

Press release

Foreign direct investment flows to eastern Europe have peaked

September 5, 2007—Foreign direct investment (FDI) inflows into the transition economies of eastern Europe reached a record total of US\$106bn in 2006, but FDI inflows to the region are now likely to begin to trend downwards according to *World Investment Prospects to 2011: Foreign direct investment and the challenge of political risk*. The report, produced by the Economist Intelligence Unit in co-operation with the Columbia Program on International Investment (CPII), charts global FDI trends over the next five years, including on the basis of a global survey of more than 600 direct investors.

A modest decline in FDI inflows to the region is forecast for 2007, to a still very high US\$104bn. Total FDI inflows are likely to continue to trend downwards after as a result of the near-exhaustion of major privatisation opportunities in much of the region and sharply increasing labour costs in many countries. "Continuing business environment problems and competition from other destinations will contribute to a tailing-off of FDI inflows into many of the new EU member states" observes **Laza Kekic**, Director of Country Forecasting Services at the Economist Intelligence Unit and one of the report's editors. Political risk and business environment problems will keep flows below potential in much of the CIS.

FDI in 2006

FDI inflows into eastern Europe increased by 37% in 2006—exactly equal to the growth rate in global FDI in 2006. The region displaced Latin America and the Caribbean as the second most important emerging-market destination for FDI after developing Asia. Three economies in the region were among the top emerging-market FDI recipients in 2006—Russia (third), Poland (tenth) and Romania (11th). The US\$106bn total inflows represented almost 5% of the transition region's GDP, the highest ratio achieved so far. For the Balkans the FDI inflows/GDP ratio exceeded 10% in 2006, and it was almost 8% for the Baltic states.

The 2006 increase in FDI inflows affected all transition subregions—except east-central Europe, where inflows equalled the 2005 total—and most economies in the area. For a large number of countries, the 2006 inflows represented a record total (Russia, Poland, Romania, Slovakia, Bulgaria, Croatia, Serbia, Montenegro, Latvia, Lithuania and Kazakhstan). The growth in FDI inflows was the result of large-scale privatisation sales in some countries; growth in reinvested earnings, as well as a real estate boom in many new EU member states; ongoing strong growth in FDI into the Balkans; and commodity investments into some CIS states. There was a very strong increase in FDI flows into Russia, which more than doubled in 2006 to US\$28.7bn. The lure of ample market opportunities and very strong consumer spending growth in Russia more than offset the impact of some deterioration in the business environment—especially as far as investment in natural resources is concerned.

FDI inflows into eastern Europe

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 |
|------------------------|------|------|-------|-------|------|------|------|------|
| Inflows (US\$ bn) | 66.9 | 77.1 | 105.9 | 104.0 | 94.3 | 94.1 | 94.8 | 96.9 |
| % of world total | 9.2 | 7.9 | 7.9 | 7.1 | 6.7 | 6.4 | 6.2 | 6.0 |
| % change, year on year | 90.8 | 15.4 | 37.2 | -1.8 | -9.3 | -0.3 | 0.8 | 2.3 |
| % of GDP | 4.4 | 4.1 | 4.7 | 3.8 | 3.0 | 2.8 | 2.6 | 2.4 |

Source: *World Investment Prospects to 2011*.

Medium-term trends

Russia will be the main destination country for FDI in the region over the medium term (although as a share of GDP and in per-capita terms inflows will still remain relatively modest). Despite increased state control and continued problems in the operating environment, Russia is nevertheless expected to record

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some improvements in its business environment in the medium term. WTO membership, expected in the next couple of years, will have a positive impact. Annual average FDI inflows into Russia are projected at above US\$30bn during the next five years.

FDI inflows into the ten new EU member states from eastern Europe (including Bulgaria and Romania, which joined in January 2007) peaked in 2006 at US\$53bn. They are forecast to decline to US\$43bn in 2007 and to fall further, stabilising at just under US\$40bn per year, in 2008-11. Although this will still amount to a good performance in terms of FDI inflows as a share of GDP, given rising wage costs in much of the region, the danger of a diversion of cost-sensitive forms of FDI to even cheaper destinations may loom larger than any promise of much more relocation to these countries of investment from the West.

Opportunities versus political risks

The survey revealed sharp differences in the assessment of political risks in east central Europe, on the one hand, and in Russia and other CIS states on the other. All four forms of political risk (risks of political violence, FDI protectionism, and threats associated with geopolitical tensions and governmental instability) are less of a concern to investors in east central Europe than in most other emerging markets. By contrast, in Russia, as well as central Asia, political risk is high on the agenda.

In the survey 20% of respondent rated as "high" the risk of terrorism in Russia and central Asia. The corresponding proportion for the risk of FDI protectionism was 38% - higher than for any other region. Some 55% believed that rising Russian-Western tensions will have a significant negative impact on business. Russia was actually rated the world's second riskiest market, behind only Iraq. For now, however, the opportunities clearly trump the risks. Russia rated well as desired FDI destination: 53% of those surveyed said that Russia was important to their investment plans.

World Investment Prospects to 2011 is available from www.eiu.com/wip or www.cpii.columbia.edu

Copies are available for members of the press from the PR contacts below.

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The Emerging Markets Conference, 24-25 September

The main findings of the report will be presented at the Economist Conference's Emerging Market Summit at the Millennium Hotel London, on the 24-25th September. *For more information:* <http://www.economistconferences.com>

About the Economist Intelligence Unit

The Economist Intelligence Unit is the business information arm of The Economist Group, publisher of *The Economist*. Through our global network of over 500 analysts, we continuously assess and forecast political, economic and business conditions in 195 countries. As the world's leading provider of country intelligence, we help executives make better business decisions by providing timely, reliable and impartial analysis on worldwide market trends and business strategies. More information about the Economist Intelligence Unit can be found on the Web at www.eiu.com.

About the Columbia Program on International Investment

The Columbia Program on International Investment (CPII), headed by Karl P. Sauvant, is a joint undertaking of the Columbia Law School, under Dean David M. Schizer, and The Earth Institute at Columbia University, directed by Jeffrey D. Sachs. It seeks to be a leader on issues related to foreign direct investment (FDI) in the global economy. The CPII focuses on the analysis and teaching of the implications of FDI for public policy and international investment law. Its objectives are to analyze important topical policy-oriented issues related to FDI, develop and disseminate practical approaches and solutions, and provide students with a challenging learning environment. More information about the Program can be found on the Web at www.cpii.columbia.edu.

Foreign direct investment inflows into eastern Europe

| | 2006 (US\$ bn) | 2007-11 av (US\$ bn) | % of regional total |
|----------------------------|-------------------|-------------------------|---------------------|
| East-central Europe | 31.2 | 26.4 | 27.2 |
| Czech Republic | 6.0 | 5.4 | 5.6 |
| Hungary | 6.1 | 5.1 | 5.3 |
| Poland | 14.5 | 12.6 | 13.0 |
| Slovakia | 4.2 | 2.2 | 2.3 |
| Slovenia | 0.4 | 1.0 | 1.1 |
| Balkans | 27.4 | 18.1 | 18.7 |
| Albania | 0.3 | 0.5 | 0.5 |
| Bosnia and Hercegovina | 0.4 | 1.1 | 1.1 |
| Bulgaria | 5.2 | 2.6 | 2.7 |
| Croatia | 3.6 | 2.6 | 2.7 |
| Macedonia | 0.4 | 0.4 | 0.4 |
| Montenegro | 0.6 | 0.5 | 0.5 |
| Romania | 11.4 | 7.7 | 8.0 |
| Serbia | 5.6 | 2.8 | 2.9 |
| Baltics | 5.0 | 3.6 | 3.8 |
| Estonia | 1.6 | 1.4 | 1.4 |
| Latvia | 1.6 | 1.0 | 1.1 |
| Lithuania | 1.8 | 1.2 | 1.3 |
| CIS | 42.2 | 48.7 | 50.3 |
| Russia | 28.7 | 31.4 | 32.4 |
| Ukraine | 5.2 | 4.9 | 5.1 |
| Belarus | 0.4 | 1.0 | 1.1 |
| Moldova | 0.2 | 0.3 | 0.3 |
| Armenia | 0.3 | 0.4 | 0.4 |
| Azerbaijan | -0.7 | 1.6 | 1.7 |
| Georgia | 1.0 | 0.9 | 0.9 |
| Kazakhstan | 6.1 | 6.7 | 7.0 |
| Kyrgyz Republic | 0.1 | 0.2 | 0.2 |
| Tajikistan | 0.3 | 0.4 | 0.4 |
| Turkmenistan | 0.3 | 0.4 | 0.4 |
| Uzbekistan | 0.3 | 0.4 | 0.4 |
| East Europe total | 105.9 | 96.8 | 100.0 |

Source: *World Investment Prospects to 2011*.