Not all FDI contribute equally to capital accumulation and economic growth

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Relative to the size of its economy, Bulgaria is the largest recipient of FDI in the CEE region. Stock of FDI reached 83% of country's GDP in 2014, which as Chart N1 indicates exceeds all CEE peers. This is crucial because more FDI should translate into more capital, leading to higher productivity and stronger GDP growth. But while Bulgaria has been the most successful CEE country in attracting FDI, its capital stock has increased more or less in line with the average levels reported in the CEE region, while at the same time most recent data put capital stock in Bulgaria as the second lowest in CEE. As Chart N2 shows, net capital stock per capita in Bulgaria is 18.6% of the EU 28 average in 2015, rising with 8.8 pp, when compared with where the same ratio was two decades ago in 1995. Using the same metrics Czech Republic, Estonia and Slovenia emerge as the CEE countries with the largest capital stock at the moment. This is important because economic theory suggest that there is a strong cause and effect relationship between capital stock and income levels, where the countries with the highest capital per capita should be also the countries with the highest income per capita. Indeed, as Chart N3 shows, Czech Republic, Estonia and Slovenia which top the ranking of CEE countries in terms of capital stock per capita are also among the highest income per capita economies in the region.

The available empirical material therefore seem to reconfirm the strong cause and effect relationship between capital and income levels which economics textbooks suggests. At the same time, however, the empirical materials appears much more mixed when it comes to the link between the size of FDI and capital levels in the CEE region.

In what remains of this short piece of research I will focus on one of the reasons which, though perhaps not the most important one has a relevant role in explaining why the link between FDI and capital endowment is so ambiguous. I will argue that in the case of Bulgaria, and perhaps also in some other CEE countries, the benefits of FDI in the period prior to the 2009 crisis has depended not so much on the sheer size of FDI inflows than on their composition. In the same vein, vulnerabilities and risks associated with FDI in this particular period has had more to do with their composition rather than with their size. I will end my remarks with some policy implications.

Economic textbooks tell us that the more developed economies generate domestic savings in excess of domestic investment needs. In emerging markets, at the same time, there are major investment opportunities but limited domestic savings resources. As capital account is liberalized capital is allocated across the world to its most efficient uses. This usually takes the form of long-term debt or equity FDI originating from developed economies that goes to finance productive investments in emerging markets. Productive investments, the theory goes on, generate return which is used to repay debt and reward equity investors. In so doing, productive investments contribute to the economic growth and jobs creation in the recipient economy.

In the real world some FDI flows take exactly this form. Most of the FDI channeled into the CEE automotive industry, for example, have not only brought the increase in productive capital, but also contributed to the transfer of technology and skills that have been instrumental in stimulating rapid economic growth. But reality is more complex than that. Some FDI have had little to do with financing sustainable increases in capacity of the economy to produce more goods and services. Instead they have financed consumption rather than investments or have been channeled to the acquisition of already existing assets, which again haven't added much to the increase in productive capacity of the recipient economies. In some cases, FDI financing consumption have taken excessive proportions fueling a rapid increase in household indebtedness. In a similar way, when FDI channeled into acquisition of already existing assets have exceeded a certain limit they have contributed to the inflating of bubbles in the prices of different assets categories. All this means that some part of FDI have not played the positive role described by the mainstream economic theory, allocating capital across the world to its most efficient use. Instead they have rather harmed the recipient economies by contributing to a destabilizing increases in indebtedness and sometimes pushing real estate prices far away from the levels suggested by the fundamentals.

This more complex and refined picture of FDI, which have already been observed and well documented during Southeast Asian emerging marker crisis in the last decade of the XX century, distinguishes between at least two different types of FDI when it comes to their effect on the recipient economy. Perhaps more importantly, it suggests that it is not only the size, but more so the composition of FDI that matters. It is also one that helps to shed some more light on why empirical findings for the period prior to 2009 fail to reconfirm the link between the size of FDI and the level of productive capital in the CEE region, including Bulgaria.

The sector structure of FDI channeled to the CEE region helps to find more evidence in support of this claim, in my view. In Chart N4 we can see a sector breakdown of the stock of FDI channeled into the CEE region. FDI into industry can be seen as a proxy for the first type of FDI described above. These FDI boosted the availability of productive capital in the recipient country, while also helping the fundamentally important transfer of new technology and skills to take place. Not surprisingly these FDI are not only the most beneficial but also the least volatile. Empirical data show that FDI channeled into the CEE industry varies from less than one-fifth of total in most of the Baltic countries to close to a half of total FDI stock in the best performing Slovakia and Romania.

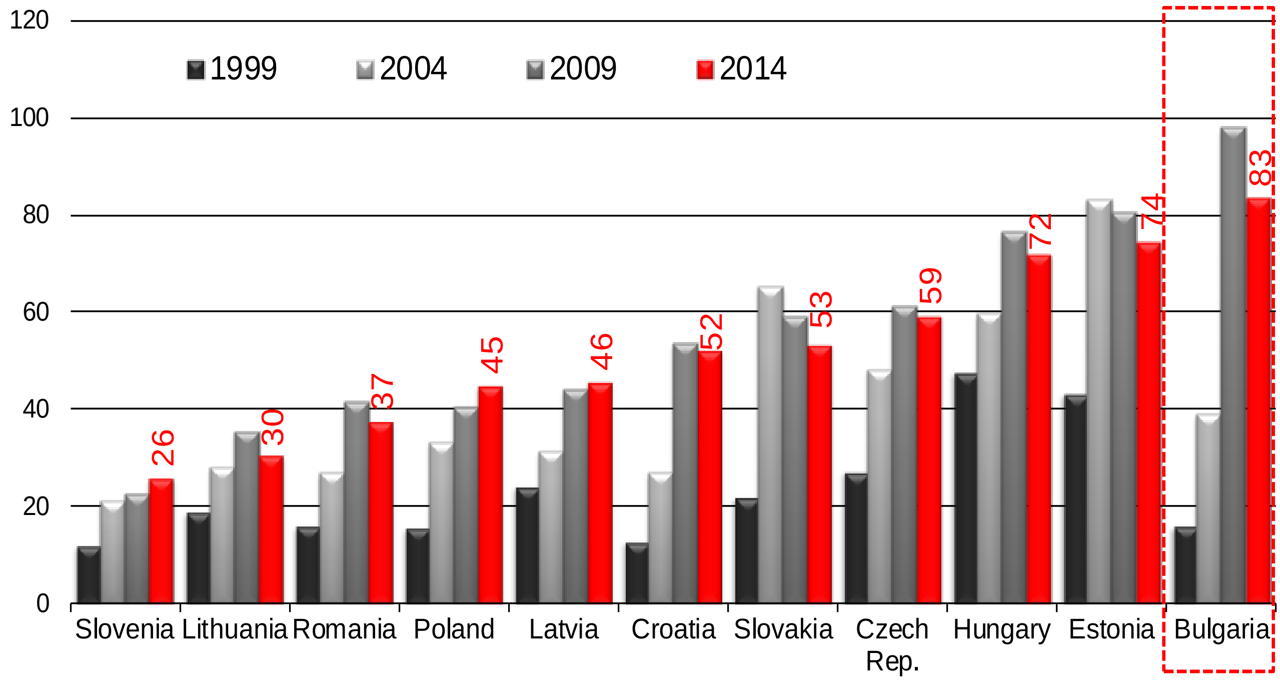
FDI to real estate and construction sectors have been most relevant in Croatia, Bulgaria and the Baltic countries where they are varying between a quarter and a third of the total. These are also the countries where the most pronounced real estate bubbles were observed. Other CEE countries have also exhibited unsustainable increases in real estate prices over the last decade, but these seem to be the ones where FDI have had only a limited role to play. Data suggest, that in the years leading up to the 2008 crisis some of the CEE economies have also gone through a very rapid increase in consumption, where part of the FDI channeled through the wholesale and retail trade as well as financial sector have also played some part. This type of FDI has been most significant in Slovenia and Croatia where they have accounted for 57% and 46% of total FDI stock, but have been relevant practically in all CEE economies. It should be noted as well that the picture of FDI channeled into these two sectors and particularly through the financial services sector is blurred, because there is no clear cut between bank flows that financed productive investments, on one side, and sometimes unsustainable increases in real estate prices and consumption, on the other.

Policy implications from this are profound. Perhaps the first important conclusion here should be that capital stock per capita in Bulgaria remains well below that in the developed economies, which, in turn, justifies continuing the public policies in support of investments, including FDI funded investments. At the same time, we need a more selective approach to FDI. One that deliberately drives FDI toward what we see as desirable investments, with the greatest potential to boost economic growth and jobs creation. We need almost every possible FDI which helps productive investments to increase, especially in higher-value added manufacturing sector, but not an excessive increase in real estate developments. We need more FDI to boost export potential of the economy, but not to encourage too much imports. We definitely don’t need repetition of the past episodes of excessive consumption, especially when financed with a too rapid accumulation of debt, as our own experience has demonstrated that this can lead to financial fragility.

All this seems easier said than done, especially when taking into account our commitment to the free movement of capital. But even in the context of the liberalized capital account, the toolbox of policy makers is not empty. We have funding schemes to encourage exports lending. We have prudential regulations, which the central bank can use to cool down credit fueled boom in consumption, if such is to materialize. In exceptional circumstances, we can use taxation to prevent unsustainable increases in the real estate prices and the prices of other assets categories. But apart from all these, in essence, crisis prevention tools we can use the system of stimulus which Bulgarian state agency for encouragement of FDI has at its disposal.

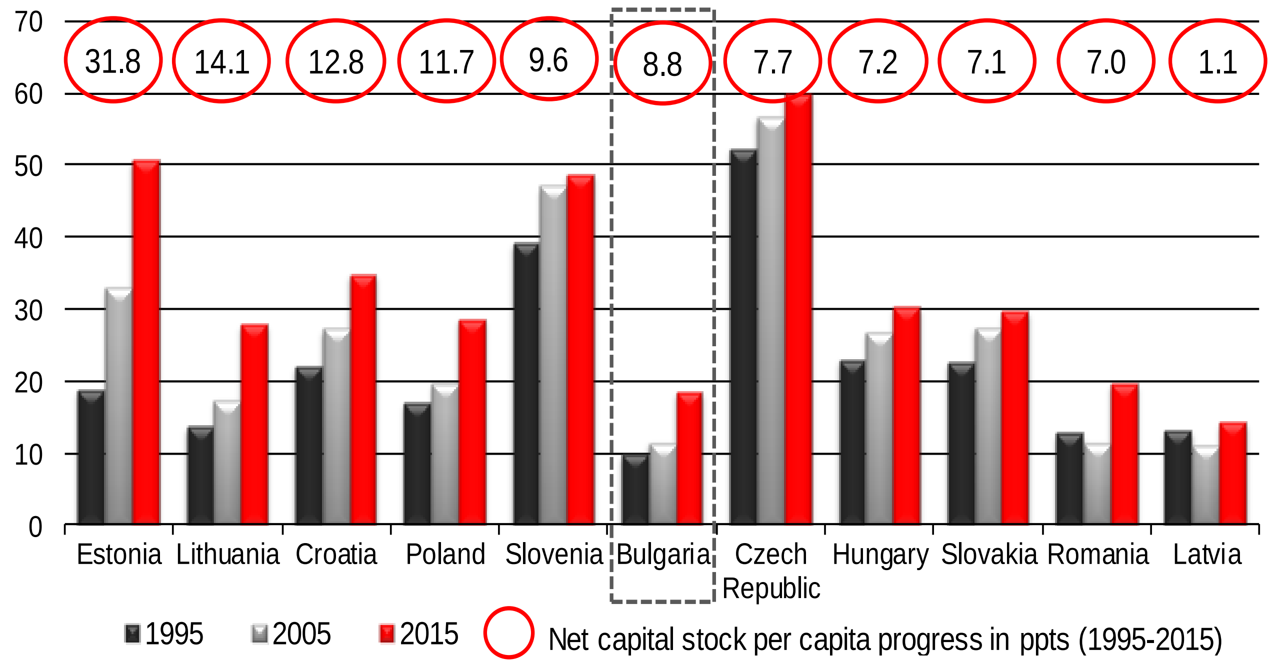
Bulgarian agency in support of FDI stands ready to provide almost every incentive that EU laws permit. These include a long list of stimulus varying from purely technical support and shortened administrative procedures to partial reimbursement of training expenses, tax exemption, and direct subsidies in the form of below market price acquisition of state-owned land. All these are powerful instruments which if and when are in good hands can help to achieve a lot. It is key to emphasize that the acting framework of incentives already takes a selective approach toward FDI. The rules already prevent public support for FDI in the real estate sector which is positive. At the end I want to take the chance to encourage Bulgarian authorities to keep this framework of stimulus under constant scrutiny to make sure that the limited public funds have been put into the best possible use and that only the FDIs with the strongest contribution to economic growth and jobs creation will receive public support.

Chart 1: FDI inward stock in CEE countries, as % of GDP (1999- 2014)



Source: UNCTAD, UniCredit Bulbank Economic Research

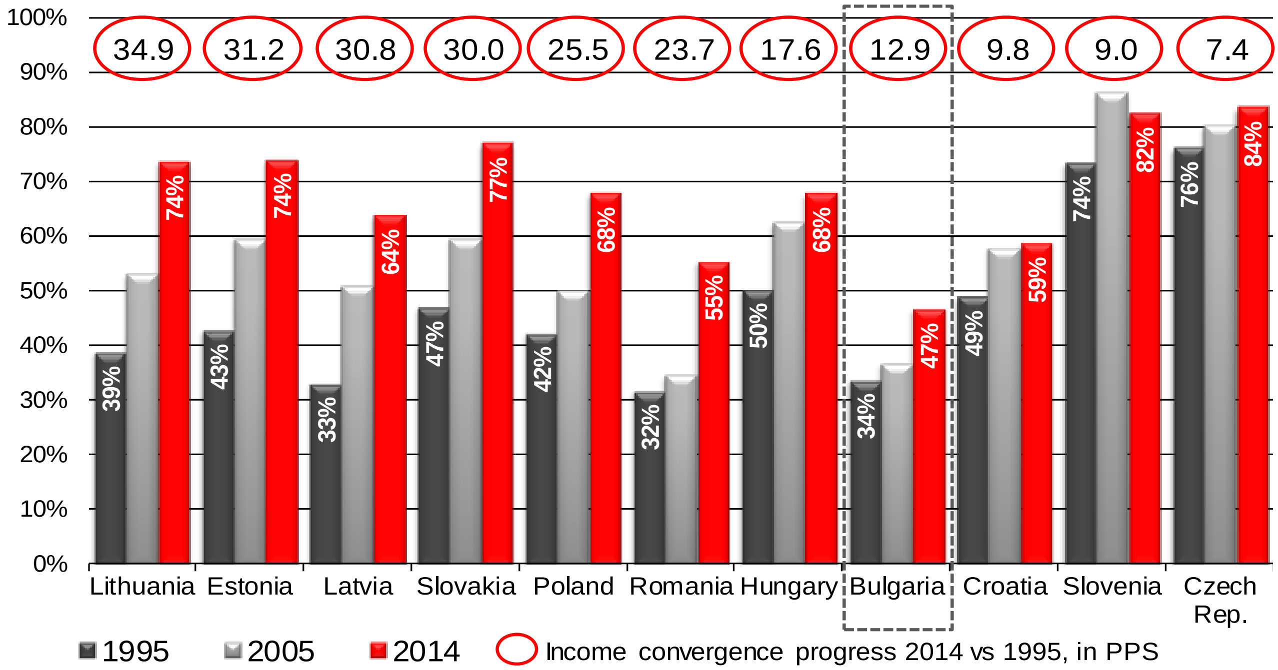
Chart 2: Net capital stock per capita as % of EU (28) average by CEE country (1995-2015)



Source: Eurostat, UniCredit Bulbank Economic Research

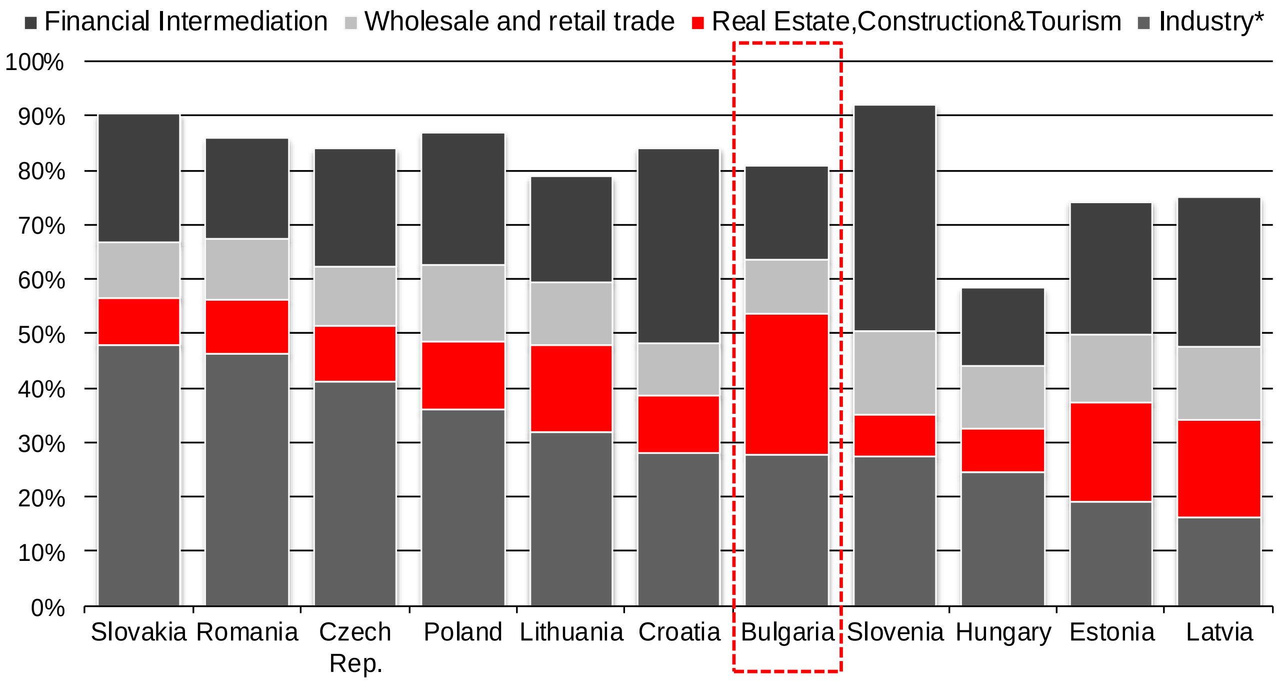
Note: Net capital stock in a given year is the net capital stock from the previous period net from Gross fixed capital formation at constant prices minus (Consumption of fixed capital at current prices divided by the Price deflator gross fixed capital formation) times 100.

Chart 3: Income convergence progress 2014 vs 1995, average GDP per capita increase in CEE, in PPS terms, EU28=100



Source: Eurostat, UniCredit Bulbank Economic Research

Chart 4: FDI stocks by industry in CEE countries, relative share from total FDI, % (2012)



Source: Eurostat, UniCredit Bulbank Economic Research
* Industry includes Manufacturing, Mining & Quarrying and Electricity, gas, steam, water and waste.

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