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Project name: **MACROECONOMIC INSTABILITY AND THE PATTERNS OF FOREIGN DIRECT INVESTMENT**

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Executive Summary

It has been showed that among the developing countries the fastest growing ones are the biggest recipients of foreign direct investment (FDI). Moreover, it is generally accepted that FDI brings at least four things of value: financial capital, management skills, technology, and access to export markets, and, therefore, sustains growth. Consequently, in many countries FDI is viewed as a panacea for diverse problems related to economic development and it is continued to be at the forefront of economic policy decisions. Therefore it is crucial to understand which factors determine flows of FDI.

The standard practice in the literature is to view FDI as arising from three distinct types of advantages. The firm must possess or control a unique mobile asset (i.e., patent or trademark) it wishes to exploit (*the ownership advantages*); it must exploit differences in country natural endowments, transport costs, cultural factors and government regulations to be cost efficient in the asset abroad in addition to or instead of in the firm's home country (*the location advantage*); and it must be in the firm's interest to control the asset's exploitation itself rather

than contracting out use of the asset to an independent foreign firm (*the internationalization advantage*). It is argued that if only the first condition is met, firms will rely on exports, licensing or the sale of patents to service a foreign market, while in the presence of *internalization incentives* FDI becomes the preferred mode of servicing foreign markets, but only if location-specific advantages are present.

The purpose of the research undertaken was to contribute to the theory of foreign direct investment by identifying how above mentioned advantages influence an inflow of FDI in uncertain environment. In the framework of the project the following two papers have been developed:

“On Determinants of Foreign Direct Investment in Transition Economies” (written by Andrzej Baniak, Jacek Cukrowski and Jan Herczyński and published as a Central European University Department of Economics Working Paper 8/2002)

The goal of the paper is to explore how some location specific advantages determine the flow of FDI into transition countries. In particular, the authors analyze the legal environment for FDI in some transition economies. Then they model the impact of stability of the economic and legal environment on the pattern of FDI assuming that the decision making firm is risk averse. The analysis shows that (i) higher variability of basic macroeconomic fundamentals reduces the flow of FDI, (ii) high volatility of fiscal and business regulations makes the inflow of FDI smaller, and (iii) macroeconomic and legal instability leads to adverse selection of the investors. Based on theoretical findings the authors formulate a clear message to policy makers stating that in order to expect significant flow of long term and non-speculative foreign capital, first of all, a stable economic and institutional environment is needed.

“Demand Uncertainty, Perfect Competition and Foreign Direct Investment” (written by Jacek Cukrowski and Ernest Aksen)

The goals of the paper are (1) to understand the basic reasons for FDI inflow and (2) make clear what are gains from FDI. In the paper the authors formulate clear message stating that inflow of FDI does not need to be explained by any specific factor such as location advantage or ownership advantage, but it is a natural process driven by rational behavior of firms operating in perfectly competitive markets in uncertain environment. Thus, except of the

internationalization advantage, no other conditions need to be fulfilled in order to observe flow of FDI. It is shown in a novel setting that flow of FDI between similar – even identical – countries with perfectly competitive markets is possible and can be welfare improving, despite obvious losses due to higher transaction/management costs in foreign plants.