

# **The determinants of FDI in Central, Eastern and South-eastern Europe: Lessons from the past and prospects for the future**

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## **Abstract**

The last fifteen years have seen a remarkable growth of foreign direct investments (FDI) in Central, Eastern and South-eastern European countries. This growth has led to a substantial interest by the international economics literature to empirically investigate the fundamental factors that drove FDI behaviour. The reason is twofold. First of all, FDI became an important part of the domestic economy. In 1990, the FDI stock averaged just 0.9 percent of GDP, ranging from virtually zero in several countries to 3.8 percent in Slovenia. By 2005, the FDI stock averaged 36 percent of GDP, ranging from a minimum of about 20 percent in Albania to a maximum of 93 percent in Estonia. Secondly, foreign investments played and still play a crucial role in those countries' transition from centrally planned to open market economy, providing important inflows of financial capital, and technological know-how and managerial expertise. However, the pattern of absolute FDI inflows has been quite erratic, with Central and Eastern European countries receiving the bulk of FDI and Southern and Eastern European countries still lagging behind. Therefore, an in depth analysis of the factors determining FDI inflows is needed not only to understand these differences but also to predict future patterns of FDI into the area and provide policy makers with guidelines on how to improve the inflows of FDI in their own countries.

This paper provides a critical review of the literature concerning the determinants of FDI in European transition countries, with a special emphasis on the external factors that are likely determinants of the location and the magnitude of foreign investments. The contribution of the paper is to evaluate what we can say with relative confidence about who has invested where, by how much and why, given the evidence, and what we cannot say because of the lack of evidence.

The paper starts with a summary of the major trends in foreign investment in Central, Eastern and South-eastern European countries since the fall of the Berlin Wall. A brief discussion of the most important predictions of the main theories on the determinants of FDI will precede the analysis of the empirical evidence on such determinants in Central, Eastern and South-eastern European countries. This discussion aims at highlighting not only similarities and differences across countries, but also the issues which still need further exploration because of the lack of robust results. Taken together, this analysis can serve as a guide for how to understand future patterns of FDI into the region.