

**THE REFORMS NEEDED TO
ATTRACT MORE FDI IN EGYPT:
LESSONS FROM THE CEEC
EXPERIENCE**

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Abstract

Strengthening a country's attractiveness toward foreign direct investment (FDI) has become a new imperative of economic policy. The achievements of the Central and Eastern European countries in this field appear to be very instructive. Based on a synthesis of empirical and survey literature, as well as on a qualitative comparative analysis of FDI determinants, this paper aims to draw some lessons for Egypt from the experience of Poland, Hungary and the Czech Republic during the 1990s. The study highlights the importance of multi-regional cooperation as the main determinant of the Egyptian FDI attractiveness.

1. Introduction

Strengthening a country's attractiveness towards foreign direct investment (FDI) has become a new imperative of economic policy (Michalet 1999). This finding concerns both the developed and the developing countries, since the world economic system is oriented toward globalization, based on the internationalization of free trade, free capital flows and FDI movements.

FDI flows can have a positive impact on a country's development prospects and economic growth through the transfer of know-how, technical innovations, managerial and marketing skills, which leads to the improvement of productivity (Lim 2001). The impact of FDI on growth generates equally a positive effect on the poverty reduction in the host country, namely by the higher wages paid to the local work force (Klein, Aaron and Hadjimichael 2001). FDI is also important in terms of job creation and export dynamization.

At the macroeconomic level, FDI flows represent a capital account relief (Bevan and Estrin 2001), with a relatively stabilizing effect in the long run, as compared to portfolio investments (much more volatile) or to public aid (much more constraining and leading to debt accumulation).

For all these reasons, the attractiveness towards FDI becomes imperative to every economic development strategy. Thus, the competition between the nations in the attraction of FDI becomes more and more intense, leaving each transnational corporation (TNC) with a vast choice regarding its foreign localization.

Therefore, the developing countries have to accomplish structural reforms in order to create a favorable environment for national and foreign investment, concerning political and macro-economic stability (Michalet 2000), the degree of internal competition (Blomstrom and Kokko 1997 & 2000), dispute settlement mechanisms, the development of infrastructure and human capital (Borenszstein, De Gregorio and Lee 1998), and the development of the national financial sector (Hermes and Lesnik 2000). For any of these reforms to be carried out, an adequate institutional framework needs to be established.

The developing countries should also get genuinely involved in the world economy through multilateral and bilateral free trade and investment agreements with developed as well as developing countries (Petri 1997). Ganesan (1998) reports that by January 1997 there were 1330 investment treaties in over 162 countries, which compares with less than 400 at the beginning of the 1990s. Also in 2001, almost all the members of the World Trade Organization (WTO) were engaged in one or more bilateral free trade agreements.

In this paper we focus our interest on the Egyptian attractiveness potential. Today Egypt no longer ranks among the 20 largest recipients of FDI among developing countries, even though it should (United Nations Conference on Trade and

Development (UNCTAD), 1999). FDI flowed into Egypt at a steadily increasing pace throughout the 1990s, but flows to other developing countries have been increasing more rapidly. One of the most remarkable experiences is that of the countries in Central and Eastern Europe, which now account for more than 12 percent of the inward investments in developing economies.

Egypt began its economic reform and stabilization program in 1991 under the hospices of the International Monetary Fund (IMF) and the World Bank. At the same time several Central and Eastern European countries (CEECs) made their first steps in the transition process, opting for quite similar programs suggested by the same international institutions. The starting level and the starting period being almost equal, one could have assumed that the final results would also be much alike. During the last decade though, it became obvious that some of the transition countries, namely Poland, Hungary and the Czech Republic, have made strikingly faster progresses and have become much more attractive to FDI than Egypt.

Therefore, the purpose of the current study is to explore in depth the experience of these three countries, and to find those differences in their development path, that allowed them to promote FDI more successfully, in order to lay out the potential policy implications for Egypt.

We have structured our research in five sections. The first section is an introduction. The second is dedicated to the comparative analysis of the FDI trends and patterns in our reference countries. We use statistical data in order to draw a broad picture of the inflows and stocks volume, sectoral distribution and home country provenance of FDI.

The third section discusses the determinants of FDI. We begin with a brief theoretical overview, followed by a critical synthesis of the relevant econometrical models used in the most recent researches on the topic. The second part of this section includes a detailed comparison of the policies and facts behind each attractiveness determinant for our four countries. This allows us to conclude that the integration of the individual countries in a large regional market is one of the most significant determinants of their attractiveness.

The fourth section of the paper focuses on the role of regional economic cooperation as a stimulus for FDI. We examine in detail the impact of the European Union (EU) regional initiatives (Eastern Enlargement and Euro-Med Agreements), and the importance of sub-regional cooperation in solving the hub-and-spoke problems generated by them. The final section has the concluding remarks.

2. FDI Trends and Patterns

The foreign direct investment expansion in the last decade has transformed the world economy by growing faster than international trade, the traditional link among national economies. FDI inflows grew by 19 percent between 1999 and 2000, to record \$1270 billion.

Between 2000 and 2001, foreign direct investment flows into and out of OECD countries recorded their largest drop in recent decades. Total inflows in the OECD area fell from \$1,27 trillion to \$566 billion, resulting in a decline of around 56 percent. When assessing the causes of the drop in international investment in 2001 it is essential to keep in mind the previous year's levels of FDI. The total amount of FDI in 2000 stood at an all-time historical high, at almost six times the levels recorded only five years earlier. In other words, the developments in 2001, rather than a seminal decline in international investment flows, appear to have marked a correction toward more sustainable levels, following what could arguably have been an "investment bubble" in 1999 and 2000.

In spite of that downturn, major TNCs plan to continue their international expansion at a sustained pace, especially with a focus on production and distribution functions. Cross-border mergers and acquisitions (M&As) continue to be the preferred mode of expansion in developed countries, and Greenfield investment in developing countries. The most favored locations in Europe are Germany, the United Kingdom and France, while for developed countries as a whole it is the United States; for Asia it is China; for Latin America, Brazil; for Eastern Europe, Poland; and for Africa it is South Africa (Invest in France Agency, 2001).

Developing countries have made significant inroads to attract FDI in the recent years (See Table A1). From 1990 to 2000 their share in the total global stock of FDI increased from 25 percent to 31 percent reaching \$1979 billion. The southern Mediterranean countries have attracted only 4.4 percent of the total inflows in the developing countries, which is proof of their low attractiveness (Petri 1997). The Middle East and North Africa (MENA) region is trying to catch up with the global trend amounting to \$6 billion in 2000¹, but still compares poorly with other regions, like South-East Asia (\$137,3) or CEE countries (\$26,8).

2.1 FDI in Egypt

After decades of state-dominated activities, the Egyptian government began implementing more liberal policies to allow the private sector a leading role in economic growth. The economic restructuring program started in 1991 under the

hospices of the IMF and the World Bank has not achieved the necessary deep reforms.

The regional instability since the beginning of the Palestinian *Intifadah* has provoked panic among investors, and more than \$10 billion have fled Egypt during the last two years. This put the country in front of a liquidity crisis, and the massive foreign currency outflows led to a 30-percent nominal devaluation of the Egyptian pound in 2001. While the privatization process has been presented as the corner stone of the reform program, the size of State Owned Enterprises (SOEs) in GDP is about 30 percent, relatively high compared to an average of 11 percent for other developing economies (Anderson and Martinez 1998).

The chronic gap between savings and investment, which remains around \$6 billion and is considered a hindrance to Egyptian growth, is therefore expected to deepen. This makes FDI much more vital for the country. Its attraction becomes not only an objective, but an imperative for the whole economic development and citizens' welfare improvement.

During the last few years Egypt has become one of the most important host countries in the MENA region, and together with Nigeria it has attracted around 50 percent of Africa's FDI inflows (UNCTAD Investment Survey of Egypt, 1999). The average FDI growth in Egypt followed a fluctuating trend in the 90's. In 1991 the annual flows were below \$300 million, but in 1994, 1998, 1999 and 2000 they surpassed the billion dollar mark.

Nevertheless, Egypt's ranking among the largest host developing countries has fallen from 16 in 1994 to 19 in 1995, and to 23 in 1997. Comparing to other developing countries, the experience of the CEE countries is remarkable, especially Poland, Hungary and the Czech Republic.

2.2 FDI in the CEECs

Foreign investment was generally prohibited during the period of central planning. Only Hungary, Poland and Romania allowed for some FDI in the form of joint-ventures, but the amounts received were rather small. Therefore, in the beginning of our study period, the CEECs had almost no stock of FDI. In the beginning of the 90's FDI growth in these countries remained modest.

In the second half of the decade, though, growth has strengthened, inflation has been reduced markedly, the privatization programs were accelerated, and public and private institutions have been developed to provide the infrastructure for liberal, competitive and efficient economies (Vincze 1999). Consequently, FDI inflows accelerated significantly and in 2000 achieved a new record level of \$27 billion (UNCTAD, FDI/TNC Database 2001).

The proportion of FDI going to the transition economies has also risen steadily during the last ten years and now amounts to around 12.4 percent of the inward

¹ Author's calculation according to the UNCTAD World Investment Report 2001, including Arab countries, Turkey and Iran. Israel was excluded since it attracted \$5.3 billion in 2000.

investments in developing economies, and to about 4 percent of the total world inflows. Even though they started attracting FDI only recently, the FDI penetration (or the ratio of cumulative FDI to nominal GDP) of the CEECs is now comparable to that of leading recipient countries like Chile and Malaysia.

It is very important to underline, that the pattern of FDI varies considerably amongst the CEECs. Three countries – Hungary, Poland and the Czech Republic – attracted around two thirds of the annual inflows in the region until the middle of the decade, and still concentrate a large proportion of the FDI stocks.

2.3 Sectoral Distribution

In the distribution of FDI by sectors, the manufacturing sector prevails clearly with more than 60 percent of the total CEECs' inflows (Altomonte and Guagliano 2001). The trade sector comes second with 10 percent, followed closely by the financial intermediation (9 percent). Agriculture has merely 1 percent. Within the manufacturing sector, most prized by the foreign investors is the food industry, followed by the textile industry and the chemical industry.

The manufacturing sector and the services attract most of the FDI in Egypt (with respectively 47 percent and 49 percent), whereas the agricultural sector benefits from only 5 percent of the inflows (UNCTAD, 1996). The petroleum sector has been the largest recipient of FDI in Egypt with around 30 percent of the stock in 1998. The most important manufacturing industries are the chemical and pharmaceutical-related activities, the construction, engineering and food industries, the metallurgy and the textile industry. The second sector in both volume and growth is tourism, with finance coming in third place.

2.4 EU Investments

Analyzing the countries of origin, we find that the EU has been and remains the most important investor in both regions, surpassing largely the USA. During the 1994-1998 period, EU FDI in the CEECs amounted to around 70 percent of the total value of the investments recorded, or about 7 percent of the total EU investments abroad. Continuing the patterns of previous years, Western European countries dominated the FDI inflows in the CEECs in 1999-2000, with member countries of the EU accounting for the bulk of the flows (UNCTAD, World Investment Report 2001). Poland, Hungary and the Czech Republic alone have attracted 72 percent of the EU FDI initiatives in the Central and Eastern European area.

At the same time, the Mediterranean countries lost some of their attractiveness to the European investors, and in 1998 represented only 2 percent of the total EU FDI outflows. Nevertheless, the EU share in the FDI initiatives within the MENA region is about 50 percent. The three leading recipient countries for this region are Israel, Egypt and Turkey. European investors account for 43 percent of the FDI in Egypt, led by British companies (9 percent).

These findings are one of the reasons why we chose to position our analysis of the attractivity concept (Section 4) in the EU integration framework. But before that, we shall focus our interest on the factors that determine a country's attractivity towards foreign direct investments.

3. Determinants of FDI

The globalization process has become an integral part of corporate strategies in recent years, so for the transnational enterprises, just like for countries, FDI has become an imperative rather than an opportunity. In 2001, a report by UNCTAD identified 63000 TNCs with a total of 822000 foreign affiliates. The exports of these affiliates reached around \$2 trillion, about one-third of all global exports.

Foreign subsidiaries' operations in developing countries tend to divide sharply into three categories (Caves 1996). The exporters of natural resources and resources-based products go where the resources are, if conditions in the sector call for vertical integration. The second class is made up of exporters of manufactured goods or components. The third class comprises producers largely engaged in serving the developing countries' domestic market.

The economic literature agrees on two precise motivations corresponding to two different strategies of internationalization of enterprises – the horizontal and the vertical (Markusen 1995). The horizontal or "Krugmanian" strategy characterizes foreign investments which aim to secure an advantage when the host country opens up its domestic market. Therefore, FDI can be considered as an extension of the export strategy, and it can be also defined as "market seeking" since its target is the local market. On the contrary, the vertical or "Ricardian" strategy implies a new production system which specializes in one particular phase of the production process and foreign enterprises aim at lowering the production costs. Here the target market often includes the entire world, and the empirical evidence suggests that proximity to the countries of origin is particularly relevant as a determinant of FDI under the vertical strategy. An example for the application of such a strategy is the Finnish mobile giant Nokia, which produces its mobile phones batteries in lower cost European countries like Hungary and the Czech Republic.

When we examine our reference countries, empirics show that horizontal FDI is more frequent in Egypt, where as vertical investments are prevalent in the CEECs (Alessandrini and Resmini 2000). Still, Michalet (2000) emphasizes that most TNCs would like to combine both basic strategies at one location. The aim of such a global strategy is to shift FDI, guided by market-seeking and outsourcing motivations, on a regional basis.

Historically, in countries which followed protectionist policies, FDI was motivated primarily by the desire to get behind trade barriers and substitute imports (Blomstrom and Kokko 1997). Since the developing countries have

largely lowered their trade barriers, the investments got reoriented towards localizations providing export platforms. The domestic market is now considered in terms of the regional market access for products and services.

The successful implementation of a global strategy involves a selective approach of potential host-countries. An inquiry made by the Foreign Investment Advisory Service (FIAS) demonstrates that almost all TNCs have a strict hierarchy of potential countries for their investments. Michalet (2000) suggests dividing countries into four “circles”, based on their attractivity as FDI locations. In the first rank are the “triad” countries, namely North America, Europe and Japan. In the second circle are the “new frontier countries”, like China, the Asian “tigers”, Brazil; Argentina, Mexico and Chile, and our three Central European countries – Poland, Hungary and the Czech Republic. The MENA countries like Egypt, Morocco or Tunisia belong to the third circle of “potential countries”. The rest of the developing world is classified in the “peripheral” circle. We have to note that countries are susceptible to move from one circle to the other, should they improve or, to the contrary, worsen some aspects of their investment climate. Therefore, in the rest of this section we will try to identify the advantages that put the CEECs in the second circle and the policies that can help Egypt get to the upper circle.

As we can see from the FDI statistics, the competition between the nations in the attraction of FDI becomes more and more intense, leaving each transnational company with a vast choice regarding its foreign localization, which will tend to increase the international competition of its products and contribute to the optimization of its net profits. The search for higher returns is certainly the main incentive for FDI movements. A survey of the profits of the American subsidiaries localized in Egypt shows that their rate of return amounts to 22 percent, which is much higher than the average returns of affiliates in other developing countries, and twice the returns of the subsidiaries localized in Europe. Thus, we can expect that the contribution of FDI to capital formation in Egypt would be further expanded (UNCTAD Investment Survey of Egypt, 1999).

Another basic FDI motivation is the natural resources endowment of individual countries. As we have already mentioned, the petroleum sector has been the largest recipient of FDI in Egypt with around 30 percent of the stock in 1998. Nevertheless, we shall not analyze this aspect of FDI attractivity, since the three CEECs are not particularly rich in natural resources. Moreover, this issue hardly depends on a country’s economic policy, and therefore, no lessons could be drawn.

Investment Liberalization and Privatization Policy

One of the key determinants of the level of direct investments in the early years of transition has undoubtedly been the privatization process. During the 1995-

1999 period, Poland acquired \$10 157 million of privatization proceedings, Hungary – \$8778 million, the Czech Republic – \$3072 million, and Egypt - \$2512 million (World Development Indicators CD-ROM 2001).

When analyzing the privatization, we should note at least three factors – the access of foreign strategic investors, the type of privatization method chosen and the speed of privatization (proxied by the share of private sector in GDP). To evaluate the participation of foreign investors in the privatization process, we use the Bouton and Sumlinski Privatization Summary (1996), based on the World Bank Privatization Database. During the 1988-1995 period, Poland privatized 224 public entities for \$2994 million, of which 54 percent went into foreign hands. The Czech Republic privatized 39 companies, providing \$2297 million of privatization revenues, of which 88 percent came from foreign investors. Hungary registered 207 privatization operations, generating \$7957 million revenues, of which 88 percent too came from FDI. In contrast, Egypt privatized only 23 countries for \$679 million, of which only 32 percent came from foreign investors.

Econometric tests have shown that inward FDI was higher in transition countries that have privileged direct sales to voucher privatization, and in countries with larger private sectors (Holland and Pain, 1998). In 1996, Poland, the Czech Republic and Hungary had already converged on the levels observed in most Western European countries with respectively 65, 75 and 73 percent of private sector in the GDP. In Egypt the private sector is at a comparable level, reaching more than 66 percent of GDP.

As far as the method is concerned, Hungary immediately pursued a policy of sales to strategic outside owners, with few restrictions on the involvement of foreign companies. Moreover, it opened the so-called strategic sectors (telecommunications, utilities and financial services) to foreign investors around 4-5 years before any other CEEC. The mode and scope of its privatization favored the country’s attraction of FDI during the initial stages of transition (Kaminski 2001). The Czech Republic first adopted a voucher mass privatization scheme, by which companies were sold to domestic residents only. Then, as a secondary method, the state proceeded to sale to outsiders. Poland is more difficult to classify, because in practice a lot of direct sales were operated, but the 1990 Privatization Law encouraged management/ employee buy-out schemes, and voucher privatization was also experimented.

We have to underline that the most common modes of entry in Egypt remain greenfield investments and de novo joint ventures. Yet, out of 314 public enterprises 172 had been privatized by the end of 2000. A large part of that privatization process was done through methods like company liquidation, employee-shareholder associations and stock exchange public offerings. Experts recommend that Egypt diversifies the methods by including direct negotiations,

open biddings and sealed bids (Privatization in Egypt Quarterly Review, 6-9/1999). We should also note that the Egyptian government has recently emphasized the importance of BOOT (Build/Own/Operate/Transfer) schemes as a means of attracting increased private investment for infrastructure, particularly electricity generation, transportations and telecommunications (Fawzy 1998).

In the immediate future privatization-related FDI transactions will continue to lead FDI inflows into the CEEC region, but after this process gets completed, the FDI patterns may come to resemble the picture in Hungary now, where FDI inflows are driven by additional greenfield investments and, increasingly, by private cross-border mergers and acquisitions (UNCTAD, World Investment Report 2001).

We shall now briefly review the existing literature on the determinants of FDI in the CEE and MENA regions, and then, we shall explore and analyze what factors best explain the FDI attractivity of our reference countries.

Synthesis of the Empirical Literature

In table A2 we present a summary of the most recent empirical studies (1998-2002), that have tested for the main determinants of FDI in CEE and MENA countries. We have chosen six models, which use the panel data techniques to analyze statistical data ranging from 1990 to 1999 (for the largest sample) for 11 to 33 countries. The most comprehensive model, whose results we will use in our own research, has been completed by Garibaldi, Mora, Sahay and Zettelmeyer for the IMF Working Paper Series. It encompasses the largest set of dependant and independent variables and the longest data period, allowing for more robustness of the results obtained.

When exploring the models, we noticed the extreme precaution with which all authors approach the statistical data available. Alessandrini and Resmini (2000) remark that it is worth keeping in mind that official FDI statistics are based on criteria and rules of recording of the phenomena that depend on the country of origin and destination. A lot of other authors also put ahead the significant inconsistency of time series prepared by the home and the host countries, and therefore by the international institutions that use them (OECD and EUROSTAT versus UNCTAD). They all advocate the improvement in the quality of FDI statistics, because any accurate analysis is prevented by the often inadequate, heterogeneous, biased and partial data. Many data conflicts also come from the different classifications and descriptions given to similar economic terms by different organisms, therefore the use of one single data source is highly recommended. Many researchers use IMF's International Financial Statistics, because this data has the advantage of being consistently compiled, but it is not a solution to all problems, since it contains major gaps in coverage (Garibaldi et al. 2002).

Probably for that reason, a lot of the existing analyses focus on a very limited range of the most frequently cited FDI determinants, where as the study of Garibaldi et al. (2002) is the only one to have the benefit of considering a much wider set of potential explanatory variables.

We believe that another limitation of the models studied is the large heterogeneity in the choice of countries. The limited study period has obliged researches to use panel data. Yet, FDI trends have been exclusively heterogeneous across both transition countries and Mediterranean countries. There are stark differences in both the level and the composition of capital flows to each country in both regions, so we privilege the particular case studies.

Finally, we consider that the questionnaire surveys among foreign investors, like the ones conducted by the FIAS (Michalet 2000) and the international research team of Meyer, Estrin, Handoussa et al. (for the EACES Annual Conference 2002), are probably a more appropriate way of examining the importance of each FDI determinant, especially in countries, for which statistical data is scarce or unreliable.

For all these reasons we refrained from conducting econometric tests. Instead, we will now turn to the descriptive comparative study of each FDI determinant for our reference countries.

3.1 Attractivity Preconditions

When orienting their choice towards a potential localization, the TNCs compile a list of pre-conditions that need to be satisfied by a host country for it to be short listed. The investors are generally risk-averse and make their best to minimize the uncertainty of their undertakings. It is therefore important that a country's future is predictable enough so as to allow the investors to evaluate the returns of their projects and to compare them with those of the other localizations available (Michalet 2000).

According to the FIAS, the TNCs focalize first on the political stability of the host country. The economic stability ranks second among the pre-conditions of attractivity, and its importance is based on the macroeconomic variables that strengthen the economic growth: the general budget equilibrium, the balance of payments' equilibrium, the inflation rate, the foreign debt and the exchange rate stability. The legal framework is the other cornerstone in the preconditions' triangle. Let us now analyze each precondition in more detail, based on the Economist Intelligence Unit Country Outlook Series (July 2002).

3.1.1 Political Stability

Political risk affects the value of a transnational corporation through changes in future cash flows and investors' required return. The cash flow impact of political risk is clearly of interest to investors and managers (Butler and Joaquin

1998). The lack of democracy, the internal instability, and the perspectives of radical government changes all act like hindrances to a country's attractiveness.

Using a rigorous econometric analysis Garibaldi *et al.* (2002) show that legal and political climate rather than macroeconomic fundamentals have shaped FDI flows to transition countries. A typical example of the importance of political stability for FDI is Hungary. The country may be a less favorable destination than others in terms of the size of its domestic market or its initial standard of infrastructure, but it remained until 1993 the only CEE country in the region in which internal and external political conditions were settled (Szanyi 1995). This relative stability provided a firm basis on which potential investors could make longer-term business calculations, therefore it is not surprising that Hungary attracted more than twice the FDI inflows in any other CEE country during the 1991-1994 period (See Annex Table 1).

Internal Stability

Since the beginning of transition, the political power in the CEECs has changed hands several times. The year 2002 was marked by parliamentary elections in the Czech Republic and in Hungary, which returned center-left forces to power. The new coalition governments have either had a narrow election victory, and therefore a slim majority, or are formed by potentially weak alliances. Nevertheless, the goal of joining the EU in the first wave of eastward enlargement should keep them united and help them shape the countries' policies. Poland is also governed by a left coalition, whose main objective is to complete the EU admission negotiations by end-2002.

An important conclusion we can draw is that no matter which party wins the elections in a CEEC, it is expected to pursue the same reform-oriented and pro-EU policies as the previous administration. This, of course, provides the needed internal political stability and predictability that the investors are looking for.

In Egypt, the political stability is perceived as the major obstacle to business establishment and operations (UNCTAD Investment in Egypt Survey 1999). The government of the president Hosni Mubarak, who represents the highest authority of the country, in power since 1964, is expected to retain firm control of the national institutions in the near future. However, the normally subdued domestic political scene has become unusually animated in recent months as frustrations have mounted over regional developments, particularly the escalation of violence between Israelis and Palestinians. The growing regional instability fosters concerns about the resulting deterioration of the economy, which is undermining living standards. Internal tensions are expected to heighten if a settlement of the Israeli-Palestinian conflict is not found, and for that reason Egypt must urge the US, even if it that has proved to be largely ineffectual, to put pressure on Israel to reach a lasting settlement with the Palestinians.

External Stability

In the globalized world, the countries' policies have become so interdependent, that it is no longer possible to examine the internal stability outside the context of international relations. As it becomes obvious from the Egyptian example, the external or regional stability is now more important as an FDI determinant than the internal one.

Egypt's overriding international relations concern is to persuade the US to step up its engagement in the Israeli-Palestinian conflict, and to convince the US administration that it has to bring pressure to bear on Israel if any meaningful peace process is to restart. Egypt also argues that a military attack against Iraq would only serve to worsen regional tensions and heighten growing Arab anger at the US.

On the other hand, the Central European countries benefit from a peaceful and prospering regional context, and their main foreign policy objective is to join the EU in the first wave of eastward enlargement. They have already closed the majority of the negotiable chapters of the *acquis communautaire*, and even though those who remain open are also the most controversial ones, one can reasonably expect them to become full members of the EU as soon as 2004.

3.1.2 Economic Stability

Macroeconomic stability is widely viewed by policymakers, academics and the press as creating a conducive environment for foreign investors (Garibaldi *et al.* 2002). The basic variables of macroeconomic performance are economic growth, inflation and exchange rate.

GDP Growth

In 2000 the Czech economy put an end to its three-year recession and its GDP growth unexpectedly attained a high of 3.1 percent. In 2001 the country continued this upward trend and achieved a 3.3 percent growth. The global slowdown affected its economic conditions in 2002, and the Czech National Bank lowered its annual forecast to 2.1-3.1 percent. Yet, strong inflows of FDI and robust domestic demand are expected to again boost the Czech economic growth in 2003. In 2000 Hungary's growth amounted to 5.2 percent, supported mainly by vivid domestic demand. Even though the trend was slightly lower in 2001, the expected growth for 2002 remains at the high 3.5 percent. The Polish economy experienced a relatively hard landing in 2000, as strict monetary policy impacted on domestic demand. In 2001 there was no recovery of consumer spending, so growth went even more sluggish. The forecasts for 2002 put the figure at only 1.3 percent, and that's under the condition of stable German and EU recovery.

Since the Egyptian exchange-rate difficulties persist, the expectation for the Egyptian GDP growth are around just 0.8 percent for the fiscal 2002. The

number of visitors to Egypt falls sharply due to the regional instability, and since the tourism employs some 2.2 million Egyptians, it also curtails private spending power. It also damages the trade activities, so the active government spending remains the only fuel for growth.

Inflation Rate

The stability of the price level is particularly important for the process of economic decision taking, which requires that prices perform their usual information function and that their changes remain predictable. Many transition countries experienced hyperinflation in the beginning of the 1990's. Poland started the decade with an inflation of 553 percent, and even though it gradually diminished it, the indicator went below the traditional 10 percent barrier only in 1999 (EIU Country Data Database 2002). Yet, the country is now making rapid progress and through the favorable external factors expects to reach the target of 3 percent annual inflation in 2003. Hungary too had problems in bringing the CPI changes below the 10 percent level, which happened only last year. The Czech Republic was slightly more successful with an average inflation of only 8 percent for the entire period and less than 3 percent in 2001. In that respect Egypt measures up, with almost 8 percent as well and no hyperinflation periods. According to the Central Bank of Egypt, the annual average inflation for 2001 fell to 2.3 percent from 2.7 percent in 2000.

Exchange Rate Policy

The exchange rate stability is a significant determinant of FDI. Commitment to fixed exchange rate affects FDI positively (Garibaldi et al, 2000). Maintaining stable real exchange rates is the best course a country can take (Sadik & Bolbol 2000).

The Czech Republic followed a peg with sterilization style policy before its mild currency crisis of May 1997 (Vincze 2001). The same year Czech monetary policy switched to a floating regime. From 1993 on, Poland increased its exchange rate flexibility gradually, starting from a traditional crawling peg (to the USD, DEM, £, FF, SWF), then widening the band width (to +/- 7 percent) until abolishing it. Since April 2001 the Polish zloty is floating freely. After its mini exchange rate crisis in 1995, Hungary moved from an adjustable peg regime to a crawling band (with a +/- 2,25 percent), linked to the DEM and the USD.

As we can see from Figure 5, the Polish zloty, the Czech crown and the Hungarian forint have followed very similar paths of consecutive appreciations and depreciations, where as the Egyptian pound has remained stable through most of period and has suffered severe depreciation at the end of it.

All four currencies faced problems, but the three Central European countries solved them rather costlessly, mainly by using their international reserves and letting the currencies float more or less freely. In 1995-1996 Poland tripled its

foreign reserves to \$18 billion and ended the decade with more than \$26 billion in 2001. Hungary and the Czech Republic had periods of increasing and decreasing reserves, ending the decade with an average of \$12 billion each.

After the start of its reforms in 1991, Egypt chose a managed floating regime for its pound and maintained the pound/dollar exchange rate perfectly stable until 1999. The country constantly increased its international reserves until 1998, when they amounted to \$20 billion. Since 1997, though, the foreign currency inflows decreased significantly due to the drop of the tourism revenues, and the capital outflows increased massively due to the Israeli-Palestinian conflict. In addition, the commercial deficit rose to more than \$12 billion, exerting serious pressure on the exchange market equilibrium. Nevertheless, the government failed to stamp out the informal market, partly because it proved unwilling to back up the official rate by furnishing the market with sufficient US dollars from Egypt's foreign reserves. All this led to the nominal depreciation of the official rate from 3.4 to 4.5 pounds/dollar between 1999 and 2001.

3.1.3 Institutional Framework

Institutional and legal shortcomings like unpredictable regulation, red tape, confiscatory taxation and difficulties in enforcing contracts are important impediments to private business in general, and particularly to foreign investments (Garibaldi *et al.* 2002). A transparent, stable and non-discriminatory legal and regulatory environment is one of the basic institutional prerequisites to be fulfilled by a host country. Bureaucratic procedures and institutional rigidities must also be banned (Michalet 2000). It appears that macroeconomic stability without a business friendly environment was not enough to attract foreign investment (Kaminski 2000).

Dispute Settlements and Bureaucracy

When looking for approximate measures that can capture the dispute settlements and bureaucratic type issues in transition countries, we use the World Bank data set compiled for the World Development Report in 1997. Among the 20 transition countries in the survey, Poland, Hungary and the Czech Republic stand out with one of the lowest scores, meaning that both local and foreign investors have a very positive perception of the domestic institutional constraints.

The 1998 UNCTAD/ERF Survey of foreign firms operating in Egypt shows us that the dispute settlements procedures rank fifth among all the major obstacles to business establishment in the country. The problem consists of the fact that the Egyptian judicial system is considered as slow and its procedures as cumbersome. One solution to that problem is the provision that allows for investment disputes to be solved by arbitration, which has been actually used in 80 percent of all dispute cases.

As far as red tape is concerned, anecdotal evidence is provided by the U.S. economist Lester Thurow, according to whom “Egypt has gained credit for inventing bureaucracy and yet it has the slowest bureaucracy in the world”.

Corruption

In the 2001 Corruption Perception Index, published by Transparency International, Hungary ranks 31 with an overall score of 5.3, Poland is 44 with a total score of 4.1, the Czech Republic – 47 with a score of 3.9. (A score of 10 indicates a country clean of corruption, and a score of 0 – a completely corrupt country). As a result, the experts of this NGO urged the leaders of the transition countries to do far more to establish the rule of law and transparency in government, because this is crucial to their economic progress, and to the development of an open society. In the same survey Egypt ranks 54 with a global score of 3.6, indicating that the same recommendations should be taken into account by the Egyptian government.

Well-Functioning Financial System

Since the beginning of transition the Central European countries have made significant progress in the consolidation and modernization of the financial sector. Through the privatization programs the majority of the Polish, Hungarian and Czech banking sectors are under the control of prominent foreign banks, that brought with them all the western banking products and techniques. The local stock exchanges have very recent history, but have developed significantly and prove to be quite active.

The Egyptian government has also identified the need to strengthen the financial institutions and implemented the needed reforms. Special interest was granted to the stock exchanges, which allow international firms to engage in the stock market, providing new capital, expertise and investment services.

Unfortunately, with the beginning of the Palestinian *Intifadah*, the Egyptian stock exchange market collapsed sharply. Portfolio investors lost a lot of their recently accumulated benefits, creating significant pressure on the whole banking credit market. This was due to the large equity-guaranteed credit offered to the investors. After the exchange market crisis, investors were no longer able to pay their credits back, and the entire financial system was seriously disturbed. In order to remedy the banking sector, the Egyptian government is encouraging foreign banks to operate in Egypt. It also looks to merge many of the actual operating banks in order to consolidate their potential.

3.2 Motivations of the FDI Localization Choice

When a particular country fulfills the investment prerequisites, analyzed in the previous subsection, it enters the investor’s short list. His decision to choose one localization from all the short listed countries then is shaped up by the following

type of criteria – market size, communications and infrastructure, qualified labor force and competitive local companies.

In their efforts to promote FDI, the developing countries tend to offer diverse establishment incentives, like abolishing discrimination against foreign investors, yielding tax and customs duty exemptions, or creating free trade zones. This issue is rather broad and we shall note just two things – fiscal incentives are randomly cited by investors as important, where as national treatment is considered an essential issue. Generally speaking, the Central and Eastern European countries grant freedom of establishment and national treatment for foreign investors in almost all manufacturing activities and many service sectors. With the 1997 Egyptian investment law, most sectors of the Egyptian industry have also become open to FDI without restrictions on foreign equity ownership, and granting foreign investors “national treatment”. Industrial policy, in particular, encouraged FDI into eight new industrial cities established in the desert (Meyer, Estrin, Handoussa et al. 2002).

Other incentives that are susceptible to attract the foreign investors to a particular country will be discussed in the remainder of this section.

3.2.1 Infrastructure Development

When considering this issue, we must note our large definition of the term “infrastructure”, which includes such features as human capital, physical infrastructure (roads, ports, railroads), telecommunications, the access to information and the network of competitive local firms.

Competitive Labor Force

Cheap labor was playing a determinant role for the localization choice of TNCs in the 1960’s and 1970’s, when the vertical outsourcing strategy was predominant (Michalet 2000). Today all CEE and MENA countries are considered as low cost areas with respect to Western Europe and the USA. In 2001, the average nominal cost of labor per hour in our reference countries ranged between \$2.5 for Hungary, \$2.9 for Poland and \$11.6 for the Czech Republic. For Egypt data is available on a daily basis with an average of \$3 per day.

Considering these low levels, the availability of qualified manpower becomes a major consideration. Foreign firms prefer locations with a highly skilled labor force (Alessandrini & Resmini 2000). As measures of the qualification we have taken several indicators – the rate of secondary school enrolment, the rate of tertiary school enrolment, and the research and development expenditures.

The presence of specialized engineers and scientists in key sectors is the major locational advantage of CEE countries (Michalet, 2000). Poland, Hungary and the Czech Republic have the impressive 97 percent of secondary school

enrollment and above 23 percent of tertiary school enrollment. Egypt's base of trained and skilful technical personnel has attracted foreign companies involved in a range of economic activities (UNCTAD Investment in Egypt Survey 1999). In Egypt secondary school enrollment ranges above 78 percent, and tertiary is around 20 percent.

As far as R&D expenditures are concerned, in Central Europe these range from 0.75 percent to 1.1 percent of the gross national income, where as Egypt spends only around 0.22 percent, and experts suggest that the government should consider investing more in R&D or granting foreign investors more incentives for entering R&D intensive sectors.

Telecommunications and Physical Infrastructure

International investors need proper transportation links inside the host country and with the rest of the world. An efficient communications system is also a key factor for TNCs to efficiently manage branches around the globe. Subsidiaries need to be able, on a day-to-day basis, to send and receive faxes, e-mail, and make telephone calls (Michalet 2000).

After we examined the positions of our reference countries in the World Development Indicators database, we were able to conclude that the four of them have sufficiently developed transportation and communication networks. The UNCTAD survey of international investors (1998) also puts the good physical infrastructure as one of Egypt's competitive advantages for FDI.

Access to Information

The availability of business information has been cited by foreign investors as the second major impediment to business operations in Egypt (UNCTAD 1999). The need to facilitate the establishment of foreign companies has pushed governments to create FDI promoting agencies. Poland created the *Państwowa Agencja Inwestycji Zagranicznych* or PAIZ, the Czech Republic – the Czech Invest Agency, Hungary – the Hungarian Investment and Trade Development Agency or ITD, and Egypt transformed the role of the existing General Authority for Foreign Investment or GAFI in order to better answer the needs of investors.

The Internet sites of these agencies deliver multilingual information about the current economic and legal framework in the countries, the available investment projects, the diverse incentives provided by the respective governments and so forth. Other useful electronic sources are the web sites of the different ministries, government institutions and central banks, but we should note that often the data provided by the different institutions is contradictory, which might send the wrong signals to the foreign investors.

The Existence of Performing Local Enterprises

The presence of efficient local firms is an increasingly important dimension of a country's attractiveness value (Michalet 2000). Most often they are engaged in supporting, sub-contracting operations. In Central and Eastern Europe the reform programs have put particular emphasis on the measures to strengthen the local companies, since one of the three Maastricht criteria for EU accession is the country's capacity to resist the competitive pressure inside the common market.

In Egypt, the large network of small and medium enterprises (SMEs) provides foreign investors with a vast choice of qualified and competitive partners. In 1998, the SMEs in Egypt totalled 218 400, dominating the private sector. The survey of Meyer, Estrin, Handoussa *et al.* (2002) demonstrates that foreign investors seem generally satisfied with the level of these locally available suppliers, with professional services, IT, telecom and utilities ranking particularly high. When evaluating the performance of their direct competitors in Egypt, foreign firms attribute the highest scores to their marketing capabilities, and the lowest to their level of technology and quality of products and services. This finding is a striking difference with what has been found for Central and Eastern Europe, where foreign investors scorn local management and marketing capabilities, but appreciate highly technological capabilities.

3.2.2 Market Accessibility

A big and growing market is the main determinant for all companies in the FIAS survey (Michalet 2000). However, this is no longer just a synonym for a big domestic market. More and more, global investors are mainly attracted by big and growing regional markets.

Population

We take the population as a proxy measure for the absolute local market size. In this respect, Egypt has 66.7 million inhabitants, or more than the population of the three countries taken together. In Central Europe, Poland has the largest market with its 38.6 million inhabitants, the Czech Republic has a population of 10.3 million, and Hungary of 10 million. It is also interesting to note, that the demographic trends are completely opposed – in Egypt the population grows constantly, where as in Central Europe it has been in steady decrease ever since 1990. Still, recent empirical investigations suggest that most firms invest in the CEECs to find new market opportunities for their products (Lankes and Venables 1996, Resmini 1999). This can be explained by the "shortage economy" syndrome, or the prospect of open unsaturated markets.

Real GDP per Head (PPP)

The real per capita gross domestic product, calculated on a purchasing power parity (PPP) basis, is often used as a relevant measure of actual demand or of purchasing power, and defined by international investors as another

representation of the local market size. The 2001 EIU country data attribute the highest GDP (PPP) per head to the Czech Republic – \$14 520, followed closely by Hungary - \$10 330 and Poland – \$9280. On this basis Egypt lags way behind with about \$3540, but we should not forget the size of the Egyptian population.

Real per Capita Rate of Growth

Besides the absolute figures, it is also useful to note the starting levels and the growth rates. The three Central European countries had negative growth in the first few years of transition, with the exception of the Czech Republic, which had negative growth figures again in 1997 and 1998. The latter though started the decade with a relatively high level of GDP per head (at above \$10 000) and has had an average growth rate of 1.8 percent, with 3.3 percent in 2001. Hungary began the decade at \$9470, and its economy grew on average with 1.6 percent, ending last year with a growth of 4.1 percent. Poland started from \$5920, followed an average growth of 2 percent and ended up with 1 percent growth in 2001. In 1990 Egypt had a GDP per capita equal to \$2271, and even though it had slightly negative growth only in 1991, with an average of 1.8 percent it could not catch up with any of the leading transformation countries. This, of course, to some extent is due to the constant fast pace of growth of the Egyptian population.

Geographic Proximity and Regional Market Size

As we have already underlined several times, a large number of theoretical and empirical investigations prove that international investors now perceive the concept of market size in a regional context. We shall briefly reiterate, that in the case of vertical strategy, investors are interested mostly in the proximity between the home and the host country, where in the case of a horizontal strategy, they are looking for a localization serving a large region, even if it is far away from the home country.

When analyzing the results of our six reference FDI econometric models (See Annex Table 2), we found that their most essential common denominator is the positive and highly significant coefficients of the market size and geographic proximity explanatory variables. Moreover, FDI in Central Europe seems to follow the “headquarters approach”. Even where companies started off with the intention to penetrate the local market, the main aim of the investment became to supply the regional market as well. Investors have been attracted by or have upgraded their investments because of the potential of the regional market (Inotai 1998). Therefore, we decided to dedicate the entire fourth section to that issue.

4. The Importance of Regional Cooperation

The argument that formation of regional economic associations will stimulate FDI inflows is standard in most textbooks on international economic integration. Recent empirical evidence also suggests that regional economic integration provides an important stimulus not only to trade, but also to FDI. For example,

Brenton (1996) found that the EU Single Market program lead to a significant increase in investment by EU firms in other EU countries in the late 1980s. Empirical investigations of Spanish and Portuguese EU accession, as well as of Mexican NAFTA accession, also suggest that joining an economic integration scheme can provide an impetus to inward FDI (Brenton, Di Mauro and Lucke 1998).

As presented in the third section, FDI considers the target market in a regional context. The global direct investment strategy seems to be enhancing this new form of regional free trade agreements, since they afford a large market access to their products (Laurence 1996).

In the context of our reference countries, regional integration is deeply related to the European Union, since it is the major economic partner of both CEE and MENA countries. During the past decade, the EU has multiplied the regional cooperation agreements with its Eastern and Southern neighbors.

When trying to draw lessons from the analysis of FDI prerequisites and determinants in Section 3, we were led to one main conclusion, which is that the main advantages of the CEECs all stem from their geographical, historical and cultural proximity to the European Union, and even more precisely, from their integration process and prospects of full membership. Therefore, we need to analyze the characteristics of the EU relationships with our two target regions (the CEE and the MENA countries), as well as the particular initiatives that have been undertaken during the last decade.

4.1. The Eastern Enlargement Initiative

The EU responded to the collapse of communism in Central Europe by providing aid and offering preferential arrangements initially solely in terms of market access (Kaminski 2001). On one side, Western Europe had no choice but help Eastern Europeans create market economies in the region and lift up living standards, had it not suffered from huge waves of migration. On the other, regional agreements with the EU were clearly the most attractive policy option to CEECs.

In 1990 the Central European countries received zero-tariff access from the European Community for some of their industrial products within the General System of Preferences. The most important fact, however, was the signing of the Association Agreements (AA) with the EU, which went into force on March 1, 1992. The agreements made access to EU markets much easier for a large part of their exports and also easier than in their mutual relations, thus diverting trade flows – especially in the case of industrial products – toward the EU (Rudka and Mizsei 1994).

The standard returns from this type of integration are enhanced credibility of commitment to liberal economic policies and improved market access, which in turn can induce increased FDI inflows. For instance, the gradual adoption of the *acquis communautaire* by the CEECs has already vastly contributed to the improvement in the business climate and made them more attractive to foreign investors (Kaminski 2001).

The integration triggered by the Association Agreements has offered a number of advantages with the potential for attracting foreign investors. First, there are the economies of scale associated with the preferential access to EU markets. Second, the AAs guaranteed the right of establishment to EU firms. Third, provisions aligning economic regimes with those in the EU were particularly significant, because their implementation amounted to the promise of an orderly transition to an economy based on competitive markets.

In sum, the Eastern Enlargement initiative can be viewed as the base for all the CEECs' reforms and progress. It was the EU "know-how" that designed the transition process, and its strong political engagement to restructure the CEECs guaranteed to their economies a fast and efficient insertion in the global economic system.

4.2. The Limits of Euro-Mediterranean Free Trade Agreements

The economic relations between the EU and the Mediterranean countries were regulated by Cooperation Agreements dating back to the 1970s. In November 1995 the ministers of foreign affairs of the EU countries and of 12 Mediterranean countries signed the Barcelona declaration and established the Euro-Mediterranean Partnership, whose aim is to create an area of political stability, security and peace, based on the economic development. The first Euro-Med Agreement was signed with Tunisia in July 1995. Morocco, Israel, Jordan and Egypt have since finalized their negotiations, where as Algeria, Lebanon and Syria are still discussing the terms of their respective agreements.

The basic objectives of the Euro-Med Partnership are the establishment of free trade in manufactured goods, preferential access for agricultural products, and gradual liberalization of trade in services and capital, limiting though the movements of the labor force.

The extent to which regional integration frameworks act as determinants of FDI depends on the scope and depth of integration foreseen by the specific integration project (UN World Investment Report, 1998). Thus, the first limit of the Euro-Med agreements is that they only provide for shallow integration (Ghesquiere 1998).

Comparing further the Euro-Med Agreements to the Association Agreements of the CEECs, we find a lot of similarities in their structures. Nevertheless, several

differences exist precisely in the depth of the commitments and the integration provided by the two types of agreements.

Regarding the FDI, one essential divergence is related to the right of establishment (Hoekman and Djankov 1996). The Euro-Med Agreements do little to ensure investors of national treatment or to grant the general right of establishment, where as the CEECs agreements clearly spell out that right of establishment is a central part of the deal.

Poland, for example, granted immediate freedom of establishment and national treatment for most manufacturing activities and construction, leaving the exceptions and the service sectors for the end of 1997. The Czech agreement liberalized FDI immediately in all sectors, except some strategic ones like the defence industry or the financial services, for which it was allowed a ten-year transition period. The Hungarian agreement was similar, adding some more services to the list of excluded activities.

By signaling the fact that they are open to FDI, the CEECs increased the incentives for foreign firms to establish and transfer much needed know-how by reducing political risk. The Euro-Med Agreements, to the contrary, limit commitments to those of the General Agreement on Trade in Services (GATS), and risk sending a signal to foreign investors that liberalization is not on the immediate agenda.

Another significant difference lies in the capital movement' provisions. The Euro-Med agreements require only that capital flows related to direct investment in Tunisia by EU firms in companies formed in accordance with current laws can move freely, and that income can be liquidated and repatriated. The CEEC agreements again go further by requiring free mobility of capital and unrestricted repatriation of profits and initial capital of firms that establish in partner countries.

Still, we find out that the main differentiation between AAs and Euro-Med comes from the provisions about the rules of origin, and more particularly, about the right to cumulate origins.

Rules of Origin

Rules of origin exist to enforce discrimination (Hoekman 1993), and they have grown in significance with the spread of preferential trading. The European free trade arrangements with its neighbors initially did not diverge from this practice.

Where two or more countries have been involved in the manufacture of a product, the general concept applied in formulating rules of origin (ROOs) is that a product has an origin where the last "substantial transformation" took place. Therefore, imports from say Hungary processed in Poland but not to the extent to

meet the AA rule of origin criterion, and exported to the EU, were treated as “outside” imports.

Since the EU is larger than any single CEEC or their aggregate, the arrangement was clearly more advantageous to EU firms than to CEEC firms. Thus the AAs have led to the emergence of one hub-and-spoke pattern, putting spoke CEEC firms at a disadvantage regarding hub EU firms (Baldwin 1994). Attempts to address this deficiency had led first to CEEC acceptance of new rules of origin, based on the diagonal cumulation of origin.

Instead of extending the new rule to all CEECs, the European Commission requested that CEECs sign free trade agreements (FTAs) among themselves, and then, in 1996, adopted the Pan-European Cumulation Agreements, extending rules of origin to all European associates of the EU. A major feature of the Pan-European Rules of Origin is that they allow for different kinds of cumulation procedures (diagonal and bilateral) of inputs and industrial processes to confer origin (Ghoneim 2002).

According to the cumulation procedure, ROO are broader in their geographical coverage required for a certain product to be granted origin. This procedure relaxes the level of restriction of the ROO and reduces their negative impact on production distortions and trade and investment diversion.

The Europe Agreements of Tunisia and Morocco also provide for the cumulation of origin between these two countries, and between each of them and Algeria. This is expected to help create more intensive inward and outward flows between the Maghreb countries (Hoekman and Djankov 1996).

The actual EU-Egypt Association Agreement implies rules of origin are very similar to those included in the agreements of Morocco and Tunisia. The basic rule is that products confer origin if they are wholly obtained in Egypt, or if they have undergone sufficient and economically justified working or processing, resulting in at least 60 percent of the value added (El-Megharbel 2000).

The ROOs of the Egypt-EU Agreement embody a special provision that allows Egypt and the other Mediterranean countries that have concluded a FTA with the EU as well as among themselves *and* have the same set of preferential ROO with the EU to cumulate their national inputs (diagonal cumulation). This provision is supposed to make the determination of ROOs less restrictive. However, this provision is idle in practice as a result of two main reasons, namely, the different set of preferential ROOs that some Maghreb countries adopt and the low intra-regional trade between Egypt and the Mashreq countries (Ghoneim 2002).

The Hub-and-Spoke Effect

The European partnership agreements with both CEE and MENA countries are of hub-and-spoke (H&S) type. As Kowalczyk and Wannacott argued (1992), if a

small country concludes a free trade agreement with a large country, the welfare incidence will most likely be positive for both of them. However, if the larger country (the hub) signs similar bilateral treaties with other small countries (the spokes), the welfare of the original small country will decline as a result of trade diversion. A similar effect is expected regarding investment. The EU enlarges considerably its market size, by affording free access for its products to all the spokes. On the other side, the spokes' attractiveness in terms of market size rises only by the size of the EU market (See Figure 6).

Figure 6 clearly demonstrates that the EU, being a hub for many bilateral free trade agreements, has become an export platform of very high attractiveness. If the spoke countries maintain high intra-trade barriers, then foreign firms could choose to invest in the EU hub. Thus, a Japanese investor, for example, would prefer to localize in, say Ireland, and have free access for his products in the entire EU, plus in all the spoke countries, instead of investing in, say Jordan, and limiting itself to the EU and Jordan's markets only. We can also note, that several spoke countries have chosen to liberalize trade among themselves, thus creating block spokes (like CEFTA) and minimizing the negative H&S effects. This process is known as sub-regional cooperation.

4.3 The Importance of Sub-Regional Cooperation

The international experience offers some empirical evidence on the likely effects of integration on FDI flows. The Southern Common Market (Mercosur) is considered as a successful case of sub-regional integration, which resulted not only in a tremendous expansion in intra-regional trade, but also in significantly higher FDI inflows. Also, the bilateral trade liberalization agreement between Brazil and Argentina of the mid-eighties evolved into a customs union signed in 1991 and entered into force in January 1995. Paraguay and Uruguay were also signatories in addition to the two former countries, which initiated the integration process.

As a result, FDI inflows grew rapidly, at even higher proportions than intra-Mercosur trade. The average annual flows rose almost fourfold just two years after the union went into effect, and the region increased its share in the total worldwide FDI flows (Lahouel 1999).

CEFTA

In the first years of post-communist transformation, the damaging H&S consequences of failure to develop multilateral free trade agreements had most serious consequences for the inflows of FDI into CEECs (Baldwin 1994). Too much competition for FDI and increased trade barriers among the Central European countries lowered the attractiveness of the region and resulted

in less, not more, investment in each country. By creating the Central European Free Trade Agreement (CEFTA) and committing themselves to not raising additional trade barriers, Central European countries managed to rule out or at least greatly reduce that problem.

The high-level meeting between Poland, Hungary and Czechoslovakia, organized in Visegrad, Hungary, in February 1991, is regarded as a milestone in the rapprochement among the three countries (Rudka and Mizsei 1994). It formally inaugurated their cooperation, and hence gave the initial name of the group – the “Visegrad Triangle”.

The Central European Free Trade Agreement was signed in Krakow in December 1992 (after difficult negotiations) and went into effect in March 1993. The Krakow Declaration approved earlier projects on mutual economic, infrastructural, cultural, and scientific cooperation and added several new initiatives, such as the creation of a financial working group and an energy-policy working group, arrangements to promote trade and protect investments, and the development of joint ventures in commercial banking. It provided for the gradual elimination of tariff and nontariff barriers in the trade of most industrial goods among the four countries within the next eight years, ending in January 2001.

When analyzing the factors about the extent to which regional integration frameworks act as determinants of FDI (UN World Investment Report 1998), we shall note that CEFTA provides for only shallow integration, but even this had an impact on FDI determinants because it was also a precursor for much deeper integration in the EU context.

The conditions for belonging to CEFTA were WTO membership, an EU Association Agreement and bilateral free trade agreements with the members, so the countries had already satisfied rather strict tests in terms of commitment to liberal trade regimes and capacity to satisfactorily implement them. Timetables for the reduction of barriers have been accelerated, which was another strong positive signal to potential inward investors.

The behavior of foreign investors in the newly created CEFTA group is particularly instructive. Some Western firms established a presence in only one country, from which they tried to conquer the whole sub-regional market. This generally created trade and exerted pressure for further trade liberalization. Others started productions in all countries, but in different sub-sectors, so these productions became complementary. Therefore, it is reasonable to argue that the conclusion of the CEFTA was in itself a significant factor in the jump of foreign direct investments (Rudka and Mizsei 1994).

We shall point out that the EU wanted and supported CEFTA. EU put pressure for more regional cooperation as a precondition for membership. Sub-regional cooperation was expected to serve as a training ground or learning process for economic development, institution-building, political cooperation, development of mentality and behavior patterns, the ability to build consensus, collective approaches to solving common concerns, and so on. Geopolitical and security considerations were also emphasized. The EU had an economic interest in intensified sub-regional cooperation, to provide easier market access for its goods, companies and capital during the transformation process. But also deeper sub-regional cooperation would save the EU from some of the competitive pressure from competitive CEE products.

Mediterranean Sub-Regional Cooperation

The EU had the same attitude towards Mediterranean sub-regional cooperation, inciting the new members of the Euro-Med Agreements to sign free trade agreements among themselves. The potential sub-regional agreements will largely reduce the negative H&S effects (as in the case of CEFTA). Sub-regional cooperation among the South-Mediterranean countries appears necessary to countervail the inherent dangers of the simple vertical integration that is about to take place, if not egoistically, at least imprudently, since totally uncoordinated (Berthomieu 1998).

In February 1989 Tunisia, Morocco, Algeria, Libya and Mauritania signed the Marrakech Treaty, creating the Arab Maghreb Union (AMU). The main objectives of the AMU are to strengthen all forms of ties among Member States in order to ensure regional stability and enhance policy coordination, as well as to introduce gradually free circulation of goods, services, and factors of production among them. Common defense and non-interference in the domestic

affairs of the partners are also key aspects of the Treaty. The Treaty highlights the broad economic strategy to be followed, namely, the development of agriculture, industry, commerce, food security, and the setting up of joint projects and general economic cooperation programs.

Considering the geographical position of Egypt, the country has almost no possibility for entering sub-regional cooperation with respect to its EU Agreement. The potential for regional cooperation among the Mashreq countries seems unrealizable in the short term, due mainly to the Israeli-Palestinian conflict. The Oslo peace process had prepared the regional environment for potentially successful cooperation, but these efforts vanished because of the anti-peaceful Israeli government policy. Bordering the embargoed Libya and Sudan, which are not candidates for the Euro-Med Agreements in the near future, Egypt's potential for trans-border cooperation is even more severely limited.

If the European Union truly aspires to the economic prosperity and regional cooperation in the Mediterranean, it has to engage itself much more directly in the creation of the area of political stability, security and peace, which remains the foundation of the Barcelona process. The Fifth Euro-Mediterranean ministerial conference, held in April 2002 in Valence (Spain), was largely dominated by the Israeli-Palestinian conflict, which risks pulverizing the entire Barcelona initiative, as underlined by the participating French minister of foreign affairs, Hubert Vedrine ("Les Echos", 24 avril 2002).

In this context we have to underline the original dimension that Egypt presents in its relations with the EU. Contrary to the Euro-Maghreb relations, which are strongly axed on purely economic cooperation, the Egyptian government sees in its rapprochement with the EU a way to push for a much stronger political role of the Union in the Middle East. Egypt wishes to maintain an important political position in the entire region, but for that it needs a certain number of external alliances.

This is the main reason behind the Egyptian government's policy for integrating a growing set of regional cooperation agreements, which we identify as multi-regional cooperation strategy.

4.4. Multi-Regional Cooperation Strategy

As we have already underlined, a country engaged in regional integration is most attractive to the foreign investors if it occupies the position of the hub. By becoming member of several regional free trade agreements, Egypt has the opportunity to grow to be a virtual hub and enlarge its market significantly, turning itself into a much more attractive export platform to international investors.

During the last few years, the Egyptian authorities became the driving force behind the creation of several bilateral and multilateral cooperation agreements. They have started negotiations for the establishment of free trade agreements with countries like the USA, Turkey, the European Union, the member countries of the Arab League and the countries of East Africa.

COMESA

In 1998 Egypt joined the 21 African countries members of the Common Market for Eastern and Southern Africa (COMESA).

COMESA was established in 1994 to replace the Preferential Trade Area for Eastern and Southern Africa (PTA), which had been in existence since 1981. Its aims and objectives are to facilitate the removal of structural and institutional weaknesses of member states so that they are able to attain collective and sustained development.

These goals are to be achieved through the establishment of a full free trade area guaranteeing the free movement of goods and services produced within COMESA and the removal of all tariffs and non-tariff barriers. The members also wish to create a customs union under which goods and services imported from non-COMESA countries will attract an agreed single tariff in all COMESA states. Finally, free movement of capital and investment is to be supported by the adoption of common investment practices, so as to create a more favorable investment climate for the COMESA region.

The Pan-Arab Free Trade Agreement

In January 1998 eighteen Arab countries created the Pan-Arab Free Trade Agreement (PAFTA). Members made specific commitments with regard to tariffs and tariff-like charges. By way of annual reductions of 10 percent of customs duties, fees and taxes, goods are scheduled to be moving duty-free among the states through the establishment of the Arab Free Trade Zone by 2008. The most recent negotiations tend to reduce this period to 2005 (Atef Ebeid, "Al Ahram", 5 September 2002). Besides that, dispute settlements have been successfully guaranteed by the creation of strict rules and of the Arab Investment Tribunal, which will look after their proper application.

Nevertheless, specific lists of import-sensitive agricultural and manufacturing products can remain protected during the transition period. According to Zarrouk (1998), this provision of the PAFTA protocol

agreements distort bilateral trade flows rather than stimulate trade between Arab countries.

Abolishing non-tariff barriers and creating common rules of origin are also an aim of PAFTA, but rules of origin appear to be a serious hindrance to the application of the Arab free trade area. The common Arab rules of origin are still under discussion and are the object of vivid disagreements between member countries. One group underlines the need for supporting existing rules of origin on the basis that the local component in Arab commodities should account for 60 percent, compared to 40 percent for foreign input and not the contrary as expressed by the second group. Morocco, Algeria Tunisia, Egypt, and Syria call for reactivating inter-Arab trade relations, protecting existing industries, guaranteeing promotion of industries, together with providing support and protection for domestic industries. Others, like Jordan and Lebanon, as well as most of the Gulf states, see no risk in adopting soft rules of origin that could lead to easy, leakage of foreign commodities to the Arab region.

The creation of competition and anti-monopolistic rules, and the liberalization of services are recommended as ways of further development of the PAFTA.

Nevertheless, the potential of the PAFTA agreements can be qualified as limited because of the small share of Intra-Arab trade in the total trade of member countries, the low share of intra-industry trade in the total Intra-Arab trade (as computed by Havrylyshyn and Kunzel, 1997), and the relative similarity of the main export products.

This limited potential of the PAFTA was the main argument for the importance for Egypt to engage itself in the Euro-Med Agreement. Linking the two agreements helps Egypt in the harmonization of its domestic policies, especially in the alignment of its production standards and competition policy laws to those in the EU, providing certainty and credibility to the domestic economic environment. Another area of bending domestic policy is the Euro-Med provisions concerning government subsidies and public aid to local industries. This could help Egypt and the other MENA countries to make the commitment not to engage in tax breaks and subsidies in order to compete for FDI (Zarrouk 1999). Moreover, linking Euro-Med and PAFTA agreements has a

significant welfare effect, if the integration is deep, as estimated by Hoekman and Konan (1999).

The PAFTA will contribute as well on minimizing the “hub” and “spokes” effect resulting from the Euro-Med agreement by enlarging the Egyptian regional market size.

The combination between the Euro-Med, the PAFTA and the COMESA agreements places Egypt in the “hub” of a large regional market, allowing free access to more than 800 million customers. This multi-regional cooperation could become the main FDI attractivity determinant in Egypt, but only if one very important condition is fulfilled – the Egyptian government has to implement the reforms necessary to the creation of a welcoming and transparent investment environment (Fawzy 1998).

The multilateral free trade agreements increase FDI inflows into a region, but they guarantee nothing for individual countries, since the supplier to the regional market will be more disposed to locations where the other FDI-relevant conditions are most favorable (Dangerfield 2000). The CEECs again provide us with an accurate example. While the CEFTA countries were the leading recipients of FDI into post-communist Europe, we note that Slovakia received a much lower level of FDI (\$1,7 billion) compared to Poland (\$29,1 billion).

This warning is even more pertinent in the case of Mediterranean countries – competition for FDI between them will continue to grow, since more and more of them begin to benefit from privileged access to both EU and PAFTA markets.

5. Conclusion

The experience of the Central European Countries in terms of attracting FDI is very instructive for the MENA countries. After just one decade of liberalization, they account for 12.4 percent of the investment inflows in the developing countries, three times the share of MENA countries inflows.

The main determinants of their impressive attractivity were the privatization programs, the sound political stability and the efficient institutional reforms undertaken under the hospices of the European Union.

The Central European countries created the basis of their attractivity by selling their State-Owned Enterprises to foreign investors. In the first years of transition privatization proceedings from FDI attained 88 percent in Hungary and the Czech Republic. During the rest of decade the investors continued to be attracted by the privatization process, since the countries used all types of methods susceptible to bring them in. Therefore, we recommend that Egypt introduce in its privatization strategy more diverse options like direct negotiations, open bidding and sealed bids.

According to our synthesis of empirical and survey literature, Egypt still has to commit more effort in order to fulfill the indispensable preconditions requested by potential foreign investors, so that the country could appear in their short-lists.

First, comes the problem of political stability. In 1998 it was already considered as the principal impediment to investment in Egypt, and this situation was further worsened by the increased tensions between Israel and its neighbors since the beginning of the Palestinian *Intifadah*, and the impasse of the Israeli-Arab peace process. The Egyptian government needs imperatively to multiply its alliances in order to achieve its primary strategic goal –peace and stability in the region.

Second, the country is actually going through an economic and currency crisis, similar to the ones experienced by the Asian countries. The Egyptian authorities should reconsider their macroeconomic policy in depth, in order to escape the past errors, and to benefit from the successful experiences of other countries. We consider that the exchange rate policy is both the reflection and the base of the whole economic activity. We can conclude from the experience of Poland, the Czech Republic and Hungary, that even though their exchange rates have largely fluctuated, this has not been a hindrance to the FDI inflows. It appears that the investors begin to apprehend the exchange rate risk and that the currency fluctuations no longer provokes their reluctance. To the opposite, a fixed exchange rate regime starts to seem much less credible, since it is difficult to manage by the authorities in the context of economic globalization. Therefore, we recommend that the Egyptian government revise its fixed exchange regime, and opt for a more or less free-floating system.

In terms of development of the institutional framework, the CEECs took full advantage of the European integration process, since it was the EU “know-how” that designed the entire transformation process. Based on this experience, Egypt can expect to benefit from the conclusion of different bilateral and multilateral cooperation agreements, which require more transparency and harmonization efforts, in order to enhance its attractivity regarding this third FDI precondition.

When we turn to the FDI motivations, Egypt appears very competitive in terms of infrastructure development with its vast, cheap and qualified labor force, its good communications network and its performing local enterprises. Nevertheless, we incite the Egyptian authorities to improve access to and the quality of business information, which is often cited as the second biggest impediment to investment in the country.

The foremost FDI motivation according to the investors themselves is regional market accessibility. The free trade agreements provide the investors with free circulation of goods, allowing them to reach a larger number of consumers. The regional integration in the framework of the EU Association Agreements and the sub-regional cooperation within the Central European Free Trade Agreement

have been the most pertinent attractivity factors for the CEECs, since they reflect the large market access for the potential foreign direct investments.

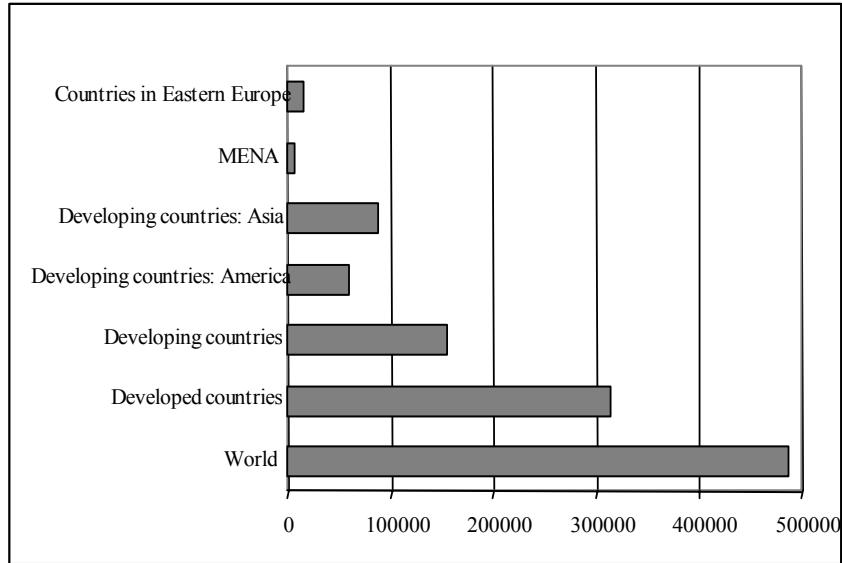
Based on its geopolitical regional weight, Egypt conducts a multi-regional cooperation strategy, which consists of becoming a member of numerous bilateral and multilateral free trade partnerships. This policy will allow it to become the hub of a vast market. However, this requires the harmonization and cumulation of the rules of origin, so as to prevent them from taking the role of free trade barriers, and consequently, of hindrances to the FDI attractivity. Finally, the Egyptian multi-regional strategy shall aim at a deep integration, in order to build up sound strategic alliances, based on common long-term interests.

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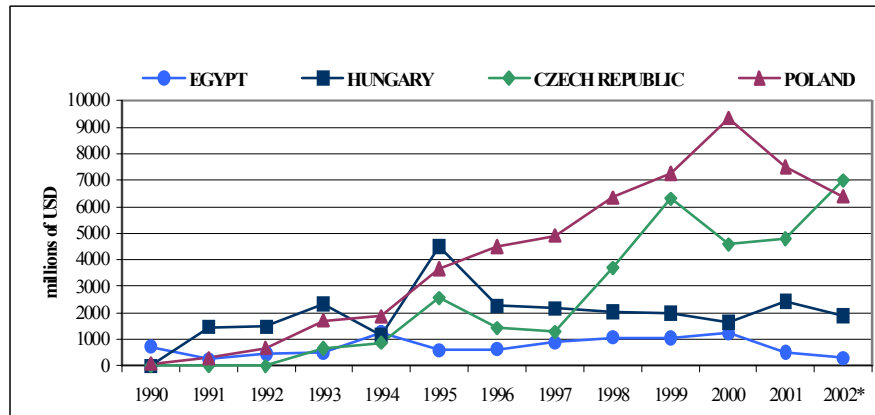
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Figure 1: FDI Inward Flows, 1996-1998 Average (in \$ million)



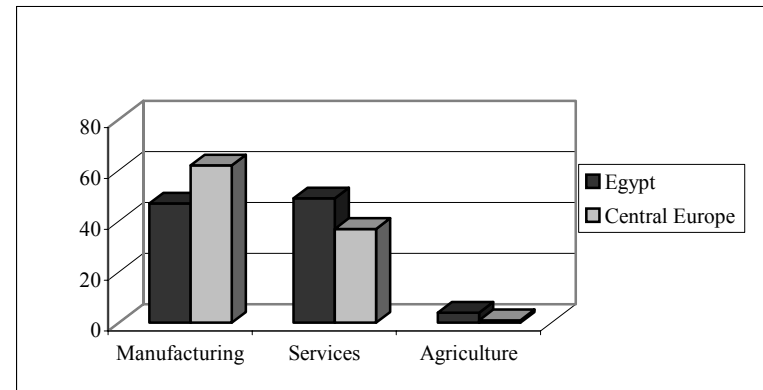
Source: Author's calculations based on UNCTAD 2000.

Figure 2: FDI Inflows



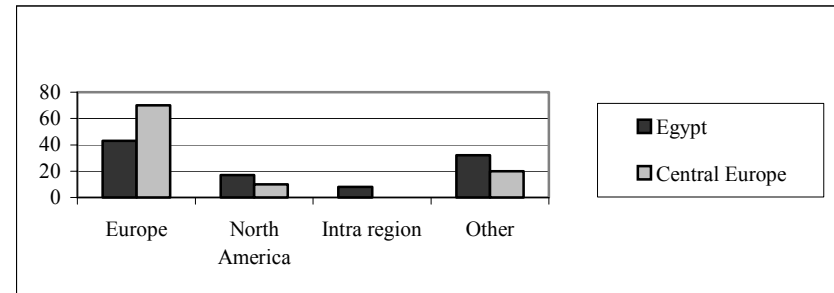
Source: Economist Intelligence Unit Country Data (*Data for 2002 are forecasts)

Figure 3: Sectoral composition of FDI inflows



Source: Author's calculations based on UNCTAD, 1996, and Altomonte and Guagliano, 2001.

Figure 4: Regional composition of FDI inflows



Source: Author's calculations based on UNCTAD 2001 and Eurostat New Cronos Database.

Figure 5: Exchange Rate Fluctuations

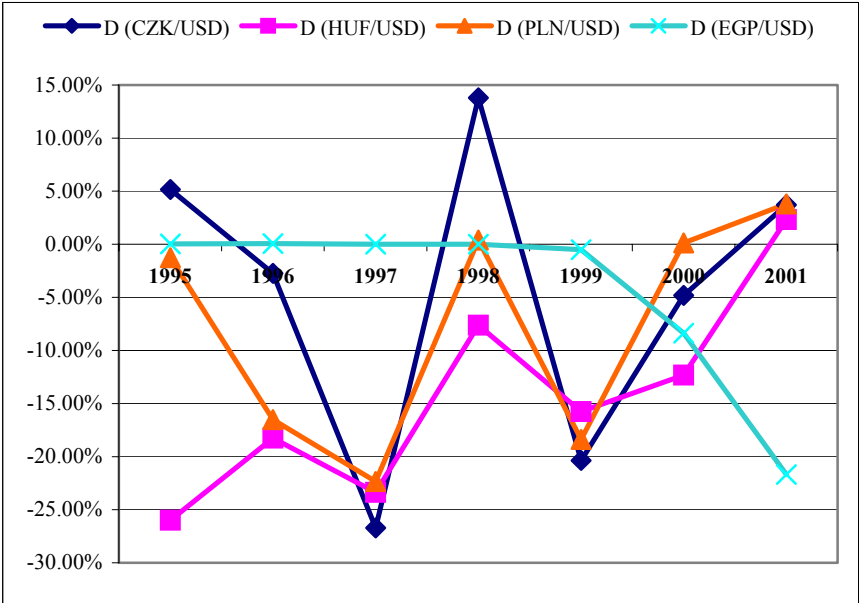


Figure 6: The EU Agreements Hub-and-Spoke Effect

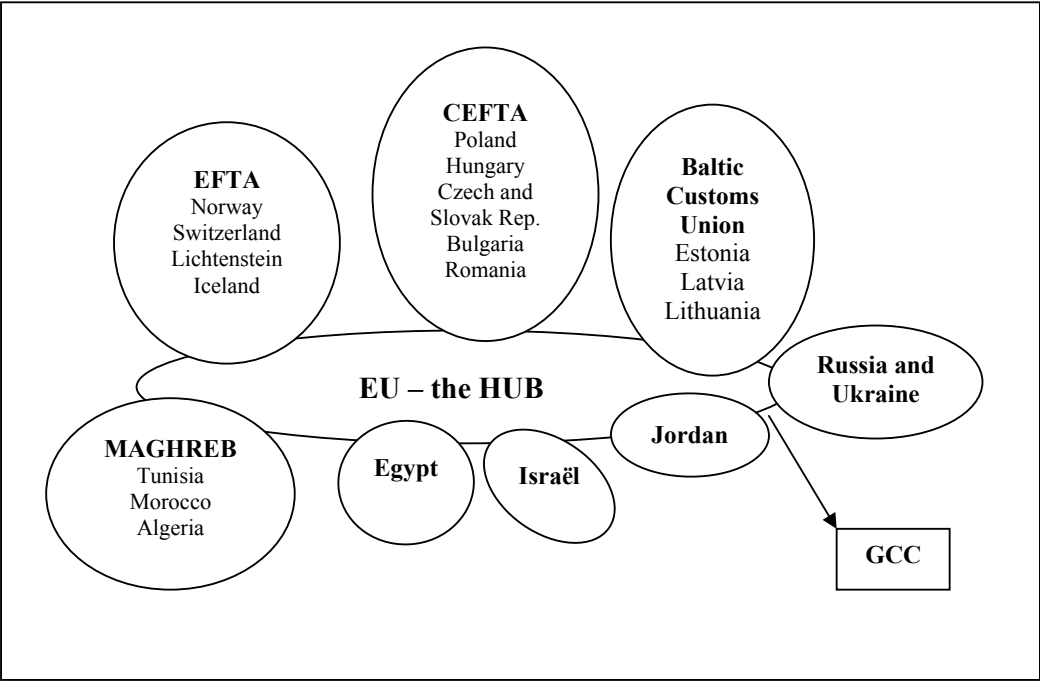
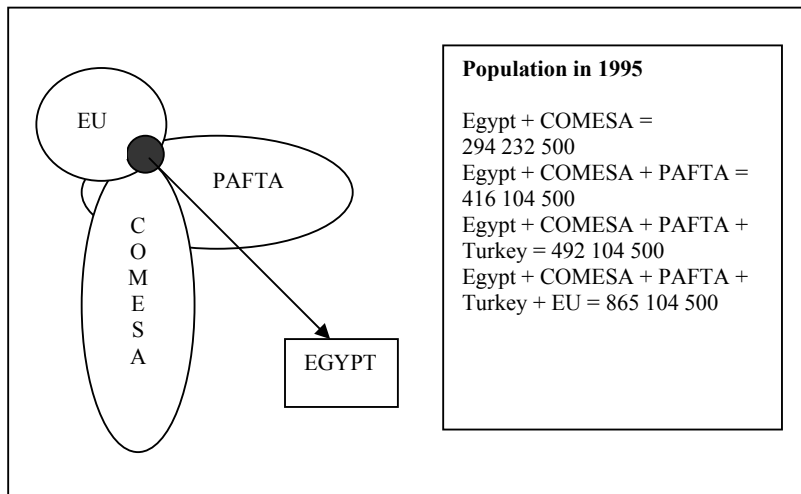


Figure 7: Egypt's Multi-Regional Cooperation and Regional Market Size



Source: WDI CD-ROM 1998

Annex One

Table A 1: FDI Inflows In Selected Developing Countries, 1990-2002 (in \$ million)

Inward direct investment by annual average, 1990-2000		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total stock 1990-2002
Brazil	15913	989	1103	2061	1292	3072	4859	11200	19650	31913	28576	32779	22636	177130
Mexico	11600	2549	4742	4393	4389	10972	9527	9186	12831	11897	12478	14192	24731	134887
Argentina	7620	1836	2439	4433	2791	3635	5610	6949	9161	7292	23984	11665	4800	88095
Singapore	7197	5575	4887	2204	4686	8550	8788	10372	12967	6316	7197	6390	5959	89632
Poland	4928	89	291	678	1715	1875	3659	4498	4908	6365	7270	9342	7500	54590
Malaysia	4061	2332	3998	5183	5006	4342	4178	5078	5137	2163	3895	3788	2500	51000
Chile	4011	661	822	935	1034	2583	2957	4634	5219	4638	9221	3675	5500	45602
Thailand	3342	2444	2014	2114	1804	1365	2068	2336	3895	7315	6214	3366	2839	41224
Czech Rep.	3322	n.a.	n.a.	n.a.	653	878	2568	1435	1287	3699	6313	4583	4800	33216
Hungary	2176	n.a.	1463	1479	2349	1145	4518	2274	2167	2037	1977	1647	2439	25395
Israel	1835	150	346	589	605	441	1349	1388	1629	1760	2889	4392	3044	20682
South Africa	1718	-76	254	3	11	374	1248	816	3811	550	1503	969	7162	19075
Nigeria	1337	588	712	897	1345	1959	1079	1593	1539	1051	1005	1227	1261	16006
Philippines	1311	530	544	228	1238	1591	1478	1517	1222	2287	573	1241	1792	15491
Turkey	1046	684	810	844	636	608	885	722	805	940	783	982	3300	12999
Slovakia	967	n.a.	n.a.	n.a.	199	270	236	351	174	562	354	2052	1475	9673
Romania	813	0	40	77	94	341	419	263	1215	2031	1041	1025	1137	8983
Egypt	774	734	253	459	493	1256	598	636	891	1076	1065	1235	510	9506
Ukraine	544	n.a.	n.a.	n.a.	n.a.	159	267	521	623	743	496	595	792	4896
Morocco	501	165	317	422	491	551	92	76	4	12	3	10	2850	5993
Tunisia	475	76	125	526	562	432	264	238	339	650	350	752	460	5424
Algeria	439	0	12	12	59	18	5	270	260	500	470	440	2000	4846
Bulgaria	427	n.a.	56	42	40	105	90	109	505	537	806	1002	689	4751
Saudi Arabia	420	1864	160	-79	1369	350	-1877	-1129	3044	4289	-780	-1884	20	6647

Table A 1: Cont'd.

Inward Direct Investment by annual average, 1990-2000		1990	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	Total stock 1990-2002
Lithuania	330	26	45	n.a.	30	31	73	152	355	926	487	379	445	3373
Estonia	303	n.a.	n.a.	82	162	214	202	150	266	581	305	387	535	3335
Latvia	278	n.a.	n.a.	29	45	214	180	382	521	357	348	407	201	3054
Slovenia	251	n.a.	n.a.	111	113	128	177	194	375	248	181	176	442	2764
Jordan	183	38	-12	41	-34	3	13	16	361	310	158	600	300	2044
Syria	178	n.a.	n.a.	n.a.	176	251	100	89	80	82	263	270	240	1781
U.A.E	165	111	111	111	111	62	399	130	100	100	160	180	210	2035
Cameroon	99	-113	-15	29	5	-9	7	145	151	160	134	127	159	959
Iran	75	0	0	0	0	2	17	26	53	24	75	100	275	822
Oman	74	142	135	104	142	76	46	60	65	101	21	23	75	1090
Total Stock		Of 34 Countries			MENA (of 8)			CEEC (of 11)			Others			
< 5000		13			3			6			4			
5000 – 25 000		11			5			2			4			
25 000 – 70 000		6			--			3			3			
> 70 000		4			--			--			4			

Source: Author's calculations according to EIU Country Data

Table A2: Synthesis of the Most Recent Empirical Models

Authors, Periods and Countries	Dependant and Independent Variables	Methodology and Results
Allessandrini and Resmini, 2000		
Basic equation: $FDI_{ijt}/POP_{jt} = \alpha_0ij + \alpha_1*G_{jt} + \alpha_2*EDU + \alpha_3*ORI_{jt} + \alpha_4*TRADE_{ijt} + \alpha_5*MAN_{jt} + \alpha_6*GTP_{jt} + u_{ijt}$		
1990 – 1997	<i>Dependant:</i> FDI	Panel data study
16 market economies (EU, USA)	<i>Independent:</i> Population	Market size, availability of skilled labor, natural resource endowments, trade with major investors and political stability (leading to a secure business environment) are the most important factors for the attraction of FDI in both CEE and MENA states.
6 MENA countries (Algeria, Egypt, Israel, Morocco, Syria, Tunisia)	GDP growth rate	
11 candidate countries (Bulgaria, Cyprus, Czech Republic, Estonia, Hungary, Malta, Poland, Romania, Slovenia, Slovakia, Turkey)	Intensity of trade linkages	
	Share of industry in the GDP	
	Growth rate of trade partners	
	Tertiary school enrollment	
	Operation risk index	
Altomonte and Guagliano, 2001		
1990 – 1997	<i>Dependant:</i> Investment (binary formulated)	Panel data study – random effects probit model
10 MED countries (Algeria, Cyprus, Egypt, Israel, Jordan, Lebanon, Morocco, Syria, Tunisia, Turkey)	<i>Independent:</i> Population	MED countries have lower attraction capacities than CEE countries, because of the weaker agglomeration economies (lower market potential), and because of the higher segmentation of regional markets.
8 CEE countries (Bulgaria, Czech Republic, Estonia, Hungary, Poland, Romania, Slovenia, Slovakia)	Level of education	
48 industries (1 mining, 39 manufacturing and 8 services)	Operation risk index	
	Legal framework	
	Dummies (for time, industries and MED area)	
Resmini, 1999		
Basic equation: $\ln FDI_{ijt} = \alpha_0i + \alpha_1i*GDPPC_{jt} + \alpha_2i*\ln POP_{jt} + \alpha_3i*DIST_{jt} + \alpha_4i*ORI_{jt} + \alpha_5i*WDIFF_{jt} + \alpha_6i*OPEN_{jt} + \alpha_7i*CONC_{jt} + u_{ijt}$		
1990-1995	<i>Dependant:</i> Foreign direct investment stock per sector, country and period	Gravity model
11 CEECs (Bulgaria, Croatia, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia)	<i>Independent:</i> GDP per capita	The concentration of the manufacturing sector shows a significant negative sign (strategic motivations seem to prevail on the possibility to exploit agglomeration economies). The other most significant determinants are GDP per capita, the population (FDI in CEECs are targeted to the local market), the operation risk index and the openness of the economy. The geographical proximity to Western Europe has been an important factor of development, but plays a minor role for FDI attraction, as do wage differentials.
4 sector types (scale intensive, high tech, traditional and specialized)	Population	
	Proximity to EU (average distance between capitals)	
	Wage differentials between the EU and the CEECs	
	Operation risk index	
	Degree of openness	
	Industrial concentration (relative size of manufacturing sector)	

Table A2: Cont'd.

Authors, Periods and Countries	Dependant and Independent Variables	Methodology and Results
Bevan and Estrin, 2001		
Basic equation: $FDI_{ijt} = f(GDP_{it}, GDP_{jt}, \Delta BYR_{ijt}, EUIMP_{jt}, RISK_{jt}, DIST_{ijt}, ULC_{jt}, GER, USA, BALTIC)$		
1994 – 1998	<i>Dependant:</i> FDI	Panel data study – random effects
18 market economies (EU, Korea, Japan, Switzerland, USA)	<i>Independent:</i> GDPs	Country risk (credit rating), unit labor costs, host market size and gravity factors are the main FDI determinants in CEECs.
11 transition economies (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia, Slovakia, Ukraine)	Bond yield differential	
	Total imports from the EU	
	Host country risk (credit rating)	
	Distance between capitals	
	Unit labor costs + Dummies	
Holland and Pain, 1998		
Basic equation: $FDI_{j,t}/GDP_{j,t} = \alpha + \beta_1*PRIV_{j,t} + \beta_2*METHOD_{j,t} + \beta_3*TRADE_{j,t} + \beta_4*RELW_{j,t} + \beta_5*RELPROD_{j,t} + \beta_6*RISK_{j,t} + \beta_7*PROX_{j,t} + \beta_8*BALTICS + \epsilon_{j,t}$		
<i>Dependant:</i> Foreign direct investment	<i>Dependant:</i> Foreign direct investment	<i>Dependant:</i> Foreign direct investment
<i>Independent:</i> Private sector share of GDP	<i>Independent:</i> Private sector share of GDP	<i>Independent:</i> Private sector share of GDP
Method of privatization	Method of privatization	Method of privatization
Trade with EU economies as proportion of total merchandise trade	Trade with EU economies as proportion of total merchandise trade	Trade with EU economies as proportion of total merchandise trade
Wage productivity (relative to weighted average of wage productivities of other CEECs)	Wage productivity (relative to weighted average of wage productivities of other CEECs)	Wage productivity (relative to weighted average of wage productivities of other CEECs)
Labor productivity (relative to weighted average of wage productivities of other CEECs)	Labor productivity (relative to weighted average of wage productivities of other CEECs)	Labor productivity (relative to weighted average of wage productivities of other CEECs)
Country risk	Country risk	Country risk
Dummy variable for proximity to the EU (=1 for CEFTA countries)	Dummy variable for proximity to the EU (=1 for CEFTA countries)	Dummy variable for proximity to the EU (=1 for CEFTA countries)
Dummy variable for Baltic states	Dummy variable for Baltic states	Dummy variable for Baltic states

Table A2: Cont'd.

Authors, Periods and Countries	Dependant and Independent Variables	Methodology and Results
Garibaldi, Mora, et al., 2002		
Basic equation: $y_{i,t} = \alpha_0 + \alpha_1 * y_{i,t-1} + \alpha(L) * X_{i,t} + \beta * Z_i + \varepsilon_{i,t}$		
1990 (92) – 1999	<i>Dependant:</i> Portfolio investment	Panel data study
28 transition countries	Direct investment	FDI is positively affected by
(Albania, Armenia, Azerbaijan,	<i>Independent:</i> (32 for each)	good macroeconomic
Belarus, Bulgaria, Croatia,	Scale variables (Population,	performance (high growth, high
Czech Republic, Estonia,	GDP – in \$ and PPP-adjusted)	fiscal balance, economic
Georgia, Hungary, Kazakhstan,	Macroeconomic variables (GDP	liberalization and trade
Kyrgyz Republic, Latvia,	growth, Average annual	reforms), rich natural resources,
Lithuania, Macedonia,	inflation, Exchange rate regime,	commitment to fixed exchange
Moldova, Poland, Romania,	General government balance)	rate. The country risk is always
Russia, Slovak Republic,	Interest rates (Real treasury bill	very significant, as are the
Slovenia, Tajikistan,	rate, Real domestic deposit rate)	errors in the credit ratings.
Turkmenistan, Ukraine,	Structural reform (Liberalization	FDI is negatively affected by
Uzbekistan)	index)	insider privatization,
	Institutional variables	restrictions to FDI,
	(Predictability of laws and	bureaucracy.
	policies, Political stability and	Wages, inflation and initial
	security, Bureaucracy,	conditions turn out
	Efficiency of government,	insignificant.
	Government-business interface)	
	Initial conditions and dummies	
	(for war, distance, liberalization,	
	and country groups)	
	Country risk rating (and its	
	residual)	
	FDI specific variables	
	(Manufacturing wages,	
	Standards of trade and foreign	
	exchange, Types of	
	privatization)	
	Portfolio investment specific	
	indicators	