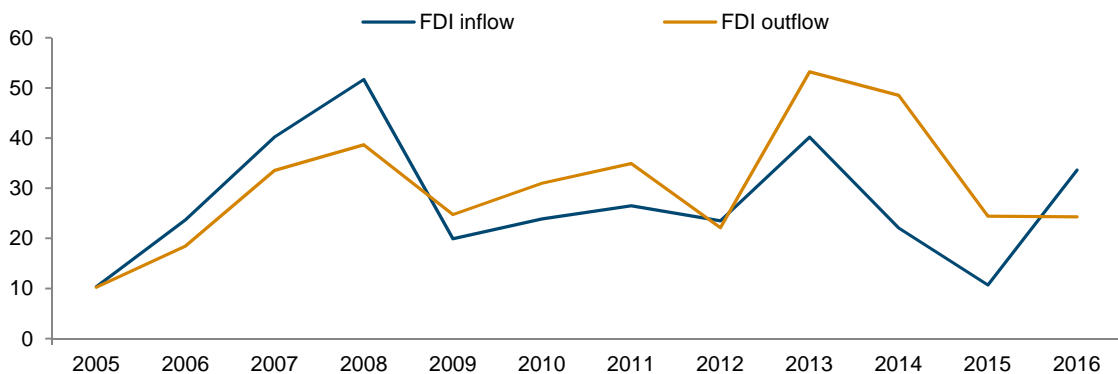
In the next section, we provide a brief overview of the main characteristics of FDI developments in the key EAEU, DCFTA and EU countries.

2. FDI in the Eurasian Economic Union (EAEU)

2.1. RUSSIAN FEDERATION

Russian FDI, which dominates the whole EAEU region in absolute terms, both inward and outward, peaked in 2013, fell significantly in the following two years and has not fully recovered yet (Figure 5). In 2014, inflows suffered a major blow and declined further in 2015 as well, to a level unprecedented in the previous 10 years – or even 20 years, if measured in percentage of GDP. Outflows were still high in both 2013 and 2014, but fell in 2015 to almost the level of 2010-2012 and stayed at that level in 2016. Net FDI was negative in 2015, as outflows surpassed inflows in the preceding three years, and thus FDI contributed to the massive capital flight from Russia. In 2016, inflows surpassed outflows by more than EUR 9 billion. The rapid contraction of FDI in Russia during 2014-2015 may be connected with the decline in economic performance, the Western sanctions on Russian companies and banks restricting their international transactions, the new Russian anti-offshore legislation and tighter EU rules governing capital transactions. In addition, the rouble lost close to 40% of its value after the collapse of the oil prices in 2014, making Russian companies cheaper in EUR terms. FDI stocks had been drastically reduced during that period as well – by more than EUR 150 billion between end-2012 and end-2015 (to EUR 240 billion). A part of the disinvestment can also be attributed to the official ‘de-offshorisation’ campaign (launched in 2014, aiming at returning Russian flight capital home and implemented since the beginning of 2015). Another part of the capital outflow can be attributed to debt service payments. A massive reduction of investments – domestic as well as foreign – is definitely no good sign for modernisation and diversification prospects in Russia.

Figure 5 / Russia: FDI inflows and outflows, EUR billion



Source: wiiw FDI Database.

In 2015, FDI inflows were exclusively in the form of reinvestment of foreign investors' earnings; the inflow of equity and loan instruments turned negative. In 2016, inflows jumped to positive values – net inflows amounted to more than EUR 9 billion, largely owing to the single big transaction in December when a 19.5% stake in the giant oil company Rosneft was sold for EUR 10.2 billion to a Singapore investment vehicle, a joint venture between Qatar and the Swiss oil trading firm Glencore, while the loan

instruments remained negative.⁶ At the same time, greenfield FDI shows a continuous level of commitment to new projects in Russia that is worth EUR 10 billion in each year from 2014 to 2016 (see wiiw FDI Report 2017). There is no contradiction here: not only is it the case that greenfield commitments may not be realised, but also – and this is the main point – directional data on FDI inflow and outflow represent a net amount of new and withdrawn investment flows. (In 2015, gross Russian FDI liabilities increased by about EUR 32 billion, and a similar amount was also withdrawn from the country.) Thus financing for new projects can flow into the country, even as other previously invested foreign assets may leave.

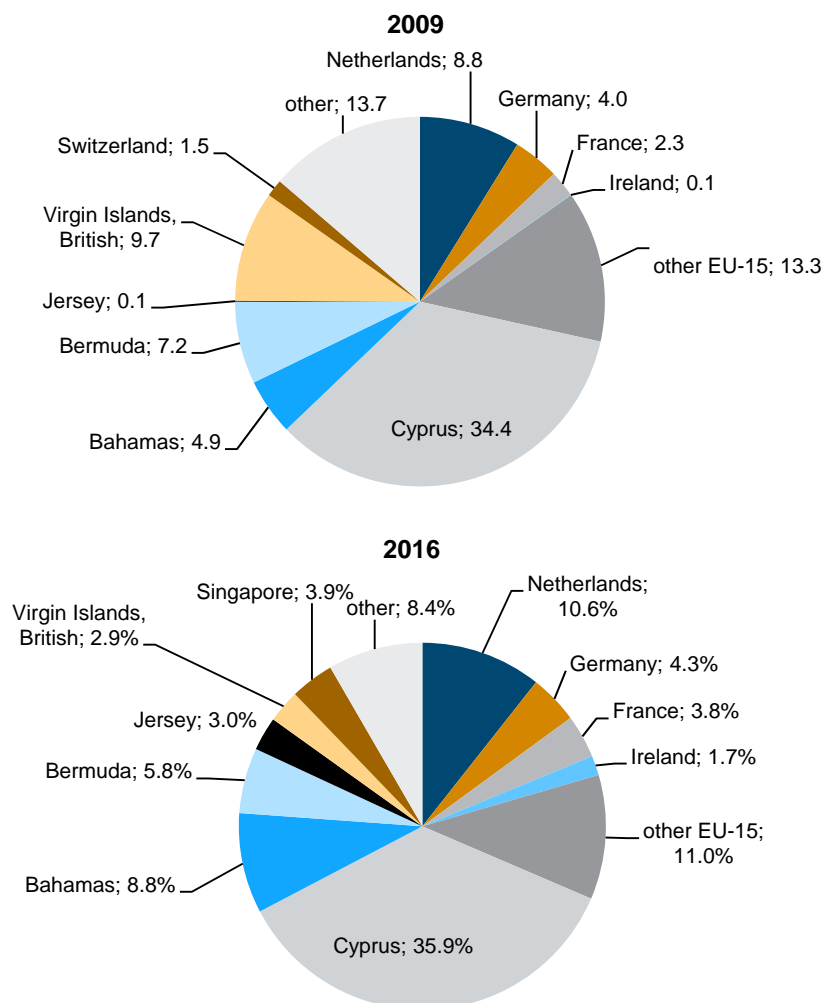
Traditionally, about half of the Russian inward FDI originates from tax havens and offshore centres, while two thirds of the outward FDI went to these destinations (Figure 6). Some EU Member States – such as Cyprus, Luxembourg and the Netherlands – as well as the offshore centres in the Caribbean, are home to Russian companies and holdings most probably chosen for security and tax optimisation reasons. The share of Cyprus has been traditionally high: about one third of stocks and both inflows and outflows related to Cyprus, and other tax havens are of similar size in the longer run.⁷ A large part of the FDI stocks in Russia is thus originally Russian capital kept abroad which returns to Russia as FDI. This round-tripping capital is essentially different from other ('genuine') FDI: it overstates the importance of FDI in Russia and is certainly not instrumental to the modernisation and restructuring of the economy.⁸ A large part of Russian FDI flows thus reflects restructuring of Russian assets and capital flight rather than genuine foreign investment flows. A reshuffling among different tax havens has taken place recently, probably due to the anticipated stricter anti-money laundering OECD and EU legislations requiring banks to identify deposit holders.

Preliminary data for 2016 show a dramatic reversal of the past years' trend: an increase of inward FDI stocks by almost 50% compared to 2015 (to EUR 360 billion as of end-2016), correcting previous large Russian disinvestments in Cyprus and other offshore havens such as the Bahamas, Bermuda and Luxembourg. In 2014, FDI inflows from Luxembourg and countries involved in the embargo against Russia declined, while Cyprus remained the main single source and destination. This came after the 2013 peak of FDI flows, when an extraordinary inflow of EUR 14 billion originated from the United Kingdom (British Petroleum acquisition of 18.5% in Rosneft), while the extraordinarily high outflow of EUR 46 billion (payment by Rosneft for TNK-BP) went to the British Virgin Islands. The following year, Western sanctions on oil companies were introduced to ban cooperation with Russian oil firms by companies that included Exxon Mobil and BP. As a consequence, the third-largest US oil producer, ConocoPhillips, withdrew from Russia. Moreover, Rosneft had to terminate its exploration project with Exxon. As a co-owner of the domestic company Rosneft, BP benefited from rising output, despite low oil prices in 2015. As mentioned above, the surge of FDI inflow in 2016 resulted from a single large transaction linked to Rosneft; the increase in stocks was due to the asset accumulation from Cyprus.

⁶ Singapore appeared among the top ten investors in Russia in 2016 with FDI stocks amounting to nearly EUR 14 billion as of end-2016.

⁷ Cyprus' extraordinary role as a special off-shore investment vehicle is visible also in the statistics published by Eurostat: inward FDI stocks per capita in Cyprus (from outside the EU) amounted to nearly EUR 50,000 in 2015; outward FDI stock per capita invested from Cyprus (outside the EU) to more than EUR 170,000 in 2015. The favourable tax regime explains the interest of Russian business in Cyprus (EY, 2017).

⁸ A similar pattern can be observed in other (post-Soviet) EAEU and DCFTA countries – in contrast to EU-CEE (see below).

Figure 6 / Russia: FDI inward stock by key partners (%), top 10 (ranking 2009 and 2016)

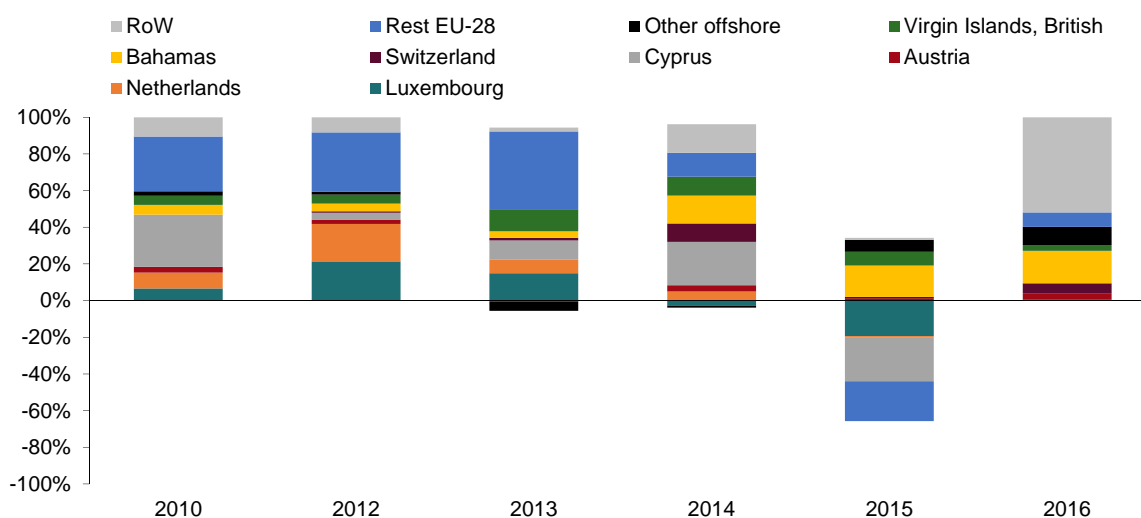
Source: wiiw FDI Database.

Russian deposit holders burned their fingers with banks in Cyprus in 2013, but this did not take away their appetite to use the island for registering firms and parking flight capital there. In fact, the tax-haven conditions in Cyprus were hardly affected by the euro crisis. Because part of the money was converted into bank shares, Russians became shareholders in Cypriot banks; if they owned 10% or more of the shares, they could gain direct-investor status. But tax optimisation and even outright criminality are not the only reasons for Russian capital to look overseas: capital owners have good reason not to trust property rights in Russia or the fuzzy business environment, and therefore feel that their money or their company headquarters are safer abroad.

The Russian government has taken action related to offshoring after Western sanctions were imposed on some of its biggest companies, businessmen and officials, restricting them in foreign fund raising or travel to certain destinations. Tighter regulation of offshore businesses as of 1 January 2015 stipulates that subsidiaries of Russian companies abroad must declare their income and pay 20% tax on their

earnings retained in countries with which Russia does not have a double taxation agreement.⁹ First this regulation applied only to majority Russian companies abroad; but since the beginning of 2016, a 25% ownership is the threshold. As a result, several oligarchs may have moved their businesses back to Russia. Under the new legislation, known as the 'capital amnesty bill', businesses and citizens who declare their foreign assets to the Russian tax authorities in 2015 could do so without facing criminal investigations about the source and movement of the declared assets.

Figure 7 / Russia: FDI inflows by countries, in % of total inflows

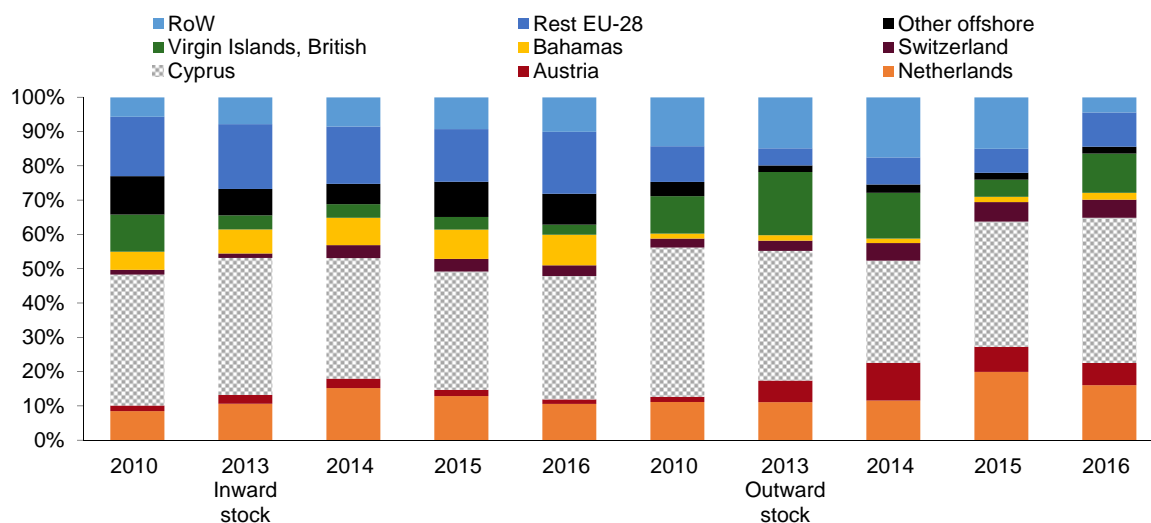


*) 2016: RoW – mainly inflows from Singapore (related to the above-mentioned Rosneft deal) which accounted for 50% of the inflow. Inflows from Cyprus were negative.

Source: wiiw FDI Database.

With all those turbulent movements in FDI flows and the loss in value of some assets, Russian inward FDI stock fell from the peak of EUR 389 billion in 2012 to EUR 240 billion in 2015 and rose again to EUR 360 billion in 2016. Russian outward FDI stock fell from EUR 309 billion at the end of 2012 to EUR 258 billion at the end of 2015 and jumped back to EUR 318 billion in 2016. About 40% of the outward stocks were held in Cyprus in 2013; that proportion declined sharply in 2014, but remained flat in 2015 (at 36%) while increasing to 42% in 2016 (Figure 8). Two further destinations for Russian investors are also important: the Netherlands and Austria (16% and 6.5% of the 2016 outward stocks, respectively). Russian FDI stocks in Austria have been highly volatile: they went up from EUR 5.6 billion in 2012 to EUR 18.6 billion in 2013 and to EUR 30.2 billion in 2014 only to drop to EUR 20 billion in 2016. Austria, the third most important destination in the EU (after Cyprus and the Netherlands), may have been one of the targets for capital round-tripping from Cyprus. About 40% of Russian FDI outflows went to Cyprus in 2016; flow data do not confirm any rapid increase in Russian assets in Austria, except for the year 2013, when outflows amounted to some EUR 3 billion. Thus the increase in inward FDI stocks is related mostly to round-tripping of capital to/from Cyprus and other offshore destinations that can be attributed to the increase in the valuation of assets, reclassifications (e.g. from SPE to ordinary FDI) and/or the identification of new holdings. Needless to say, all these transactions are rather non-transparent and difficult to follow from open sources.

⁹ Russia has signed a double taxation treaty with nearly 80 countries, including the EU, USA, China and Japan – see <https://legalknowledgeportal.com/2013/06/14/double-taxation-treaties-in-russia/>.

Figure 8 / Russia: FDI inward and outward stock, in % of total

Source: wiiw FDI Database.

The inward stock in Russia diminished more than the outward stock in 2014, but the former recovered slightly in 2015 while the latter shrank again. In 2015, Russian inward FDI stock was lower than the outward stock. The devaluation of the rouble that followed the oil price collapse in 2014 was the main reason for these shifts. Cyprus was the primary source of the FDI decline until 2015, but most other home countries' stocks also lost value in 2014-2015, including the Austrian FDI stock (EUR 6 billion in 2014 and EUR 4.3 billion in 2015). Despite the decline and geographic shifts in recent years, Russian FDI remains focused on tax havens and offshore centres; the share of round-tripping capital has increased together with the shrinking Russian FDI. Government measures could not curtail capital flight by improving business conditions to generate trust among Russian capital holders. Genuine FDI, which is not round-tripping Russian capital, has been ravaged. Needless to say, other sources (e.g. Austrian National Bank or Eurostat) report widely different FDI figures, and differences in FDI reporting methodology (assets/liabilities vs directional principle) are rather huge, particularly in the case of Russian official FDI statistics.

Positive inflows of FDI in 2016 were supported by the growth of reinvested earnings, amounting to some EUR 15 billion. In 2016 the portfolio of mergers and acquisitions in the oil and gas sector was also complemented by the acquisition of assets by Indian companies – a joint venture between Vankor India and ONGC Videsh Ltd and Vankorneft.¹⁰ The continued positive dynamics of FDI inflows that started in 2016 is confirmed by data as of the first quarter of 2017. Incoming FDI (USD 4.7 billion) rose in comparison to the corresponding periods of 2015 and 2016, by 51% and 99% respectively. Again, the increased inflow of FDI in this period is connected with such transactions as the sale of a 10% stake in the Russian petrochemical holding Sibur to the Chinese Silk Road Fund,¹¹ the launch of the construction of a Mercedes-Benz passenger car factory in the Yesipovo industrial park by the German company

¹⁰ 'Rosneft successfully closed the deal to sell 11% of Vankorneft to ONGC Videsh Limited', NK PJSC 'Rosneft' (in Russian), 28.10.2016, <https://www.rosneft.ru/press/releases/item/184363/>

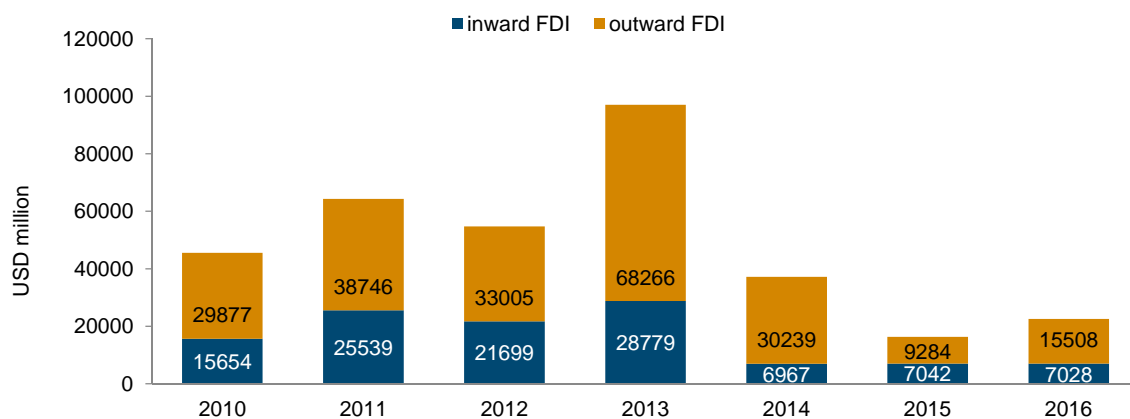
¹¹ 'The deal to sell a 10% stake in Sibur to the Chinese Silk Road Fund is closed, Vedomosti (in Russian), 25.01.2017, <https://www.vedomosti.ru/business/news/2017/01/25/674825-sdelka>

Daimler, etc.¹² At the same time, the project in Yesipovo became the largest project of Western companies in Russia after the introduction of the Western sanctions. The recent positive dynamics of growth in incoming FDI could also support the future plans of foreign investors to continue the existing¹³ and to launch new projects in Russia.¹⁴ Moreover, the import substitution strategy may partly contribute to an increase in the FDI inflows, although they would support first of all the development of local producers through new skills and technologies.

In 2014, the volume of Russian FDI directed to offshore jurisdictions decreased more than twofold in relation to the previous period, amounting to USD 30.2 billion. In the following years, this indicator continued to decline – to USD 9.3 billion in 2015 and USD 15.5 billion in 2016. Despite this, Russia in 2016 became one of the top five countries which are sources of offshore investment. As an offshore country, Cyprus became a key recipient of Russian investment in the pre-crisis period. It received about 30% of the total volume of Russian FDI in the period 2007-2016, while the share of the British Virgin Islands and the Netherlands accounted for 18.1% and 8.2%, respectively.

As for incoming FDI from offshore countries, the business reacted positively to the authorities' call for de-offshorisation of the economy. This is evidenced by the statistics of the Central Bank of Russia over the past two years. The flow of funds has increased significantly from offshore companies registered in the Bahamas and Bermuda. The growth of incoming FDI in 2016 was 37.3% and 26.4%, respectively, in relation to 2014. As mentioned above, the investments coming from these countries to the Russian economy are associated with the repatriation of Russian capital.¹⁵

Figure 9 / Russia: offshore FDI flows (USD million)



Note: Offshore statistics covers countries such as the Bahamas, Bermuda, the British Virgin Islands, Cyprus, the Netherlands and Luxembourg.

Source: CBR database.

¹² Daimler began to build a plant in Moscow suburbs, Vedomosti (in Russian), <http://www.vedomosti.ru/auto/galleries/2017/06/20/695254-daimler-nachal-zavod>

¹³ BP President in Russia David Campbell said that the company, which owns 19.75% of Rosneft, will continue to invest in Russia, despite the sanctions, Vedomosti (in Russian), 30 March 2017, <https://www.vedomosti.ru/business/news/2017/03/30/683385-bp-rossiyu-sanktsii>

¹⁴ The American Hines can buy the last Stockmann facility in Russia, Vedomosti (in Russian), <https://www.vedomosti.ru/realty/articles/2017/02/21/678503-hines-stockmann-rossii>

¹⁵ World Investment Report 2013: Global Value Chains: Investment and Trade for Development, UNCTAD, pp. 16 -65.

At the same time, the balance of FDI flows was positive with the countries traditionally considered as territories for the transit of the Russian capital, such as Cyprus and Luxembourg. This trend can confirm the withdrawal of Russian business from offshores related to the rise in the cost of offshore services, as well as to the introduction in 2015 of mandatory reporting on controlled foreign companies.¹⁶

BOX 1 / THE RUSSIAN LAW ON CONTROLLED FOREIGN COMPANIES

The law on controlled foreign companies #376 FZ was adopted on 24 November, 2014. The new legislation obliges all potential taxpayers to notify the tax authorities of the Russian Federation about their participation in the capital of controlled foreign companies (CEC) with a mandatory annual declaration and confirmation of revenues and profits received by such companies. The required share of participation for the recognition of legal entities or individuals by controlling persons in the CEC for the transition period starts from 50% in 2017. In greater detail, the law deals with the following areas.

1. By including undistributed profits of companies in the taxable base of controlling residents of the Russian Federation the law implements a taxation mechanism for the profits of controlled foreign companies (mostly offshore) in Russia. In addition, it imposes responsibility for non-compliance with the duties specified in the law (Chapter 3.4 of the Tax Code of the Russian Federation).
2. The law makes significant changes to the Tax Code of the Russian Federation on taxation of incomes of foreign companies (Chapter 25 of the Tax Code of the Russian Federation). It introduces changes in the procedure for recognising organisations as tax residents of the Russian Federation.
3. The law introduces certain restrictions on the operation of international treaties on avoidance of double taxation, guided by the rule of 'actual recipient of income' (Article 7, 312 of the Tax Code).

Source: Compiled by Y. Zaytsev and A. Knobel.

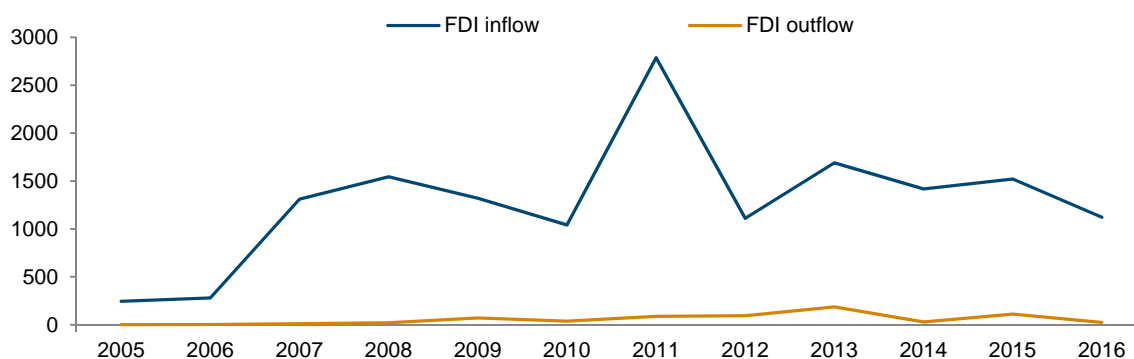
2.2. BELARUS

Belarus was a late-starter and a sluggish reformer, not really welcoming foreign investors and privatisation in general (Dobrinsky et al., 2016). The new privatisation programme started only in 2008 and foreign investors obtained some incentives. Before that, FDI was marginal. FDI inflows to Belarus peaked in 2011 and have stayed relatively modest ever since. In contrast to Russia, there have been virtually no outflows of FDI from the country (Figure 10). After controlling for the size of the country, however, Belarus has received more FDI than either Moldova or Ukraine, but less than the EU-CEE peers. The inflow of about EUR 120 per capita (year 2016) in Belarus was three times higher than in Moldova and two times higher than in Ukraine (see Table 1 above). In 2016, FDI inflows declined yet were still higher on a per capita basis than in Moldova and Ukraine. Due to the relatively short history of FDI, FDI stocks have reached lower levels than in countries with a longer FDI history. The FDI stock per

¹⁶ Reporting on controlled foreign companies was introduced by the federal law 'On Amending Parts One and Two of the Tax Code of the Russian Federation (Regarding Taxation of the Profit of Controlled Foreign Companies and the Income of Foreign Organisations)' from 24 November 2014, No. 376-FZ.

capita in Belarus (EUR 1,900 in 2016) amounted to less than 40% of the Polish and Lithuanian level while the difference measured in terms of FDI stock per GDP is marginal. The poorer DCFTA peers, Moldova and Ukraine, have much lower FDI stocks per capita than Belarus and a somewhat similar FDI penetration ratio (FDI stocks in per cent of GDP – see Table 1).

Figure 10 / Belarus: FDI inflows and outflows, EUR million



Source: wiiw FDI Database.

However, FDI in Belarus is mainly of Russian origin (FDI from Russia amounted to 57-58% of the stocks in both 2009 and 2015, the earliest and latest years respectively for which detailed data are available – see Figure 11). In addition, FDI from Cyprus – another 16% of FDI inward stocks in 2015 – is also in all likelihood of Russian origin, thus the direct and indirect FDI dependence on Russia is much greater. The concentration of flows is even higher in outward FDI: 80% of the EUR 521 million outward FDI stock is located in Russia. The Russian connection constitutes the most important difference between Belarus and its peers. Neither Kazakhstan, Ukraine nor Moldova, not to mention the new EU-CEE members, have any similar dependency rate on Russian FDI flows and stocks.

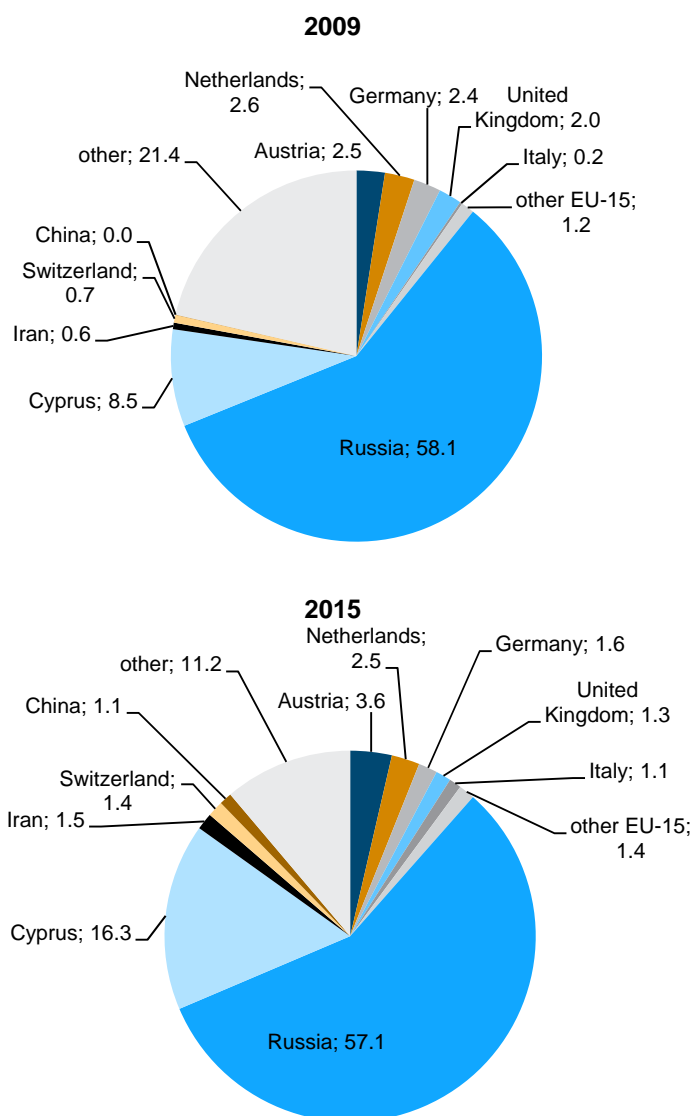
The third most important investor in Belarus, though following at a large distance, is Austria, which accounted for only 3.6% of the FDI stocks in 2015. One of the largest investment projects in the country is the Telekom Austria Group's acquisition of the local mobile telecom provider Belcom in November 2007 and the PriorBank, which is a part of the Austrian Raiffeisen Group. The number of greenfield projects has been meagre, reflecting the largely non-welcoming attitude of the country to foreign investors. Still, some Western companies are finding their way to Belarus also through Russia.¹⁷ For example, two major franchise chains, McDonald's and TGI Friday's, opened restaurants through their Russian franchise partner in Minsk. The owner of the TGI Friday's franchise, the Russian company 'Rosinter Restaurants Holding', also owns the KFC franchise in Belarus. The franchise of Burger King in Russia called 'Burger Rus' operates the Burger King restaurants in Belarus as well.

A major part of Belarus' industry is still state-owned. A peculiarity of the FDI practice in Belarus, similar to policies pursued by some former socialist countries during the 1980s, is that state-owned companies usually form joint ventures (JVs) with foreign investors. As of 1 January 2015, there were 7,099 registered companies with foreign capital in the country of which 4,052 were JVs, 3,018 were foreign

¹⁷ <http://belarusdigest.com/story/investment-climate-belarus-room-growth-22914>

enterprises and 29 others.¹⁸ The total contribution of foreign investors to the statutory capital of enterprises with foreign capital amounted to USD 2,648 million (USD 1,268 million in joint ventures, USD 1,377 million in foreign enterprises and USD 3.2 million in others). Thus about half of the registered foreign capital was in JVs. This FDI entry mode used to be favoured in transition economies in the first years of economic and political transformation, when the legal framework was in the course of being established and a dominant share of the economy was still under state ownership. A JV is a somewhat vague concept and does not represent a specific corporate form. It is supported by the authorities in Belarus and China where one of the participants in the JV is the local government or a state-owned enterprise.

Figure 11 / Belarus: FDI inward stock by key partners (%), top 10 (ranking 2009 and 2015)



Source: wiiw FDI Database.

¹⁸ <http://www.economy.gov.by/en/investors/lgoty-preferencii/FIGURES>

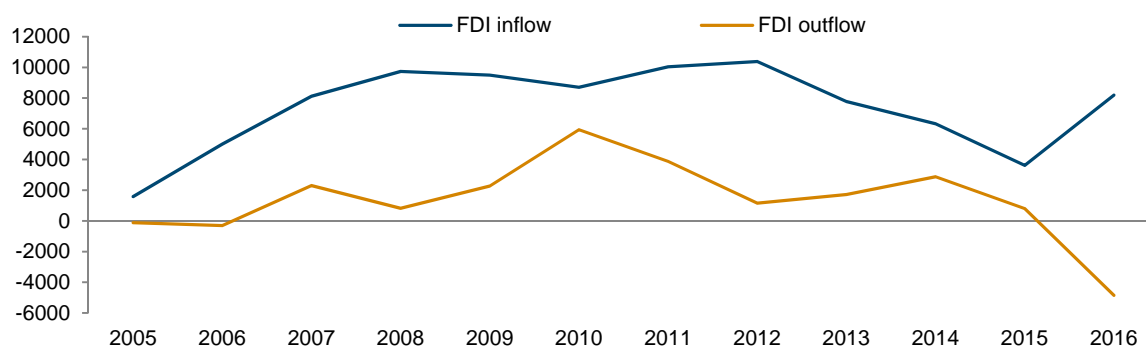
A recent example of a joint venture entry to Belarus is in car production. Chevrolet (Opel) cars will be assembled in Belarus by General Motors and Unison which itself was established as a Belarusian-British joint project.¹⁹ Unison has been assembling Peugeot and Citroën as well as Chinese cars. Later the automaker Iran Khodro joined the JV whose small transporters were assembled in the factory. Further partners in the JV are the Belarus government and the Russian company Fenox Lada. General Motors announced in June 2015 its intention to transfer part of its Russian production capacity to Belarus after demand for Opel cars fell in Russia.²⁰

In 2016 the government announced public sales and tenders for shares in 60 state-owned companies. The list published by the State Property Committee includes 56 open joint stock companies and four enterprises as asset complexes yet the process stalled owing to the economic recession and institutional bottlenecks. Special economic zones, industrial parks (e.g. the Chinese-Belarus industrial park 'Great Stone') and other incentives are yet to bear fruit. The potential for FDI in Belarus is doubtlessly high.

2.3. KAZAKHSTAN

The resource-rich Kazakh economy has attracted a lot of FDI. In relative terms, Kazakhstan recorded the highest FDI inflows and accumulated the biggest FDI stocks among all EAEU and DCFTA countries. Inward FDI stock per capita (EUR 6,900 in 2016) was even higher than the average for EU-CEE (see Table 1 above). However, FDI in Kazakhstan has been highly concentrated in both geographic and sectoral terms: about half of the accumulated FDI stocks originated in the Netherlands (Royal Dutch Shell, etc.), another 18% in the USA (Exxon Mobile, Chevron) and 10% in France (Total). The share of China (2.7% of FDI stock) is still low, yet rapidly increasing (Figure 13).²¹ 75% of accumulated FDI stocks in Kazakhstan in 2016 were concentrated in mining and quarrying; only 5% of FDI went to manufacturing. In 2016, a huge negative outflow occurred which was partly related to a reclassification of FDI activities in the mining industry.

Figure 12 / Kazakhstan: FDI inflows and outflows, EUR million



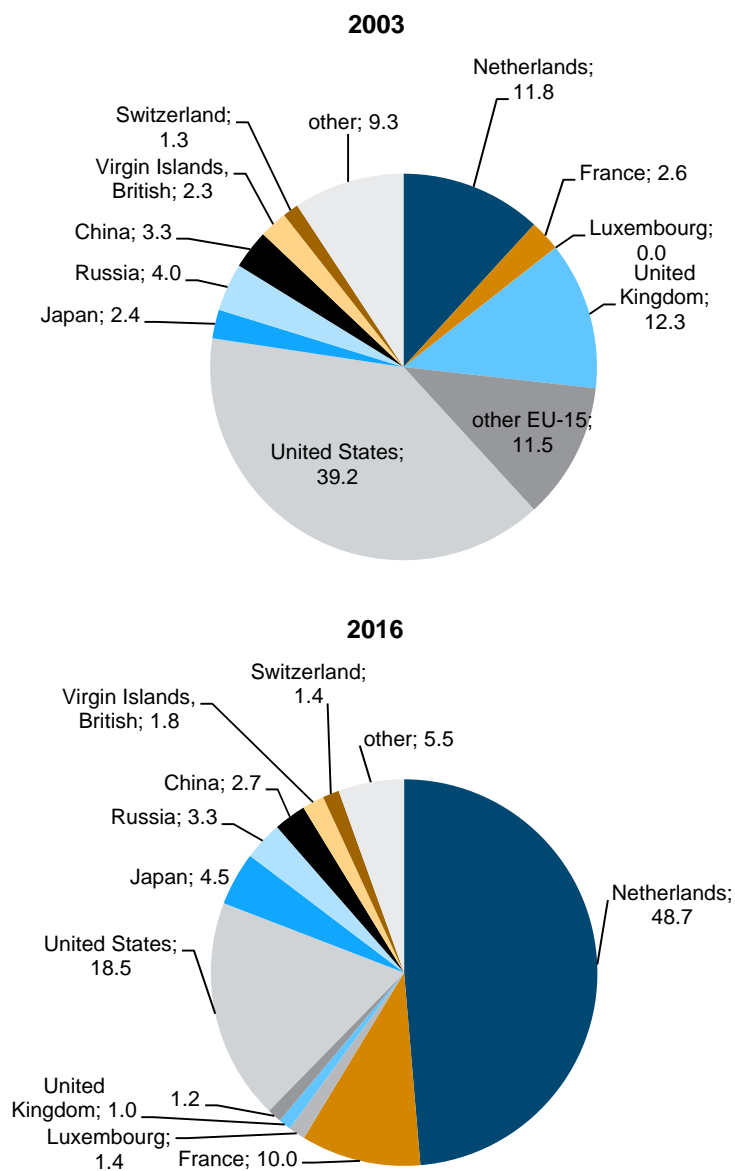
Source: wiiw FDI Database.

¹⁹ http://www.belarus.by/en/business/business-news/general-motors-to-assemble-chevrolet-or-opel-cars-in-belarus_i_0000010654.html

²⁰ <http://wardsauto.com/industry/general-motors-shifts-russian-production-belarus>

²¹ An interesting feature of Kazakh FDI – contrasting other post-Soviet countries – is that the role of Cyprus in FDI flows is rather low (just 0.3% of FDI stocks). Instead, the Netherlands is being also used for tax optimisation purposes by multinational companies.

Figure 13 / Kazakhstan: FDI inward stock by key partners (%), top 10 (ranking 2003 and 2016)



Source: wiiw FDI Database.

3. FDI in DCFTA countries (Georgia, Moldova, Ukraine)

DCFTA countries (especially Moldova and Ukraine) have been laggards with respect to attracting FDI, largely due to 'frozen' conflicts, a poor investment climate as reflected for example by their ranking in Global Competitiveness, and other serious institutional bottlenecks which hinder FDI. It is generally expected that the implementation of the Deep and Comprehensive Free Trade Area (DCFTA; signed in 2014 and fully in force since 2016) with the EU will lead to a more predictable and familiar (to EU investors) regulatory environment. The approximation to EU norms and standards is expected to facilitate inflows of foreign direct investment, the major benefits of which are modernisation and restructuring of domestic industries, job creation, technology spillovers, investment in human capital, better managerial practices, logistics improvements, etc. Importantly, this will also help integrating the domestic businesses in global value chains, something that could be difficult to accomplish by the domestic firms on their own (see Adarov and Havlik, 2016).

Similar to the earlier experience of EU-CEE countries, inflows of FDI, both greenfield and via mergers and acquisitions, are expected to be the main vehicle of industrial modernisation and restructuring in the DCFTA countries. Owing to the commercial acumen of foreign firms, investment will target the most promising areas for cooperation and result in positive spillovers for both upstream and downstream industries in the recipient DCFTA economies. As evidenced in the case of EU-CEE countries, integration with the EU indeed resulted in a boost to FDI inflows even prior to membership (i.e., as soon as a membership perspective became apparent, see Avery et al., 2009; Hunya and Richter, 2011; Grinberg et al., 2008; Liebscher et al., 2007).

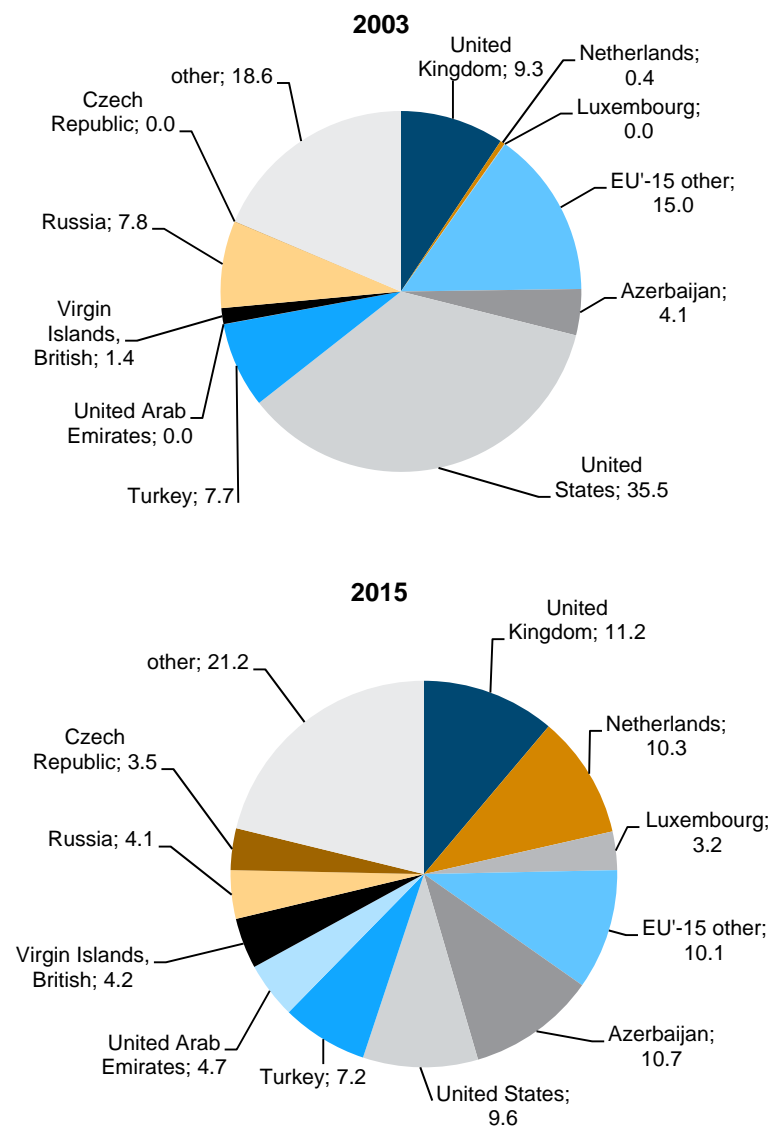
At the same time, it should be noted that the benefits of FDI inflows heavily depend on the progress in closing the gap in the regulatory environment. DCFTA countries that have already advanced in terms of reforms will thus see less additional gains due to a smaller gap. The case in point is Georgia, which made significant progress in business-related reforms already over the course of the 2000s and as a result attracted much FDI – accelerating to 15-20% of GDP over 2006-2007. According to official data, over the period 1995-2016 FDI in Georgia amounted to over USD 16 billion in total, mostly coming from Azerbaijan and Turkey, targeting the transport and communications sector.²² By 2016, FDI stocks reached more than 110% of GDP (the highest share not only among the DCFTA peers but also in comparison with CESEE, though in per capita terms FDI stocks are still somewhat lagging behind – see Table 1 and Figure 2 above). In 2016, FDI inflow to Georgia amounted to another EUR 1.5 billion according to preliminary data.

An important distinct feature of FDI in the DCFTA countries (similar to Russia) has been the skewed geographic origin of investors. In Ukraine, for example, more than 30% of FDI stocks came from Cyprus; the share of FDI from Western Europe (EU-15) was just 36% of total FDI stocks in 2016. In Georgia, a

²² Source: Ministry of Economy and Sustainable Development of Georgia, <http://www.economy.ge/en/economic-review/foreign-direct-investments> and National Statistics Office of Georgia.

lot of FDI originates from Azerbaijan, Turkey, the United Arab Emirates and the Virgin Islands (Figure 14). In Moldova, the biggest investing country is Russia (30% of FDI stocks); Cyprus accounts for another 10% (Figure 15). The extremely high shares of Cyprus in Russia, Ukraine and Moldova indicate that this kind of FDI most likely represents just a recycling of domestic flight capital and possibly also tax evasion. One can probably safely assume that this kind of FDI is not particularly conducive to an upgrading and modernisation of the economy towards EU standards and successful restructuring. Progress in DCFTA implementation and institutional reforms in general should thus rather result in diminishing the shares of offshore-originating FDI.²³

Figure 14 / Georgia: FDI inward stock by key partners (%), top 10 (ranking 2003 and 2015)

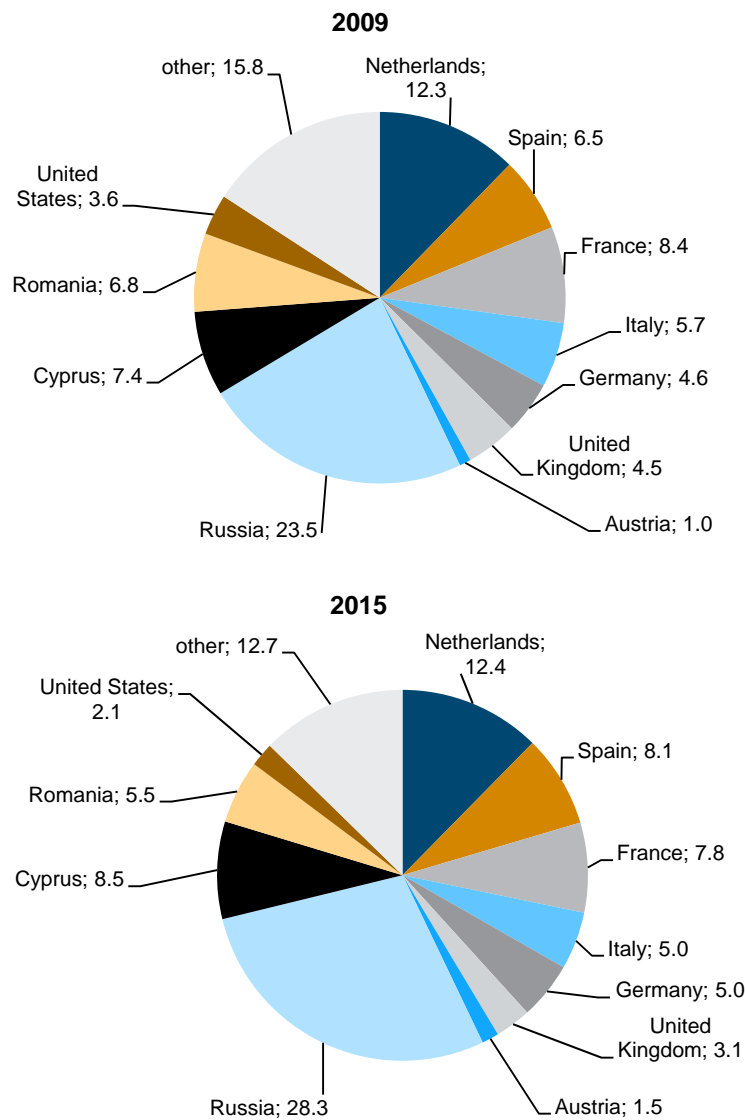


Source: wiiw FDI Database and GeoStat (estimated from cumulated FDI inflows).

²³ For comparison, 85% of FDI stocks in Hungary and Poland originate from the EU-15, in Romania that share is 80%, in Slovakia 70% (another 16% come from the Czech Republic and Korea), in Serbia 64%, etc. – see wiiw FDI Report 2017 and Table 2 below.

Moldova has so far been relatively less successful on aggregate in attracting FDI, despite the Special Economic Zone arrangements designed to improve the business environment and attract FDI in selected areas (Table 1 and Figure 2 above). The acceleration of FDI inflows that the economy saw in 2007-2008 came to an abrupt end owing to the global economic crisis (see more in Giucci and Radeke, 2012; Lupusur et al., 2017). In per capita terms, FDI stocks in Moldova are the lowest among the CESEE peers (less than EUR 1,000 in 2016) and there has not been any acceleration of FDI after the DCFTA signature either. Moreover, the single main investor in the country has been Russia, making Moldova the second most dependent (after Belarus) country on Russian investment (between 2009 and 2015, the share of FDI from Russia in Moldova even increased; Figure 15).

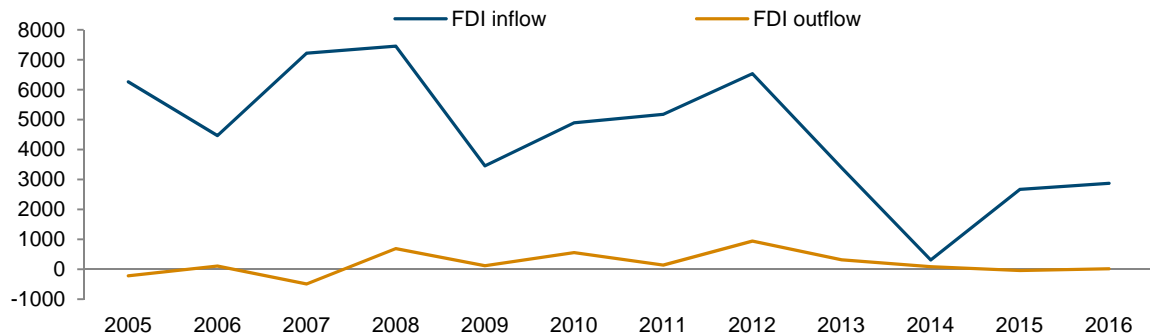
Figure 15 / Moldova: FDI inward stock by key partners (%), top 10 (ranking 2009 and 2015)



Source: wiiw FDI Database.

In Ukraine, FDI flows have been highly volatile as well (Figure 16). After a drop in 2014 resulting from the political crisis, FDI inflows somewhat recovered in 2015-2016, but remained rather low both in comparison to regional peers, the country's potential and to the needs of the country. The investment climate in Ukraine remains still rather poor: it suffers not only from widespread corruption and other institutional bottlenecks, but also from the conflict in Donbas. The share of Cyprus in Ukrainian FDI stocks remains exceptionally high – similar to that observed in Russia (Figure 17). However, the single largest institutional investor in Ukraine has been the EBRD with nearly EUR 12 billion committed as of end-2016, with capital investments in more than 380 projects.²⁴ Russian FDI projects in Ukraine (telecoms, banking, etc.) are currently facing serious obstacles due to the conflict and mutual sanctions. Strangely enough, Russian FDI stocks in Ukraine increased in 2016 and the share rose to 10% of the total, largely at the expense of Cyprus and the Netherlands.

Figure 16 / Ukraine: FDI inflows and outflows, EUR million



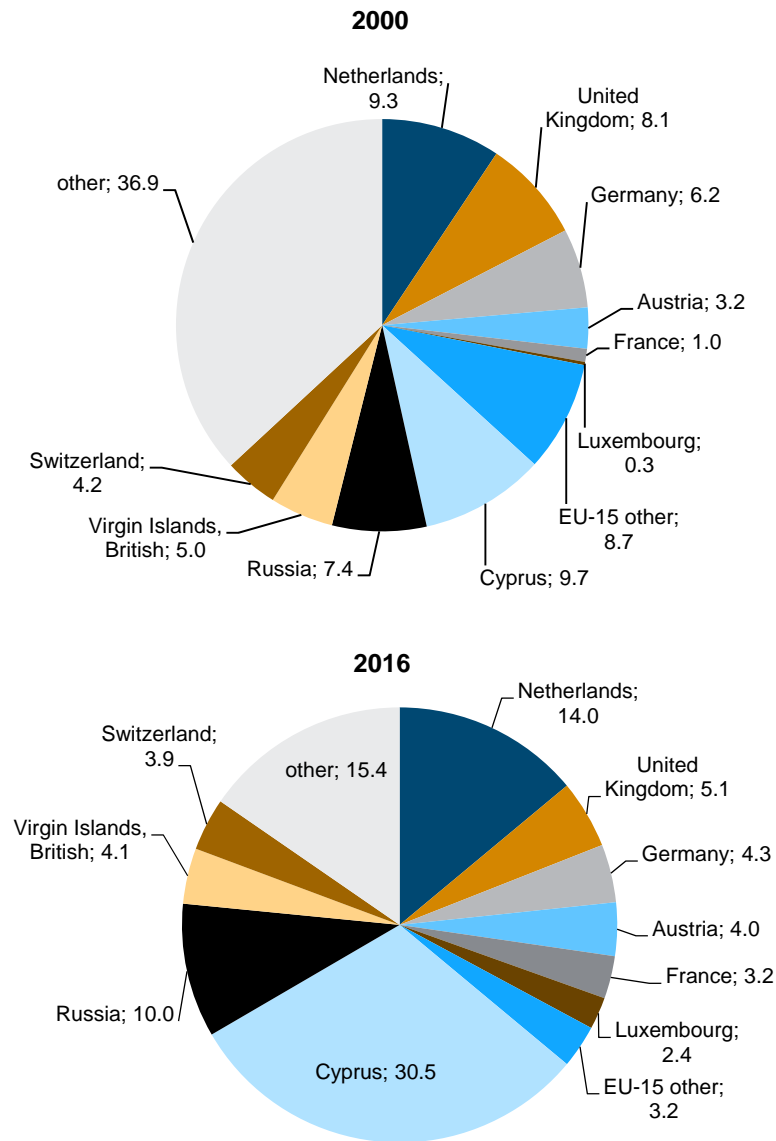
Source: wiiw FDI Database.

FDI stocks per capita have been much lower in the DCFTA countries than in the regional peer economies and in recent years there has been no noticeable increase in FDI flows yet – with the possible exception of Georgia. Higher FDI inflows to Georgia during 2014-2016 focused on construction and transport (non-tradable) sectors. In Ukraine, the reported increase in FDI inflows during 2015 and 2016 was related to the recapitalisation of banks, frequently with EBRD participation. The implementation of AA/DCFTA has so far not resulted in any marked increase of FDI in any of the DCFTA countries.²⁵

²⁴ See <http://www.ebrd.com/ukraine.html>.

²⁵ See Adarov and Havlik (2016) for outstanding implementation challenges; Jarábik et al. (2017) for a recent assessment of implementation progress in all three DCFTA countries.

Figure 17 / Ukraine: FDI inward stock by key partners (%), top 10 (ranking 2000 and 2016)



Source: wiiw FDI Database.

4. FDI in selected EU-CEE peer economies

The experience of the EU-CEE countries indicates that FDI inflows have significantly contributed to the modernisation and economic restructuring of these economies. In particular, FDI in the manufacturing industry as well as in business services such as IT, software development and logistics has been beneficial. Such investments have been particularly welcome as they helped to establish competitive export-oriented industries (the German-CEE automotive cluster is a case in point).²⁶ On the other hand, FDI in the non-tradable sectors (retail and wholesale trade, real estate) was more problematic owing to the risks of widening trade and current account deficits. Such problematic developments have been observed in several Western Balkan countries such as in Albania, Bosnia and Herzegovina, Kosovo and Montenegro (see Gabrisch et al., 2016). Foreign investments have been actively promoted and supported by state-sponsored investment promotion agencies such as CzechInvest in the Czech Republic, Sario in Slovakia, PAIZ in Poland, etc. Similar institutions should be established and revitalised, respectively, in the DCFTA countries as well.²⁷ That is of particular importance as the regional competition for foreign investments among the EU-CEE peers has been intense, while the DCFTA countries are generally lagging behind in terms of business environment, according e.g. to the World Bank's Ease of Doing Business indicators, with Ukraine and Moldova trailing far behind the EU-CEE peers. Georgia has markedly improved its overall investment and Ease of Doing Business ranking recently – now on par with Norway and Sweden – yet still ranks low in Trading Across Borders.

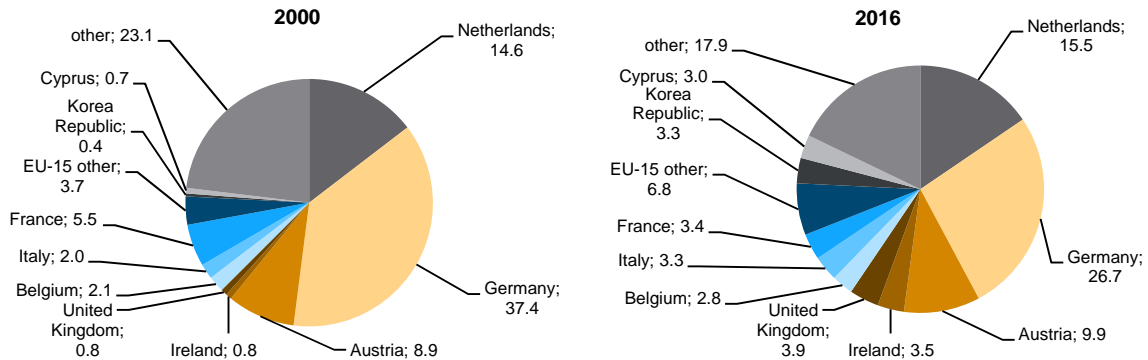
Hungary has been a pioneer among the Central and East European countries regarding reforms, trade liberalisation and attracting foreign investors. First joint ventures with foreign investors were established in Hungary already during the 1980s – about 40 years ago. However, later on, during the 2000s and especially since the introduction of more nationalist policies by Viktor Orbán's latest government, the attitude towards foreign investors has become more reserved. Especially FDI in services (banking and retail trade) has fallen victim to various restrictions such as special taxes, fees or other administrative hindrances. Hungary's accumulated FDI stocks remain high (EUR 7,500 per capita as of end-2016), yet other EU-CEE countries have either caught up (Slovakia) or even surpassed Hungary's pole position (Czech Republic and Estonia – see Table 1 above).

²⁶ See IMF Multi-Country Report, No. 13/263, August 2013; Stöllinger and Stehrer (2015); Szanyi (2017).

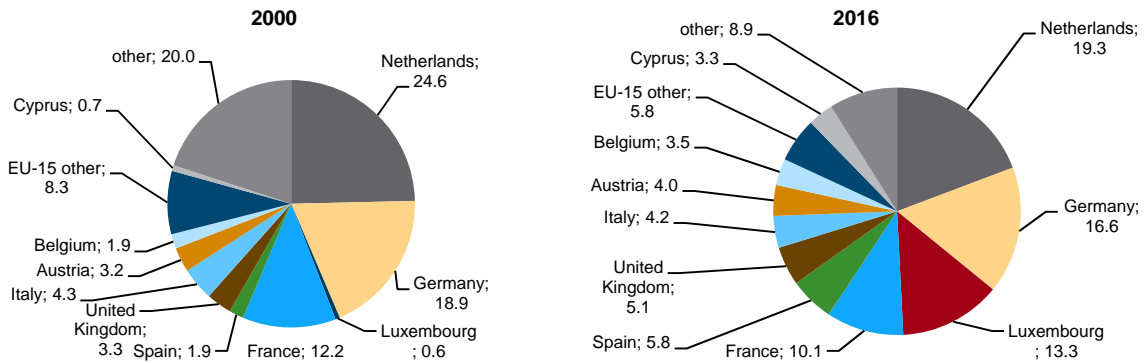
²⁷ This was one of the policy recommendations for Ukraine (see Adarov et al., 2015). The Ukrainian Investment Promotion Agency was liquidated in 2014 after a corruption scandal and has not been revitalised yet (<http://voxukraine.org/2015/09/22/problems-of-investment-promotion-in-ukraine-eng/>).

Figure 18 / Selected EU-CEE countries: FDI inward stock by key partners (%), top 10 (ranking 2000 and 2016)

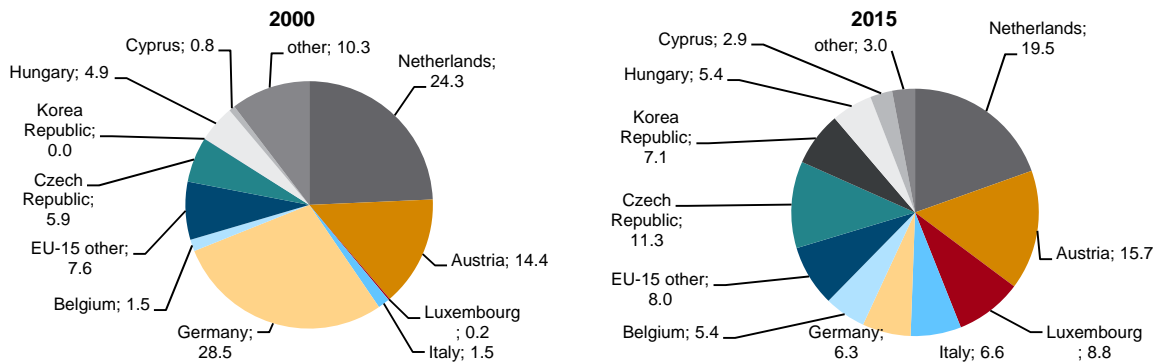
Hungary



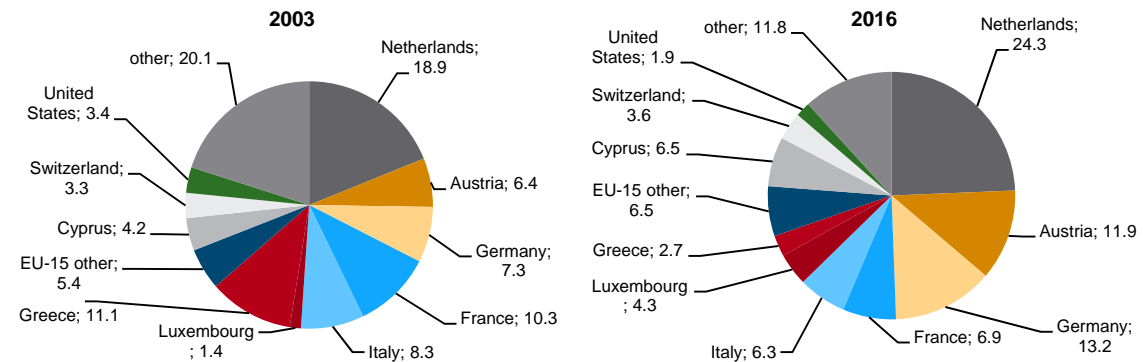
Poland



Slovakia



Romania



Source: wiiw FDI Database based on Direct Investment statistics of respective National Banks.

Poland was the second among the EU-CEE countries which opened up to foreign investors in the early 1990s. Initially, FDI was actively promoted during the first stages of transition but, subsequently, the country became less welcoming to foreign capital – especially with governments led or dominated by the Kaczynski twin brothers in power.²⁸ On the other hand, Romania and Slovakia – both relative newcomers with respect to reforms and FDI openness – were rapidly catching up and became attractive destinations for foreign investors. Table 1 and Figure 18 above provide an overview of FDI patterns in selected EU-CEE countries. In terms of FDI stocks per capita, Slovakia is now on par with Hungary, and Romania (a larger country) is catching up with Poland. As far as the geographic distribution of foreign investors is concerned, the Netherlands and Germany lead, with other West European countries (Austria, France and Italy) playing a leadings role – Figure 18. Interesting is the comparison with EAEU and DCFTA countries: in none of the EU-CEE countries is Cyprus prominently represented and the practice of round-tripping of domestic investors is much less prominent than in either Russia or Ukraine. In EU-CEE, a tax optimisation practice is partly used via the Netherlands: In the current international fiscal environment, the Dutch holding company regime is still the most popular holding regime in the world. The primary reason for this popularity is its tax efficiency (mostly zero tax rate), the flexibility of Dutch corporate and tax law and its relatively low cost of incorporation and annual maintenance.²⁹

²⁸ Both Hungary and Poland started to openly question some elements of the FDI-led development model, in particular by curtailing the activity of foreign multinationals and using the ideology of economic patriotism – for a recent overview see Szanyi (2017).

²⁹ See www.tax-consultants-international.com/read/dutch_holding_Company. For similar reasons, the Netherlands is playing an important FDI role in Kazakhstan.

5. Outward FDI stocks in major West European home countries

As shown above, **Austria, France, Germany, Italy and the Netherlands** are the key home countries providing FDI also in EAEU, DCFTA and EU-CEE countries (apart from Cyprus). In this section we show some basic facts about the investment activities of these countries globally and in the CESEE region in particular. Comparisons with the above sections are difficult: the FDI data used in this section, provided by Eurostat, are not fully comparable especially with respect to partner country details and over time (a separate issue is the treatment of Special Purpose Enterprises, SPEs – see Annex on methodology for details).³⁰

Austria has been a major investor in the CESEE region, focusing mostly on banking and insurance. In 2016, the accumulated global Austrian FDI stocks amounted to EUR 190 billion (EUR 21,740 per capita). The neighbouring EU-CEE countries (Czech Republic, Romania, Hungary and Slovakia) have been preferred investment targets (Figure 19). Russia has not been among the top 10 destinations for Austrian investors: even in the peak year 2008 just 5.4% of Austrian FDI went to Russia.

Germany is one of the largest investors worldwide, investing in manufacturing industry in particular. The total German FDI stock abroad reached EUR 1267 billion (EUR 15,360 per capita) as of end-2016 (Figure 19). The major destination for German investors has been the United States (20%); just 1.3% of German FDI went to Russia (even in the peak year 2013 just about 2% of German FDI stocks were in Russia). In contrast, 6% of German FDI went to China (excluding Hong Kong).

France has also been one of the major global investors with nearly EUR 1200 billion invested abroad as of end-2016 (EUR 17,900 per capita). The structure of partner destinations is similar to Germany (except for China). The United States accounted 19% of French FDI stocks, Russia just for 1.3% (in 2013: 1.3% as well). Nearly EUR 10 billion of French FDI went to Kazakhstan, yet this is just 0.8% of the total.

Italy has been less active in global FDI flows: just EUR 450 billion outward FDI stocks as of end-2016 (EUR 7,400 per capita). Italy has been relatively more engaged in FDI activities in Russia (2% of FDI stocks – see Figure 19). Italy has been the only EU country which increased its FDI stocks in Russia after 2013.

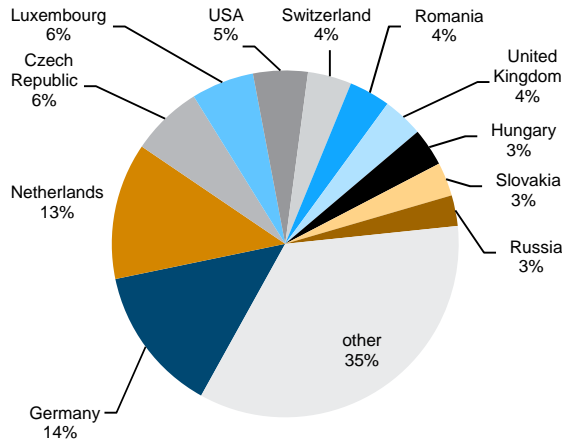
Last but not least, **the Netherlands** has been the largest investor abroad among the EU countries, with more than EUR 1300 billion accumulated FDI stocks as of end-2016 (EUR 77,800 per capita), even without taking into account SPEs.³¹ Russia accounted for just 0.3% of Dutch FDI stocks (including SPEs for 0.7%) – a similar proportion as in Hungary.

³⁰ Figure 19 and the corresponding background data are based on statistics excluding SPEs, compiled by Eurostat according to BPM6 methodology. A detailed comparison with data prior to the year 2013 (BPM5) is neither possible nor meaningful.

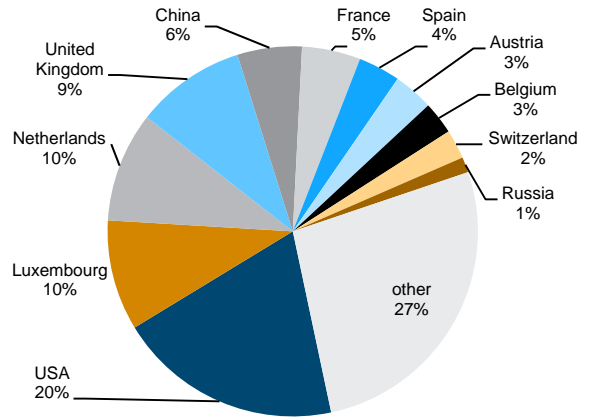
³¹ The Netherlands is one of the few countries which report both datasets to Eurostat. Including SPEs, the total Dutch FDI stocks abroad would reach EUR 4800 billion; the difference being mostly FDI SPEs registered in OPEC countries, Switzerland, Luxembourg and United Kingdom. Dutch SPEs are being used also by Russia and Kazakhstan.

Figure 19 / FDI outward stock by partners, top 10 destinations, as of end-2016

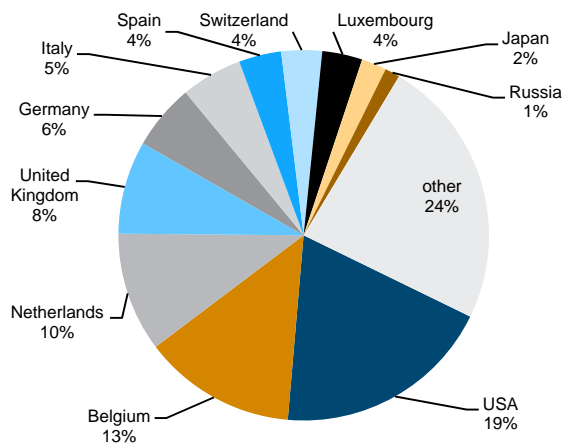
Austria (EUR 190 billion)



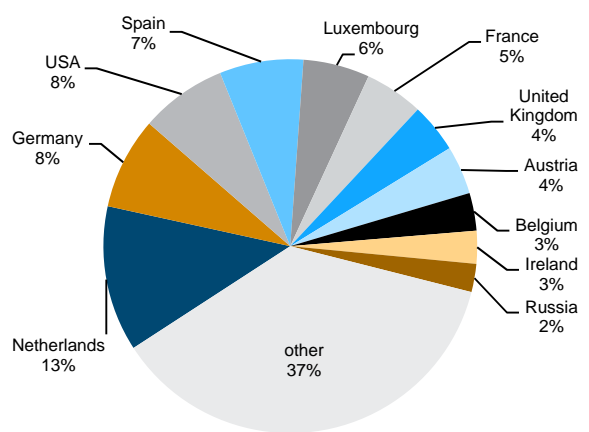
Germany (EUR 1267 billion)



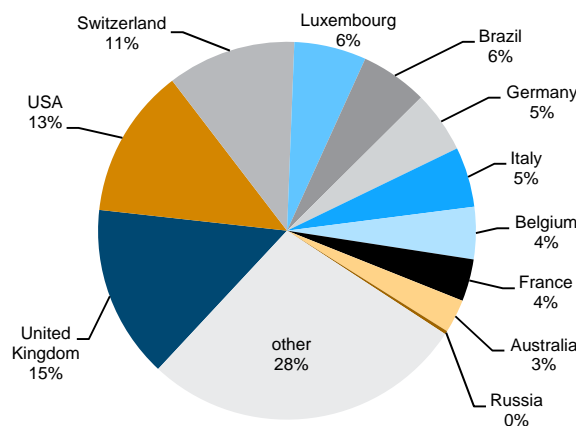
France (EUR 1195 billion)



Italy (EUR 448 billion)



Netherlands (EUR 1322 billion)



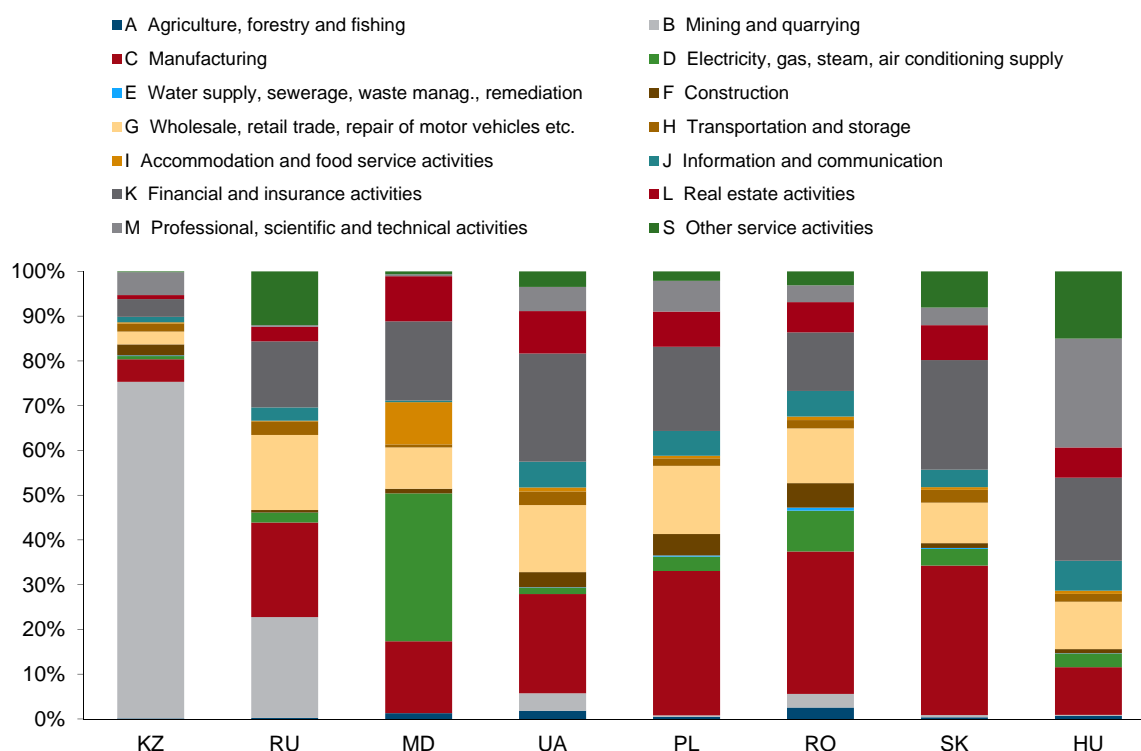
Remarks: China excluding Hong Kong; data for Netherlands excluding SPEs.
 Source: Eurostat, National Bank of Austria, wiiw calculations.

6. FDI stocks by economic activities

Last but not least, it is not just the volume of registered FDI per se and its origin, but also its sectoral structure, investors' motives (e.g. domestic market penetration vs exports) and other FDI structural and 'quality' characteristics that matter. As regards the sectoral composition of FDI in the EAEU, DCFTA and EU-CEE peer countries, there are also important differences. In EU-CEE, the bulk of FDI has been concentrated in manufacturing, trade, and financial services, each of these three broader sectors accounting for about 20-30% of total FDI stocks. In this respect, the DCFTA countries have thus not been much different from Hungary, Poland, Romania, Slovakia or Serbia. As far as EAEU countries are concerned, most FDI has been concentrated in the energy and mining sectors (especially in Kazakhstan and Russia – Figure 20). In contrast, the manufacturing industry has been the main target of foreign investors in Poland, Romania and Slovakia (surprisingly, less so in Hungary, where holdings account for a high share of FDI stocks).³² In Moldova, Ukraine and Romania, there are some (small) investments in agriculture. The energy sector is an important FDI target in Moldova and Romania; mining is important in Kazakhstan and Russia (there are no comparable data for Belarus and Georgia).

Figure 20 / FDI inward stock by economic activities in selected countries, 2016/2015

(in % of total FDI stocks)



Source: wiiw FDI Database.

³² See wiiw FDI Report 2017 for peculiarities of FDI accounting in Hungary ('special purpose entities').

Table 2 / Inward FDI stock in selected EAEU, DCFTA and EU-CEE countries by major investing home countries, 2015, shares in %

FDI recipients	BY	KZ	MD	RU	UA	HU	PL	RO	SK
Investors:									
Austria	3.6	0.8	1.5	1.8	4.8	16.7	3.8	14.2	15.7
Belgium	0.0	0.3	0.4	0.4	0.3	2.0	3.0	2.2	5.4
Spain	0.9	6.2	2.2	1.4
Cyprus	16.3	0.2	8.5	33.6	32.3	1.6	3.5	6.9	2.9
France	0.0	10.1	7.8	3.9	3.4	1.1	10.7	6.7	2.2
Germany	1.6	0.3	5.0	5.3	4.6	22.4	16.4	12.5	6.3
Hungary	0.0	0.0	0.6	0.2	1.4	.	0.3	1.5	5.4
Italy	1.1	0.1	5.0	0.4	1.0	1.2	5.1	5.2	6.6
Luxembourg	0.3	0.5	0.0	3.1	1.1	-2.0	11.5	4.1	8.8
Netherlands	2.5	50.1	12.4	12.6	15.4	28.1	18.2	25.0	19.5
Russia	57.1	2.7	28.3	.	7.4	-0.1	0.2	0.1	-0.4
Sweden	0.3	0.5	0.1	0.9	0.8	0.4	2.3	0.6	0.6
Switzerland	1.4	1.4	0.9	3.3	3.9	0.4	2.5	3.5	1.7
United Kingdom	1.3	-0.1	3.1	2.4	4.7	5.1	5.5	2.1	1.1
United States	0.8	17.5	2.1	0.5	1.7	-1.4	2.9	2.5	0.7
Other countries	13.1	15.0	20.8	31.2	16.2	21.2	4.5	6.6	20.0
EU-15	11.5	62.7	44.3	36.8	37.4	84.8	87.1	79.5	70.3
EU-28	31.3	63.4	61.0	71.0	75.5				
Total	100.0	100.0	100.0	100.0	100.0				

FDI from other countries: in Moldova mostly from Romania; in Slovakia mostly from the Czech Republic.

Source: wiiw FDI Database.

Table 2 provides detailed cross-country data on the distribution of FDI stocks by partner countries for selected EAEU, DCFTA and EU-CEE countries by major investing countries. As can be seen, in EAEU and DCFTA countries it is mainly Cyprus, the Netherlands and Russia which are the top investors whereas in EU-CEE it is mostly Austria and Germany (as well as the Netherlands). The share of FDI stocks from Western Europe (EU-15) in EU-CEE is twice as high as in both EAEU and DCFTA countries (apart from Kazakhstan where the Netherlands is dominant). Russia is an important investor in Belarus and Moldova, but practically non-existent in EU-CEE (except possibly for some off-shore FDI via Cyprus).

7. Investment climate matters

How to explain the huge differences in FDI structural characteristics across individual countries? A number of factors definitely play a role: geography, size of the country, resource endowments, costs and skills of labour, government FDI policies and the investment climate in general. Figure 21 depicts the estimated deviation of FDI stocks in each economy from its potential level over the period 2009-2015. In this estimation, various characteristics of a country (macroeconomic variables, distance from the market, trade costs, etc.) are taken into account. The average FDI potential level for each economy over the seven-year period is 100; included are years of under-performance and years of over-performance. The deviation from the explained part (the FDI potential) is a small share of actual FDI changes, just 6.1%. If a country's performance improves, it changes from below to above 100, for example in Belarus in 2012-2014 and in Moldova during 2010-2012. Thus, the investment environment in these countries has improved. A declining slope, from above 100 to below 100, means that the performance of the economy has deteriorated over time (see, for example, Hungary, Slovakia and, most notably, Russia).³³

A number of other indicators have been used to evaluate the countries' business and investment climate. Some of the most frequently used indicators are the Doing Business surveys regularly conducted by the World Bank, rankings published by the World Economic Forum and others. How are the EAEU and DCFTA countries positioning themselves in this respect?

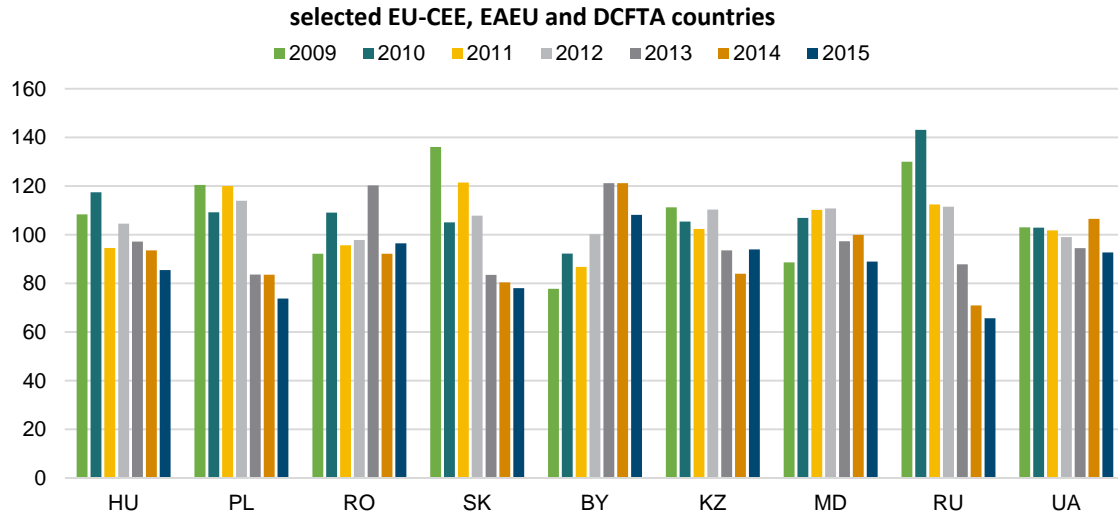
According to the latest World Bank Doing Business survey for 2018 (published on 31 October 2017 and registering big shifts in ranking scores), the EAEU and DCFTA countries covered in this paper received the following ranking (out of 190 countries surveyed):³⁴ Georgia (9), Poland (27), Russian Federation (35), Kazakhstan (36), Belarus (38), Slovakia (39), Moldova (44), Romania (45), Armenia (47), Hungary (48), Azerbaijan (57), Ukraine (76) and Kyrgyzstan (77). The Russian Federation, Kazakhstan, Belarus and Georgia were among the top 10 countries which managed to improve their ranking recently (these average rankings are based on the evaluation of 10 factors relevant for doing business such access to finance, trading across borders, protecting minority investors, etc.).

Alternatively, the World Economic Forum provided in its latest Global Competitiveness Index (published in September 2016)³⁵ the following rankings (out of 138 countries): Poland (36), Russia (43), Kazakhstan (53), Georgia (59), Romania (62), Slovakia (65), Hungary (69), Armenia (79), Ukraine (65), Moldova (100) and Kyrgyzstan (111). Only Poland, Russia, Armenia, Ukraine and Georgia improved their rankings, other countries from our sample fell back in their ranking compared to the previous assessment.

³³ See wiiw FDI Report 2017 for more details regarding the estimation methodology and other results.

³⁴ See <http://www.doingbusiness.org/reports/global-reports/doing-business-2018>; <http://www.doingbusiness.org/reports/global-reports/doing-business-2017>.

³⁵ See <https://www.weforum.org/reports/the-global-competitiveness-report-2016-2017-1>.

Figure 21 / Deviations from the average FDI potential (100), 2009-2015

Source: Estimations by M. Ghodsi (wiiw) using World Development Indicators (WDI), CEPII, UN Comtrade, CEFTA FDI Database.

Needless to say, all these rankings have been criticised and have some drawbacks. Still, they provide – together with other assessments and economic analyses – a useful shorthand overview of the countries' international investment standing. Obviously, other macroeconomic indicators and political risks analysis (in addition to industry and even enterprise-specific conditions and market analysis) are indispensable for making informed investment decisions. The remaining (geopolitical and other) risks are hard to evaluate and will always be present.

8. Conclusions

In conclusion, the analysis implies that neither EAEU nor DCFTA countries have been particularly attractive for foreign investors: taking out round-tripping inflows from offshore destinations, the accumulated FDI stock in this region would be even lower. This explains a lot why restructuring and modernisation in the region stall. This pattern can only change with marked improvements in the domestic regulatory environment and investment climate. FDI inflows should also be promoted by pro-active government policies (in large countries such as Kazakhstan, Russia and Ukraine also at the regional level) which focus mainly on attracting FDI in manufacturing and business services in order to assist the economic restructuring.

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Annex

METHODOLOGICAL ISSUES

Today there is a single methodological framework which is largely used by the EU countries and the Eurasian economies to define and account for FDI in national accounts. Thus, the central banks of EU and Eurasian countries have introduced the requirements provided by the IMF Balance of Payments and International Investment Position Manual (BPM6).³⁶ It complies with general economic concepts set out by the System of National Accounts, 2008 (SNA, 2008)³⁷ as well as with the OECD Benchmark Definition of Foreign Direct Investment (BMD4).³⁸

According to the IMF and OECD definitions, foreign direct investment (FDI) reflects the aim of obtaining a lasting interest by a resident entity of one economy (direct investor) in an enterprise that is resident in another economy (the direct investment enterprise). The lasting interest is associated with a long-term relationship between the direct investor and the direct investment enterprise and a significant degree of influence on the management of the latter. The degree of influence is measured by the direct investor's ownership of 10% or more of a company's capital.

The BPM6 stipulates the assets/liabilities presentation as well as the directional principle for FDI data presentation. The assets/liabilities presentation of FDI is used for the balance of payments and for the international investment position (IIP). The directional principle, which is organised according to the direction of the FDI relationship (inward, FDI in the reporting economy, and outward, FDI abroad), is the principle used in the Coordinated Direct Investment Survey (CDIS),³⁹ which enforces national FDI statistics submission. For current research purposes of the present study the directional principle under BPM6 is used for the analysis of FDI.

The directional principle is a core rule for FDI analysis according to the OECD. This rule applies to outward direct investments of the reporting country abroad and inward direct investments of non-residents in the reporting country. The main international institutions publishing data on FDI (Eurostat, OECD, UNCTAD) follow the directional principle as well. This principle is applied also in the wiiw FDI Database, which is used in the present study.⁴⁰

³⁶ IMF Balance of Payments and International Investment Position Manual (BPM6), <http://www.imf.org/external/pubs/ft/bop/2007/pdf/bpm6.pdf>.

³⁷ The System of National Accounts was produced jointly by the Commission of the European Communities, the International Monetary Fund, the Organisation for Economic Co-operation and Development, the United Nations, and the World Bank.

³⁸ Benchmark Definition of Foreign Direct Investment, <http://www.oecd.org/daf/inv/investmentstatisticsandanalysis/40193734.pdf>.

³⁹ Coordinated Direct Investment Survey (CDIS), <https://www.imf.org/external/pubs/ft/bop/2015/pdf/15-10.pdf>.

⁴⁰ <https://data.wiiw.ac.at/foreign-direct-investment.html>.

OECD methodological particularities

Most of the EU countries comply with OECD standards on FDI statistics, reflected in the Benchmark Definition of Foreign Direct Investment (BMD4), which sets the world standard for FDI statistics. It is fully compatible with the BPM6. The underlying concepts and definitions that apply to cross-border investments are fully in line with those set by the BPM6. These standards introduce new reporting techniques for financial measures of direct investment, taking into account the impact of globalisation and changing financing models of multinational enterprises (MNEs). It devotes, for the first time, a chapter on economic activities of MNEs as well as a chapter on the uses of FDI statistics.

The main advantage of the OECD FDI statistics is the disaggregation of FDI data on special purpose entities (SPEs) and resident operating companies, introduced by the BMD4. This allows to identify the FDI associated mainly with the physical presence of the resident operating companies and excluding SPEs. The idea is that the SPEs (i.e. entities owned by foreigners without economic activity, most of whose assets consist of foreign equity holdings) may often distort FDI statistics. First, transactions by SPEs inflate the FDI flows into and out of the country where they are located. Second, SPEs can distort the geographic distribution of FDI statistics for countries because it can appear they are receiving investment from countries whose investors are just passing capital through SPEs.⁴¹

However, in the case of the current analysis only some EU Member States publish FDI flow and stock data excluding SPEs. The Eurasian countries do not disaggregate the FDI data separating SPEs. However, using the EU countries' national FDI data cleaned from funds associated with SPEs illustrates that most of the mutual FDI flows from Russia on the one side and France, Germany and Italy on the other side are associated with the physical presence of the resident operating companies. The same tendency was observed for Ukraine, Azerbaijan and Kazakhstan with Germany and France as investment partners. The differences between FDI data according to assets/liabilities and directional principle, respectively, is particularly high for Russia.

Exchange rate issues

Given that the national FDI statistics of the central banks of Eurasian countries are provided in US dollar, for consistency reasons with the EU data they should be converted to euro. According to the IMF, the market price should be used as the basis for the valuation of FDI flows and stocks, although this means different approaches for the two types of data. For flows, the market price refers to the actual price agreed upon by transactors on the date of the transaction and should not reflect changes induced by fluctuations in exchange rates. For this reason, the period EUR/USD average exchange rate is used. For stocks, the IMF recommends to use the market price at the time of the compilation of the stocks. Thus, the end-of-period EUR/USD exchange rate is used.

⁴¹ The OECD gives a profound explanation of the meaning of SPEs. Examples of SPEs include brass plate companies, financing subsidiaries, conduits, holding companies, shelf companies, and shell companies; <https://www.oecd.org/daf/inv/How-MNEs-channel-investments.pdf>

Services

FDI flows are frequently associated with services. Transactions in services can often take place between companies in a direct investment relationship. Many of them do not necessarily involve cash payments and merely give rise to entries in intercompany accounts. If the production does not involve physical presence, such as in some cases of banking, insurance, or other financial services, the operations should be recognised as being conducted in the territory by virtue of the registration or legal domicile of those operations in that territory.⁴²

The national authorities could report updated/revised data, which could miss non-transaction changes arising from, for example, exchange rate and price changes. This refers primarily to stock data on FDI. The FDI data of the EU national central banks published in euro generally correlate the data of Eurasian countries, published in US dollar, with an exchange rate correction. The data observation starts with 2002 when the euro was introduced. This would help to decrease the errors associated with exchange rate calculations.

The interpretation of FDI flow data by the standard location factors has become increasingly difficult due to the widespread use of special investment vehicles and other reporting peculiarities (see the examples of Russia and Hungary below). Especially for the EU-CEE countries, it seems unrealistic to explain fluctuations in FDI inflows by changes in economic or regulatory conditions, which in fact are rather slow. Capital relations between subsidiaries and parent companies have become more complex: capital reserves, losses and profits are shifted around within multinational conglomerates in various forms of FDI and income. Further methodological problems arise if FDI includes capital transactions other than real investments.

Balance of Payments and International Investment Position Manual Edition 6 (BPM6)

Unless otherwise stated, FDI data used in this report are based on BPM6 definition: <https://www.imf.org/external/pubs/ft/bop/2007/bopman6.htm>

*BPM6 updates the fifth edition of the Balance of Payments Manual (BPM5). Also the corresponding OECD Benchmark Definition of Foreign Direct Investment, 4th edition 2008 replaces the 3rd edition. In BPM6, direct investment is presented on an **assets and liabilities** (A/L) basis, instead of on the directional principle (DP) used in BPM5. This increases both the net acquisition of financial assets and the net incurrence of liabilities. Netting out assets and liabilities results in the same amount as netting inflows and outflows in the (new) directional principle (FDI net is the same). The **directional principle** under BPM6 is used for FDI analysis and is provided in the **wiiw FDI Database** used for this report.*

*In the **standard components**, direct investment is classified according to the relationship between the investor and the entity receiving the investment as equity, reinvested earnings and debt instruments. The wiiw FDI Database and this report provide these data for the countries covered.*

⁴² See chapter on 'Services' in the BPM6 Compilation Guide (Companion Document to the Sixth Edition of the IMF Balance of Payments and International Investment Position Manual); https://www.imf.org/external/pubs/ft/bop/2014/pdf/BPM6_12F.pdf

*BPM6 prescribes market prices for the valuation of international accounts. However, market prices are not readily available for many assets/liabilities including for unlisted and other equity. For EU Member States the application of the 'Own Funds at Book Value' derived from the **balance sheet of the direct investment enterprise** is recommended by Eurostat in case a market price (listing on a stock exchange) is not available. The wiiw FDI Database complies with Eurostat standards.*

***Changes in FDI stocks** (positions) other than those due to transactions (flows), occur due to exchange rate movements, as well as other price changes resulting from holding gains or losses and other changes, e.g. reclassifications from portfolio investment to direct investment.*

Directional principle – the main presentation form to support FDI analysis

based on <https://www.oenb.at/en/Statistics/Reporting/New-Balance-of-Payments-Manual-in-2014.html>

*The **directional principle**, in which outward direct investments of the reporting country abroad and inward direct investments of non-residents in the reporting country are recorded on a net basis, serves for more detailed analyses by the main international institutions publishing data on FDI (Eurostat, OECD, UNCTAD). In the new 'extended' directional principle, debt instruments (loans) between fellow enterprises are treated according to the location of the headquarters (residents vs non-residents). Net basis means gross investment minus disinvestment; as a consequence, both FDI inflows and outflows can take a **negative** sign.*

*The main difference between the two presentational styles (A/L and DP) stems from the treatment of '**reverse investments**', i.e. receivables of a foreign subsidiary vis-à-vis the parent (in the reporting country). According to the assets/liabilities concept, these receivables are added to the payables of the reporting country (FDI outflow), whereas according to the directional principle, they are subtracted from active direct investments (reduce the FDI inflow). In case reverse investments are higher than the assets/liabilities, negative FDI flow and stock figures may appear.*

*All data available in the wiiw FDI Database **exclude** Special Purpose Entities (SPEs).*

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