



Directional Economics EMEA

Ready, aim, invest

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Ready, aim, invest

- Eurozone investment demand has risen to the highest levels since the financial crisis and is likely to lead to increasing FDI inflows into the CEE region.
- The CEE region is well positioned for 'near-shoring' FDI inflows, especially as the proposition shifts to business process outsourcing (BPO) from manufacturing.
- Geographical links, high quality human capital and productivity are the main advantages over the likes of China and India. The provision of EU funds also helps.

Eurozone outward FDI prospects much improved...

After years of poor economic performance, the Eurozone economy has started to grow at a surprisingly strong pace. GDP growth accelerated to 2.3% in 2017 with domestic demand improving significantly. We expect GDP growth to come in even stronger this year at 2.4%. And even though investment started its recovery last year, there is still plenty of room before it reaches pre-crisis levels. Capacity constraints are currently being reached, meaning that investment will be a necessity to keep up with strong new orders for European businesses.

Eurozone businesses are indicating that demand for investment is at the highest level since the crisis

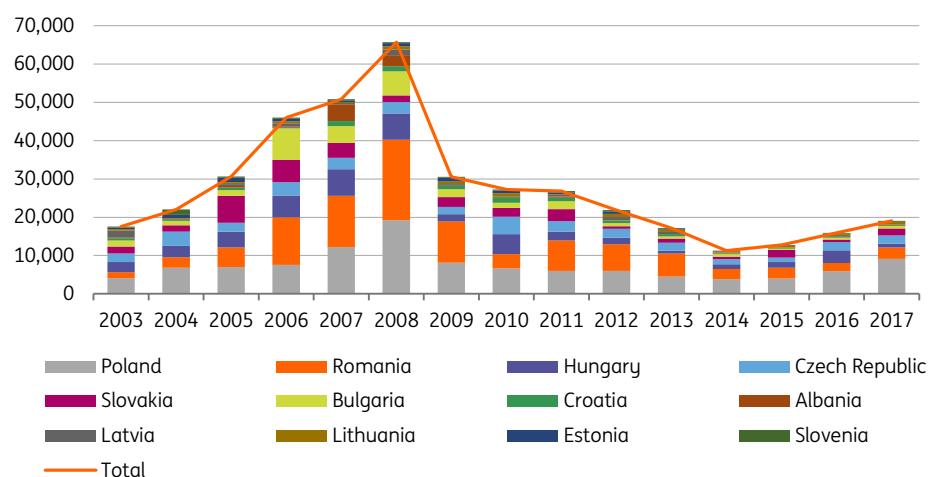
Financial conditions remain very accommodative and the strengthening of the European banking sector makes for easier borrowing conditions. This has caused the investment outlook to improve significantly, with businesses indicating that demand for investment is at the highest level since the crisis. Growth in investment is not limited to domestic economies though, investment at home and abroad is very correlated. This means that Eurozone outward FDI will likely benefit from the positive investment environment.

Real estate continues to be the dominant sector for outward FDI into the region and saw a jump in FDI in 2017. Investment in automotive and transport services has recently been adding to the pickup. Energy investments, both renewable and fossil, have not yet seen levels of FDI pick up to previously seen numbers.

But a decade after the last FDI boom, where should companies invest?

With Eurozone investment demand rising, we expect FDI to CEEs to improve further. With about 18% of total value added in CEE countries for Eurozone final demand, improving Eurozone GDP will surely help CEE investment trends. This should be helped by near-shoring gaining attractiveness, perhaps helped by global trade uncertainties emerging recently. Secondly, growth in the CEE economies is set to continue to outperform that in western Europe in the longer run adding to attractiveness for investment. But a decade after the last FDI boom, where should companies invest?

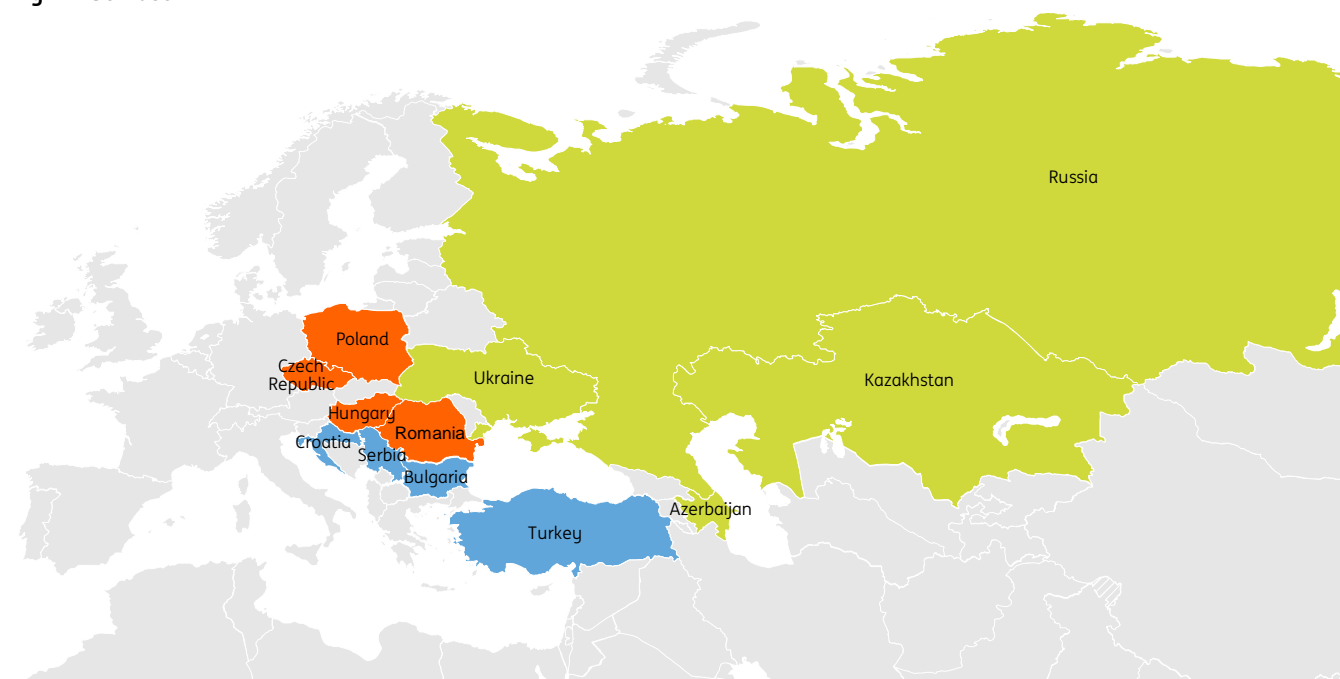
Fig 1 Western Europe FDI to CEE (US\$m)



Source: FDI Intelligence

The FDI proposition

Fig 2 Go East!



Source: ING

Fig 3 What the EMEA region offers to potential FDI investors

	Local strengths	Sector expertise/positioning	Local challenges
CE4			
Czech Republic	Favourable economic outlook Limited restrictions for dividends outflow	Automotive, machinery, electrical equip. Increasing productivity	Labour scarcity, wage growth Limitations for importing foreign workers
Hungary	Largest FDI stock in CEE Lowest corporate income tax in EU	Automotive, Electronics, SSC One of the most integrated in the GVC	Labour shortage, strongly rising wages Slightly eroding competitiveness
Poland	Nearly 50% of CE4 domestic demand Vast workforce (16m + 1m migrants)	Shared services/IT Manufacturing (diversified)	Uncertain legal environment Labour shortage, but limited wage growth
Romania	High GDP growth ratios Second lowest labour cost in the EU	Autos, BPO, IT&C, Agricultural potential High domestic value added for exports	Volatile fiscal legislation Poor infrastructure, regional disparities
Other Central & Eastern Europe			
Bulgaria	10% corporate income tax Lowest labour costs in the EU	BPO and IT, automotive, chemical Fast competitiveness gains	Rule of law and corruption issues Tricky geopolitical balancing act
Croatia	High quality infrastructure Unique geostrategic position	Tourism, shipyards, electronics Relatively high productivity level	Low labour participation and high wages Fluid politics, fragmented parliament
Serbia	Untapped, educated labour supply Committed to join the EU	Automotive, electronics, food Pre-accession funds, privatisations	Kosovo issue still unsolved Slower than expected reform agenda
Turkey	Market size & growth potential Relatively low-cost labour	Logistics, transport due to geography Government support for infrastructure	Political and policy uncertainty Volatility in neighbouring countries
CIS			
Russia	Priority market given size, growth prospect Relatively stable FX rate under fiscal rule	Consumer, machinery, materials Construction with gov't infrastructure plan	Demographic challenges, low productivity Geopolitical risks, sanctions, corruption
Kazakhstan	State focus on economic diversification Prudent monetary/fiscal policy mix	Consumer, machinery, construction Energy/commodity processing, higher VA	Institutional weakness, corruption The "succession story", local politics
Ukraine	Still promising market by size Focus on EU integration, logistical links	Agriculture, consumer goods Energy efficiency, natgas technologies	Local politics, corruption/vested interests Weakening reforms momentum
Azerbaijan	A need to diversify from oil & gas Strategic energy exporter position	Oil & gas and pipelines, refinery Agriculture, textile, consumer goods	Unorthodox monetary policy, oil depend. Institutional weakness, corruption

Source: ING

Initial manufacturing-driven outsourcing inflows to CEE have been replaced by services

CEE: The investment destination of choice

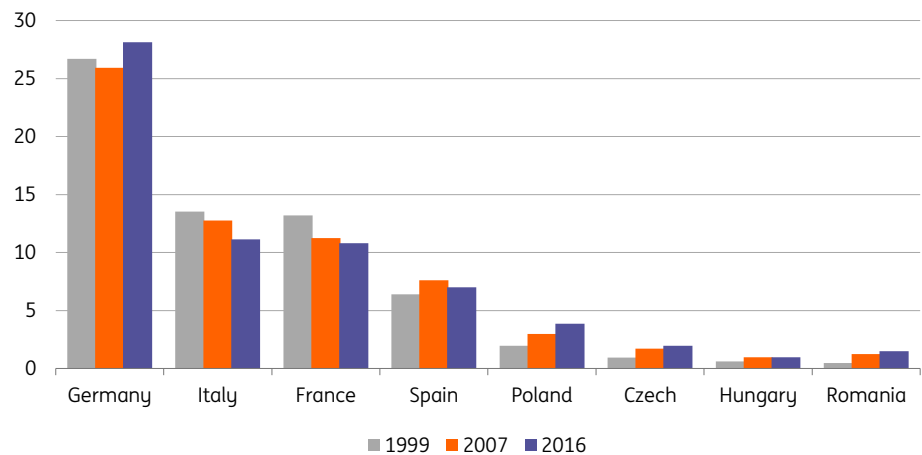
Since the fall of Communism, the CEE region has been an important recipient of investment inflows given the proximity to Western Europe and relatively cheap labour costs. Since then the development gap between East and West has been partially closed and the initial manufacturing-driven outsourcing inflows have been recently replaced by services. Faster growth rates relative to developed markets in Europe were both the catalyst and the result of investments.

The size of the target market is considered as one of the main drivers for foreign direct investments (FDIs), while the cost of labour is viewed as the main advantage of doing business in the CEE. Labour skills are not far from those in Western Europe and represent an important advantage versus other cheap labour destinations. Recent years have also seen important progress in productivity and competitiveness across CEE - but some issues relating to institutional reforms persist.

CEE countries show strong export competitiveness for the medium tech and intermediary goods segments and are less competitive in high tech and sophisticated goods. Most CEE exports have an important foreign value added component, with CEE countries well integrated into global value chains. On services, the region is very competitive in the sophisticated segment.

Tight labour markets represent an issue that has to be addressed by authorities through structural reforms to make the recent growth sustainable. However, the outlook for investments is robust as companies in the CEE region look to extend capacities.

Fig 4 Industrial production is moving East (percentage share in EU's industry gross value added (excluding construction))



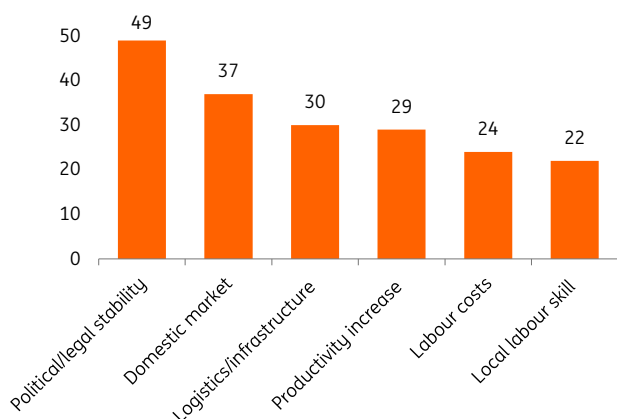
Source: Thomson Reuters, Deutsche Bank

Why companies choose to invest in CEE

According to an Ernst & Young's (EY) 2015 Global Investment Monitor, the largest driver for companies when considering FDI, apart from general political and legal stability, is the size of the target market, followed by infrastructure connections and then the possibility to enhance the company's productivity.

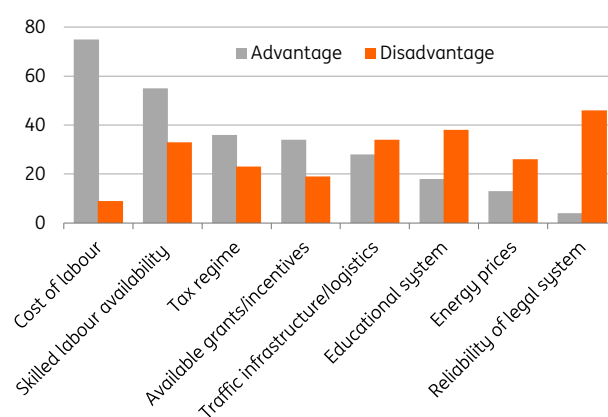
The main advantage for the CEE is the cost of labour according to a Deloitte survey from its study on the automotive industry in CEE, while the main disadvantage is the unreliability of the legal system.

**Fig 5 FDI drivers
(% of responses)**



Source: E&Y 2015 Global Investment Monitor

**Fig 6 CEE: Competitive advantages/disadvantages
(% of responses)**



Source: Deloitte Study, 2016

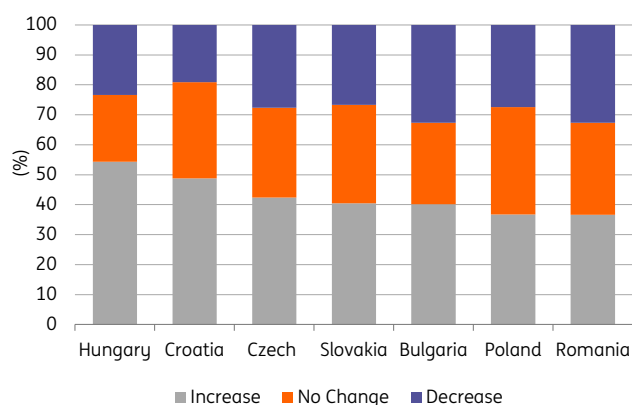
We'll use the key findings of these surveys as a lens through which to evaluate the investment proposition in CEE a little later in this report. But first we'll take the temperature of local businesses in the CEE region.

What do local managers feel about investment trends in their own countries and how is that split between manufacturing and services?

Investment outlook remains supportive

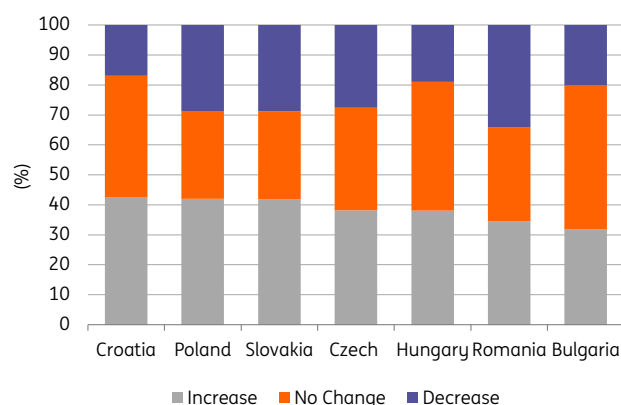
According to the EIB Investment Survey 2017, over 40% of companies in the manufacturing sector in CEE locations are planning to increase investment in the current financial year with Hungary topping the rankings. Nearly 40% of services companies are planning to boost investment this year, with Croatia leading the pack.

Fig 7 Investment plans for this year in manufacturing?



Source: EIB Investment Survey 2017

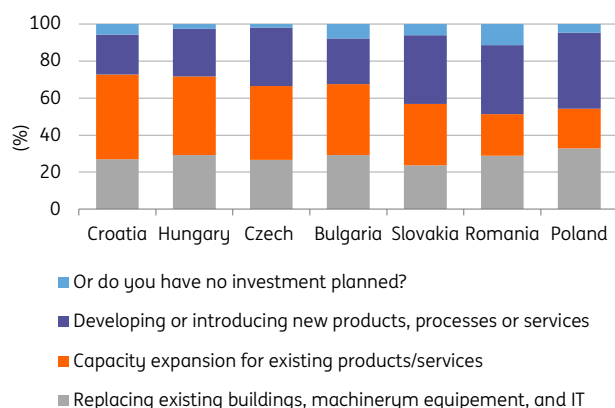
Fig 8 Investment plans for this year in services?



Source: EIB Investment Survey 2017

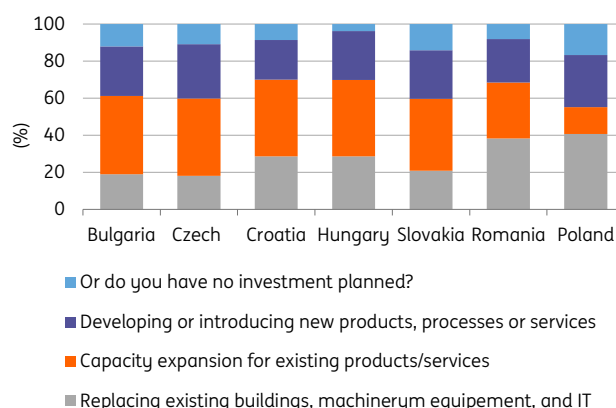
On a three-year horizon, the main focus for investments seems to be the need to expand capacity for existing products followed by developing new products and replacing the existing capacities in the manufacturing sector. For the services sector, the priorities in investment for the three years ahead are mainly on expanding capacity followed by the intention to broaden the range of services offered.

Fig 9 3-year investment plans in manufacturing



Source: EIB Investment Survey 2017

Fig 10 3-year investment plans in services



Source: EIB Investment Survey 2017

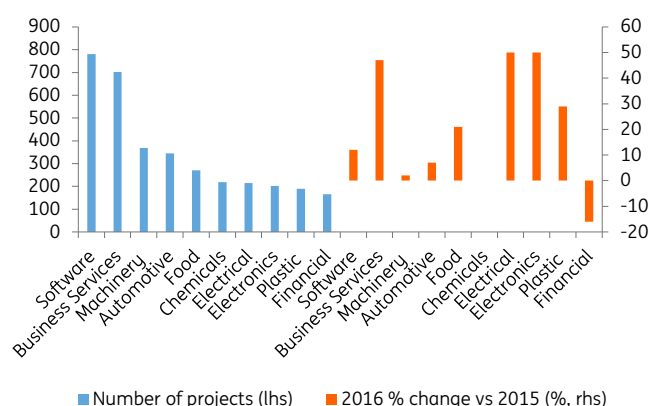
The EIB survey finds that the investment outlook has improved and a larger number of firms plan to invest into expanding capacities.

This is the most important driver of investments as firms in the CEE tend to invest less in intangible assets versus the EU average. The lack of labour and skills and the uncertain outlook are mentioned as the main barriers for business by the EIB study.

Which sectors are hot?

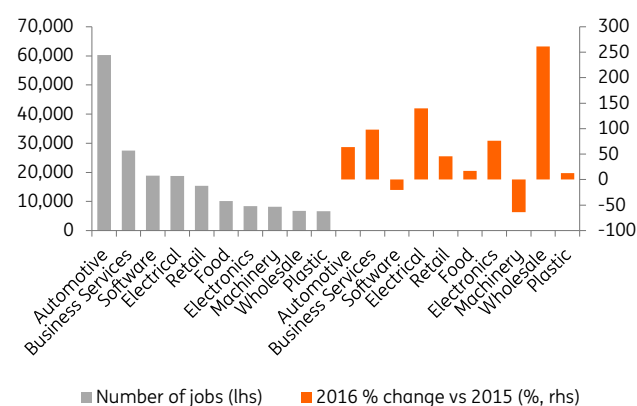
According to the 2017 EY European Investment Monitor¹, the manufacturing FDI pipeline in Europe expanded by 6% in 2016 versus the previous year, with CEE having a 49% share of total FDI in Europe manufacturing from 45% in 2015 and up by 15% YoY.

Fig 11 Most projects concentrated in software and business services...



Source: EY European Investment Monitor (EIM), 2017

Fig 12 ...but automotive creates most of the jobs



Source: EY European Investment Monitor (EIM), 2017

In Europe, high-end services are the hottest sector, but manufacturing is creating most of the jobs. Hence it tends to get more of the attention and more government incentives – an important consideration when deciding in which location to invest.

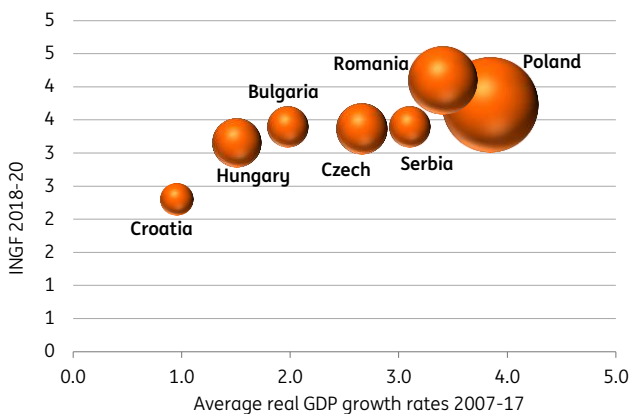
¹ Full report from E&Y here: [http://www.ey.com/Publication/vwLUAssets/ey-attractiveness-europe-2017/\\$FILE/ey-attractiveness-europe-2017.pdf](http://www.ey.com/Publication/vwLUAssets/ey-attractiveness-europe-2017/$FILE/ey-attractiveness-europe-2017.pdf)

Making the decision

Domestic markets: fast growing and converging

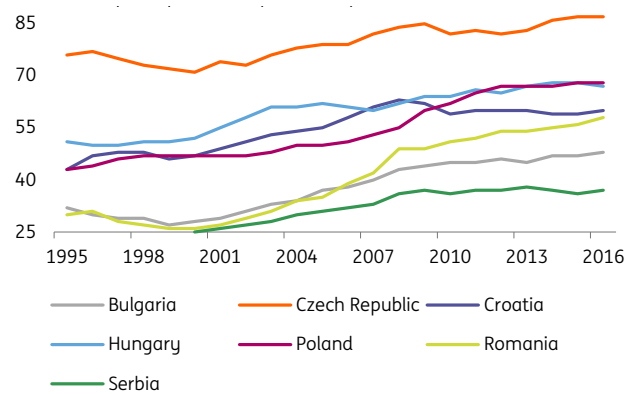
Countries in Eastern Europe have posted much faster GDP growth rates versus the Eurozone over the past twelve years. This has helped narrow the standard of living gap and led to an acceleration of the real convergence process. With the convergence process set to continue, CEE markets will become ever more appealing for companies offering top-end products and services, such as private healthcare and financial services.

Fig 13 Population vs GDP growth (%)



Source: Eurostat, ING

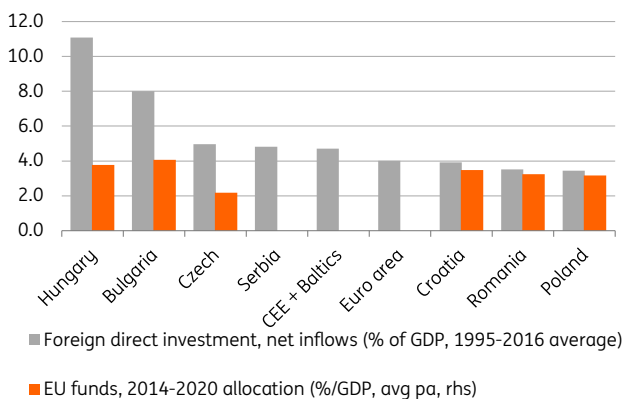
Fig 14 GDP per capita converging (ppt, EU27=100)



Source: Eurostat

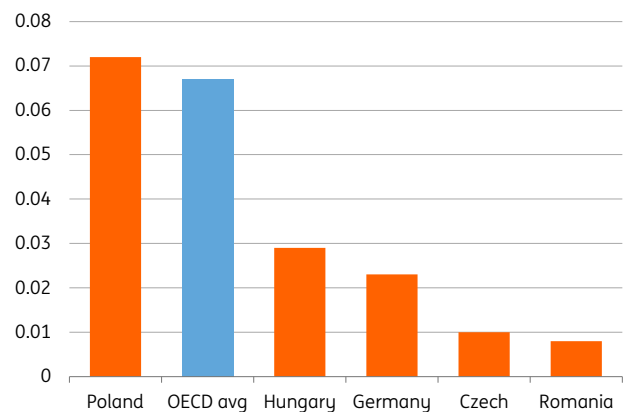
Growth rates in CEE countries are also beneficiaries of relatively large sums of EU funds aimed at helping recipients close the development gap more quickly. EU funds are helpful in several areas: from upgrading infrastructure to retraining labour resources, from research and development to agriculture and rural development.

Fig 15 FDI slowdown replaced by inflows of EU funds



Source: WB

Fig 16 FDI Regulatory Restrictiveness Index



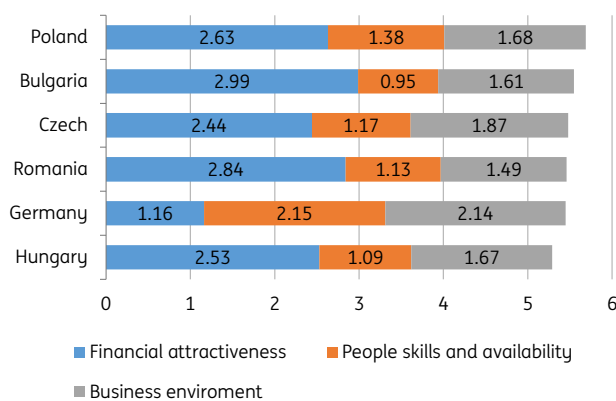
Source: OECD

And OECD data suggests that regulatory constraints for FDI are below the OECD average for most of the CEE countries (with the exception of Poland), supporting significant inflows since the fall of the Iron Curtain.

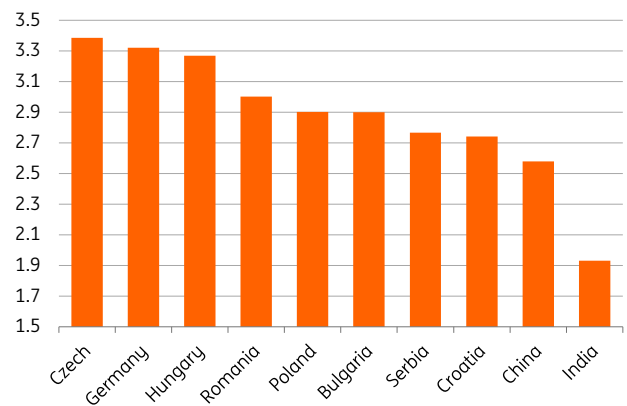
Logistics and infrastructure: the proximity advantage

Recently the region has also benefited from its status as a top destination for outsourcing services as companies are looking east for cost optimisation and labour resources.

The main advantage of the CEE versus other servicing outsourcing destinations is the business environment. And it is in close competition with Asia for financial attractiveness. Labour availability and skills are the main disadvantage of the CEE, likely due to tight labour market and unsupportive demographic trends.

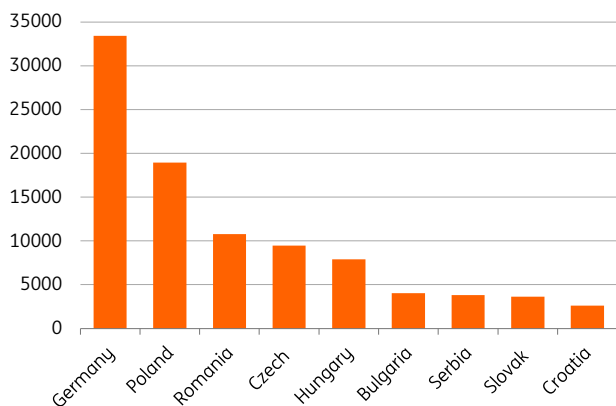
Fig 17 2017 Global Services Location Index

Source: A.T. Kearney

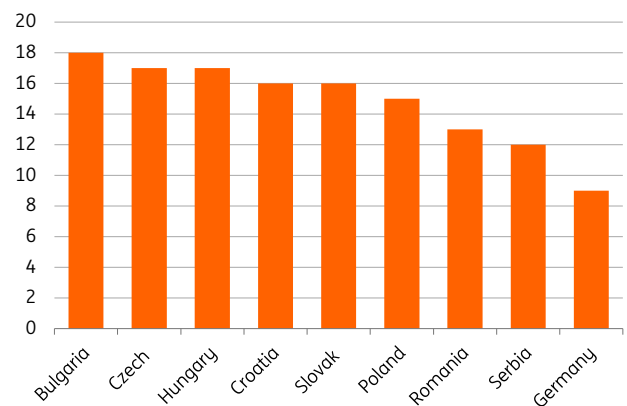
Fig 18 Index of human capital (based on schooling years)

Source: Penn World Table

Good transport connections to Western Europe are also key for CEE exports. Consequently, the time to export is relatively good, although some countries lag, likely due to bureaucratic procedures. This issue is usually crucial in global value chains.

Fig 19 Rail lines (km/square km of land area)

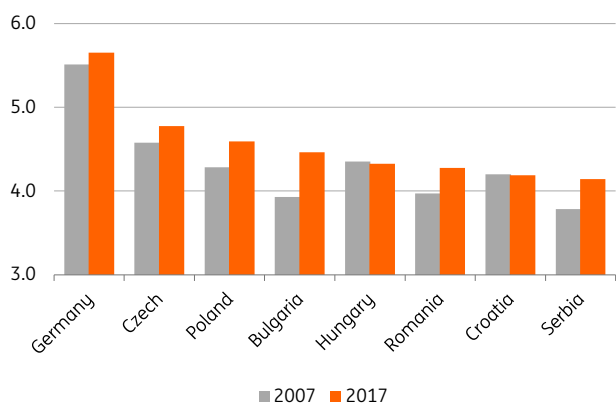
Source: ComNet

Fig 20 Time to export (no of days)

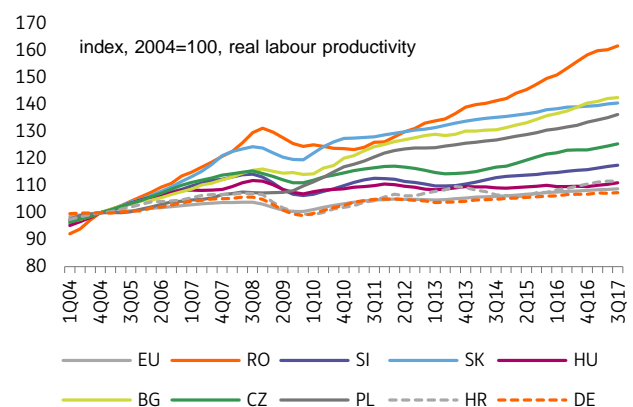
Source: CompNet

Productivity in CEE: Looking for a boost

Most countries in Eastern Europe have made significant progress in improving competitiveness over the past ten years, according to the World Economic Forum (WEF), leading to a surge in labour productivity.

Fig 21 WEF global competitiveness index (7 is the best)

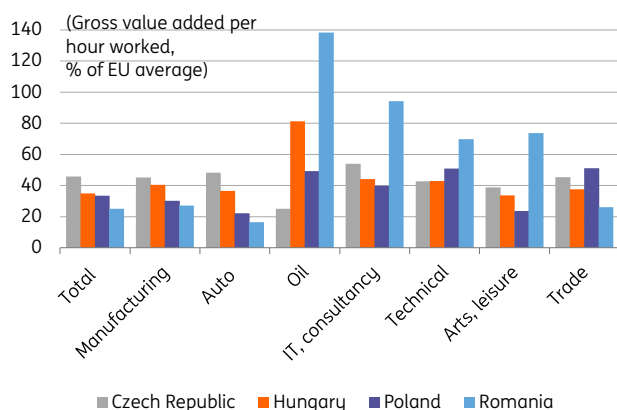
Source: WEF

Fig 22 Leading to a surge in productivity

Source: Eurostat

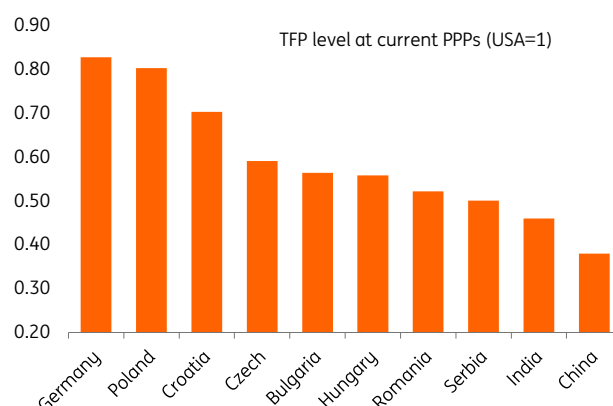
There is more room to invest in order to enhance the productivity as the CEE has mainly been a destination for investments seeking a cheap labour force. Nevertheless, productivity remains significantly above competing FDI destinations.

Fig 23 Productivity below EU average across the sectors...



Source: Eurostat, ING

Fig 24 ...but TFP* still strong versus competition



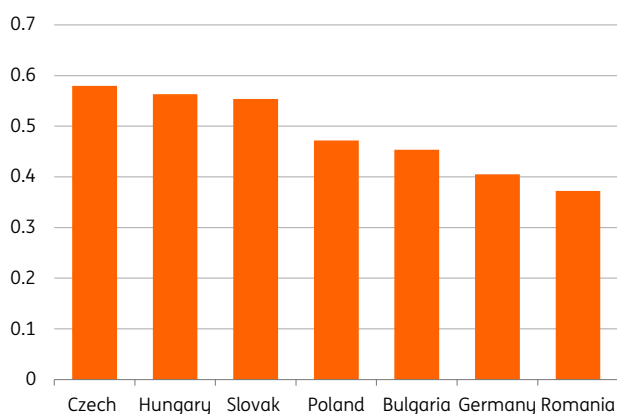
*Total Factor Productivity at current purchasing power parity
Source: Eurostat

Integration: CEE's position in the global value chain

Participation in the global value chain (GVC) index summarises the importance of the global supply chain for the country. In other words, it shows the integration level into GVCs and is somewhat similar to a trade openness indicator. The participation index has to be read in conjunction with the position index, as two countries can have identical values in the GVC position index while having very different degrees of participation in GVCs.

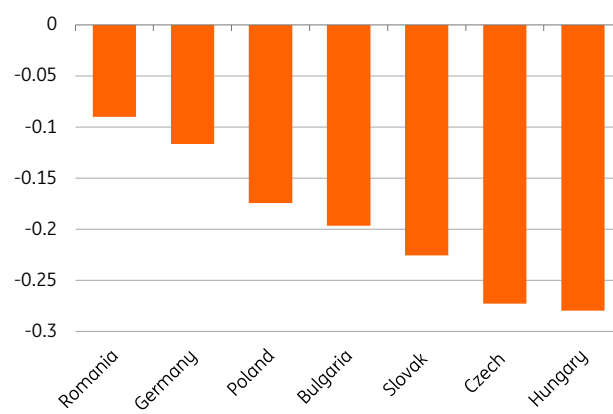
The position in the global value chain is defined as the log ratio of a country's supply of intermediates used in other countries' exports to the use of imported intermediates in its own production. This index captures a country's position (i.e., upstream or downstream) in the production chain and allows cross country comparisons to be made. If the country tends to specialise in upstream segments of a production chain (e.g., typical for countries with important natural resources), the numerator tends to be large. On the other hand, if it lies downstream, then the denominator is large.

Fig 25 GVC participation: CEE well integrated



Source: CompNet

Fig 26 GVC position: downstream on value chain



Source: CompNet

CEE countries are well integrated within the single market and the share of imported raw materials in their production is relatively high - which puts them on the downstream side of the global value chain.

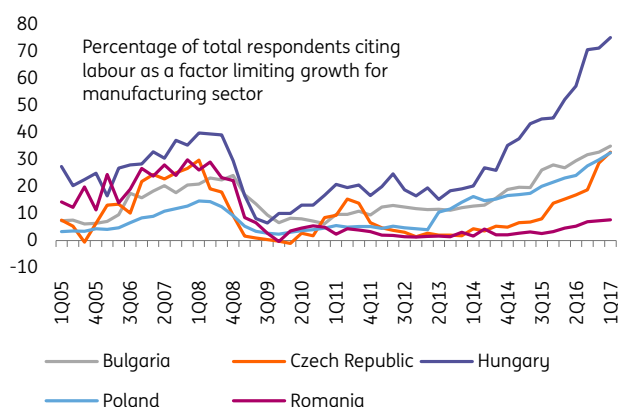
Key challenge: Labour market constraints

ING clients tell us that one of the key challenges to the CEE investment proposition is the availability of labour. Finding employees has become a bottleneck, generating knock-on effects such as high turnover and increasing labour costs.

These concerns are echoed in surveys, where labour is increasingly cited as a factor limiting growth in the manufacturing sector. Most countries in the region are near full employment, hence structural reforms are needed to increase labour force participation - which hovers below the EU average for most of the region.

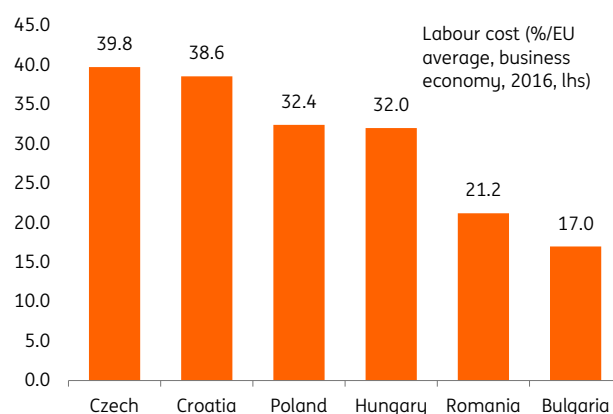
At the same time, many governments have imposed higher minimum wages to share with voters the benefits of foreign investment. In some cases, this threatens the competitiveness of labour intensive investments. Nevertheless, labour costs are still very low compared to the EU average.

Fig 27 Labour force becomes scarce



Source: Eurostat

Fig 28 Wages – a fraction of EU average (% of EU avg)

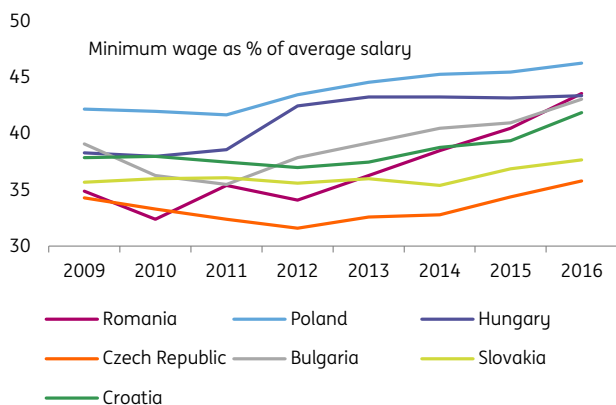


Source: Eurostat, ING

Except for the Czech Republic, labour force participation is below the EU average – albeit on an improving trend. Thus not only higher wages are needed, but also labour market reforms. Or maybe a complete re-think of labour market policy is needed to boost potential growth.

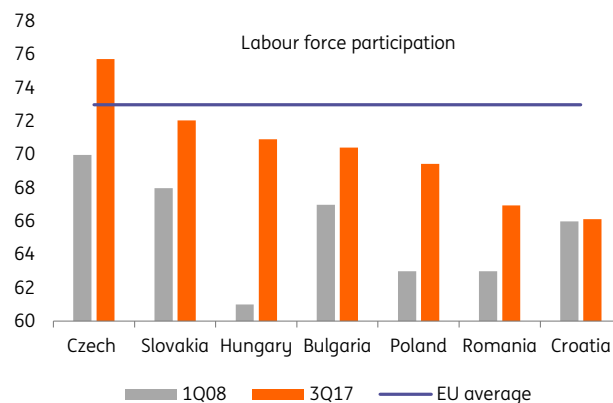
Indeed, the labour market situation in some cases resembles that of Germany in the early 2000s, when it was called 'the sick man of Europe'. Root and branch reforms, known as Hartz reforms, were needed to break the deadlock. If little progress is made here, investors will look at the next wave of EU enlargement targeted for 2025 – with non-EU countries in the Balkans enjoying the most significant labour market slack.

Fig 29 Higher minimum wages not enough...



Source: Eurostat

Fig 30 ...to boost participation; structural reforms needed



Source: Eurostat, ING

Providing the right skills in a changing economic environment is the key challenge looking forward for the CEE countries. The growth model based on cheap labour is not bullet proof as rising labour costs (due to tight labour market and government policies to hike minimum wages) are exposing the low skilled labour force either to automation or to business relocation to cheaper destinations.

Corporate tax levels: very attractive

The CEE region also benefits from a friendly corporate tax environment. Hungary stands out with the lowest level in Europe, followed by Bulgaria. All CEE countries have corporate tax levels below the EU average and significantly below the averages for other regions of the world.

Fig 31 Corporate tax rates in Europe vs other regions of the globe (%)

	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013	2014	2015	2016	2017	2018
Bulgaria	23.50	19.50	15.00	15.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00
Croatia	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	18.00
Czech Republic	31.00	28.00	26.00	24.00	24.00	21.00	20.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00
France	34.33	34.33	33.83	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.33	33.30	33.33	33.00
Germany	39.58	38.29	38.31	38.34	38.36	29.51	29.44	29.41	29.37	29.48	29.55	29.58	29.72	29.72	29.79	30.00
Hungary	18.00	16.00	16.00	16.00	16.00	16.00	16.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	9.00	9.00
Italy	38.25	37.25	37.25	37.25	37.25	31.40	31.40	31.40	31.40	31.40	31.40	31.40	31.40	31.40	24.00	24.00
Netherlands	33.00	34.50	31.50	29.60	25.50	25.50	25.50	25.50	25.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00
Poland	27.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00	19.00
Romania	25.00	25.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00	16.00
Russia	24.00	24.00	24.00	24.00	24.00	24.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00
Serbia	14.00	12.33	10.00	10.00	10.00	10.00	10.00	10.00	10.00	10.00	15.00	15.00	15.00	15.00	15.00	15.00
Turkey	30.00	33.00	30.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	20.00	22.00
Ukraine	30.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00	25.00	21.00	19.00	18.00	18.00	18.00	18.00	18.00
Africa average	32.36	32.36	30.79	30.73	30.52	28.75	28.83	28.49	28.64	29.07	28.37	27.85	28.17	28.06	28.21	28.26
Americas average	31.29	30.55	30.52	29.97	29.27	28.84	28.82	28.28	29.31	28.67	28.35	27.77	27.61	27.81	28.29	27.89
Asia average	30.19	30.35	29.79	28.99	28.34	26.24	25.37	23.72	22.91	22.72	22.13	22.00	21.98	21.41	21.04	21.21
EU average	27.95	26.69	25.15	24.83	23.97	23.17	23.11	22.93	22.70	22.51	22.75	22.39	22.15	22.09	21.33	21.29
Europe average	26.72	25.60	24.03	23.70	22.99	21.95	21.64	21.46	20.83	20.44	20.60	20.42	20.05	19.97	19.53	19.48
Global average	29.42	28.95	28.00	27.55	26.96	25.66	25.32	24.65	24.52	24.38	24.15	23.85	23.74	23.58	24.04	24.00
OECD average	30.08	29.28	28.37	27.67	27.00	25.99	25.64	25.70	25.42	25.18	25.32	24.98	24.77	24.69	23.95	23.50

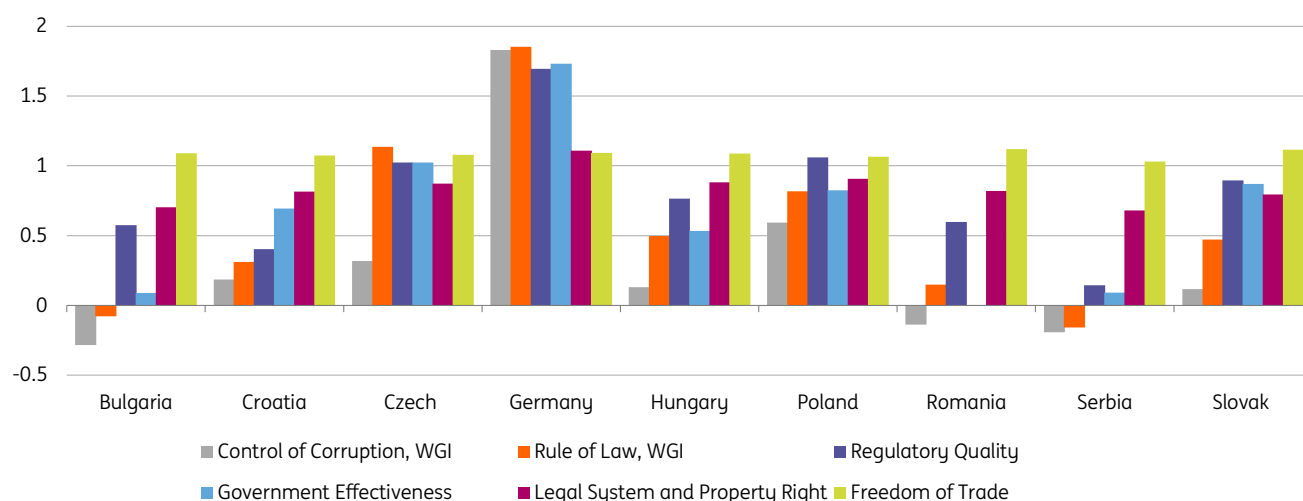
Source: KPMG

Nevertheless, stability and transparency of the political, legal and regulatory environments is deemed much more important than the relative tax advantage by companies that invest abroad.

Regulation and sensitive micro level issues

Corruption has frequently been a problem affecting investments and has been more pronounced in countries that joined the EU in the later stages. In most cases, this is combined with a weak judiciary system.

When adding to the above concerns that in some countries the progress achieved since joining the EU might be partially rolled-back, then the investment outlook may not prove so bright. In terms of regulatory quality and government effectiveness, there is a sizeable gap between those CEE countries that joined the EU in the first enlargement phase and those at later stages. As Serbia is still in a negotiation phase to join the single market, we might witness visible progress in the near future.

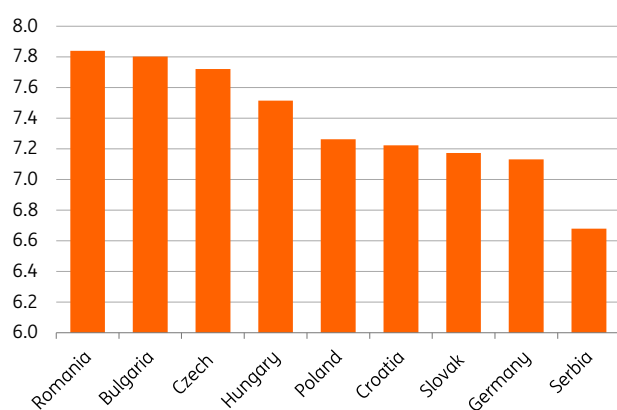
Fig 32 CEE countries still need to improve their institutions, but are scoring better than Germany on freedom of trade*

*An index comprising: (i) Credit market regulations; (ii) Labour market regulations; and (iii) Business market regulations

Source: CompNet

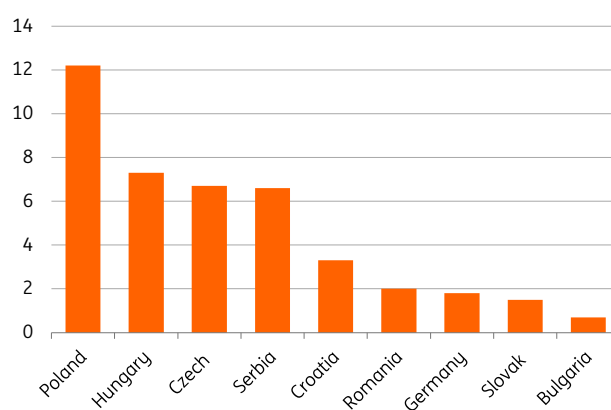
In terms of the legal system, property rights and freedom of trade, the gap to developed markets in Europe is relatively small. Typically this is because these reforms were made as a pre-condition to joining the EU.

In order to secure a high rating on freedom of trade, a country must have low tariffs, easy clearance and efficient administration of customs, a freely convertible currency, and few controls on the movement of physical and human capital.

Fig 33 Market determined prices*

*Index assessing market prices

Source: CompNet

Fig 34 Start-up cost as a percentage of gross national income (GNI) per capita (%)

Source: CompNet

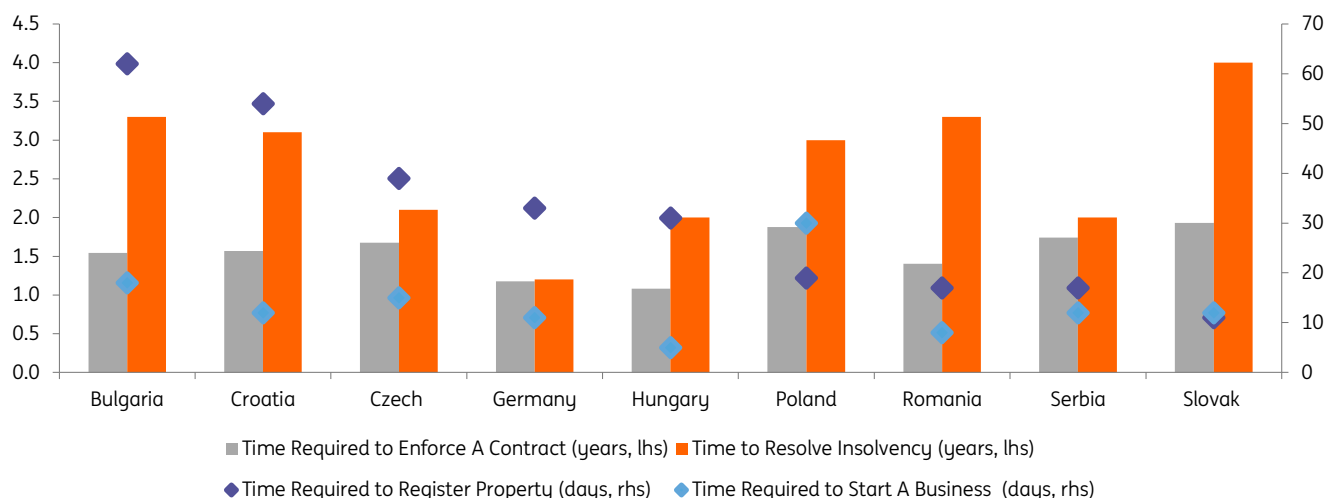
In terms of government intervention in price setting, most CEE countries are more liberal relative to Germany for example. In order to score highly in this portion of the index, countries must allow markets to determine prices and refrain from regulatory activities that retard entry into business and increase the cost of producing products.

Governments must also refrain from “playing favourites”, that is, from using their power to extract financial payments and reward some businesses at the expense of others. The cost of starting up a new business is relatively heterogeneous.

It takes more time on average in the CEE to enforce a contract measured by the number of days from filing of the lawsuit in court until the final determination and, in appropriate cases, payment.

Nevertheless, in most cases, registering a property is easier relative to Germany. The time required to start a business is relatively business friendly in most of CEE economies. Yet, likely due to legislative caveats, it takes considerably more time from the filing for insolvency in court until the resolution of distressed assets.

Fig 35 As young democracies, CEE countries need to improve legislation to become more business friendly

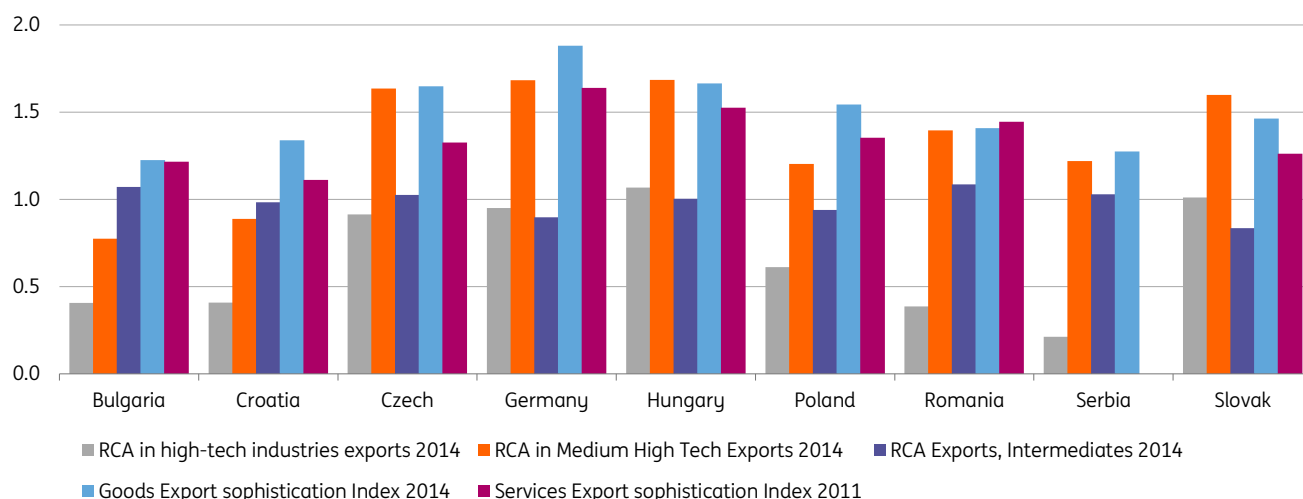


Source: CompNet

The comparative advantage: Add value or lose out?

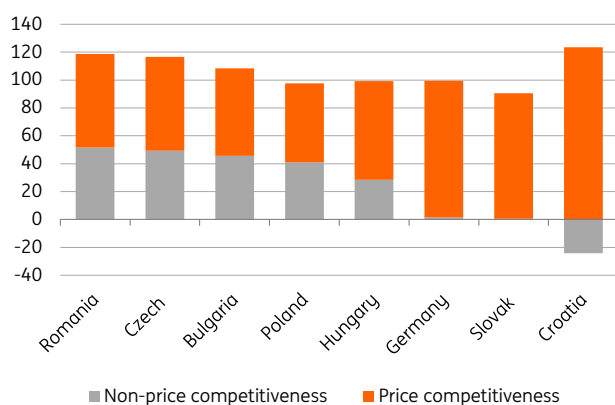
To assess export competitiveness, we use the Revealed Comparative Advantage (RCA) index which measures the importance of a sector in the export bundle of a country with respect to the importance of that sector in worldwide export flows. The benchmark threshold for this indicator is 1. If the RCA is higher than unity, the country is said to have a comparative advantage in the trade in the sector for which it was computed.

Fig 36 Revealed Comparative Advantage for different products and services

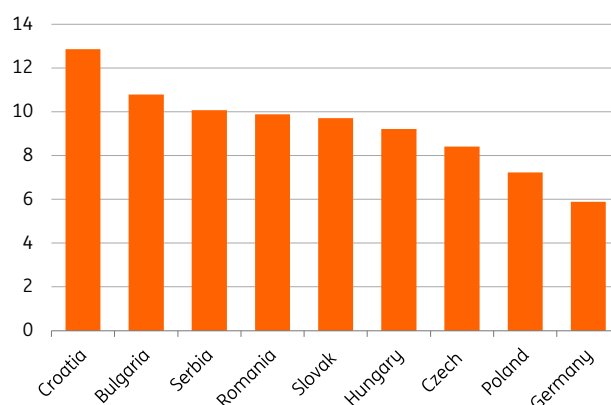


Source: Compnet

Based on the CompNet database, the region's exports are competitive in the medium high tech and intermediary goods segments and on sophisticated services and less competitive on high tech and sophisticated products. This is also supported by anecdotal evidence with car components being widely produced across the CEE and exported to Western Europe for assembly. The relative competitiveness has recently attracted large business process outsourcing projects (BPO) with market reports suggesting that there is much more upside potential.

Fig 37 Price and non-price competitiveness*

Source: CompNet. *Euros per unit of utility

Fig 38 Risk of being crowded out by China (%)

Source: CompNet

Non-price competitiveness in the CEE is very strong as the geographic position likely weighs in, but also it scores far better on human capital, regulatory and productivity metrics. Nevertheless, exports from the CEE face significant overlap with China and risk being crowded out in some of the export markets, particularly where countries are less integrated into GVCs and export goods are lower value added.

Summing up

The CEE region should continue to attract significant investment and is becoming the workshop of Europe. Competitiveness driven by low wages and EU membership providing a strong institutional anchor for safeguarding foreign investments make a compelling offering.

The geographical proximity to the Eurozone is also a clear advantage, but the CEE region stands out versus other developing markets for human talent and high productivity. To keep the current growth rate sustainable, these countries will have to accelerate reforms, especially those related to the labour market.

In particular, efforts to improve labour force participation and raise educational standards will be required to fend-off automation risks as labour costs converge towards EU averages. If not, companies will increasingly turn to the next wave of EU membership - with the Balkans targeting single market membership by 2025 and offering significantly more labour market slack.

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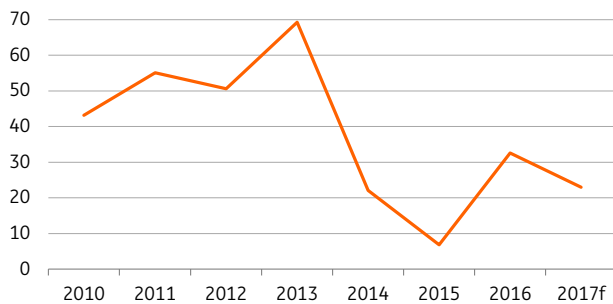
EMEA Economics Team

Focus: FDI prospects in Russia and Turkey

Russia

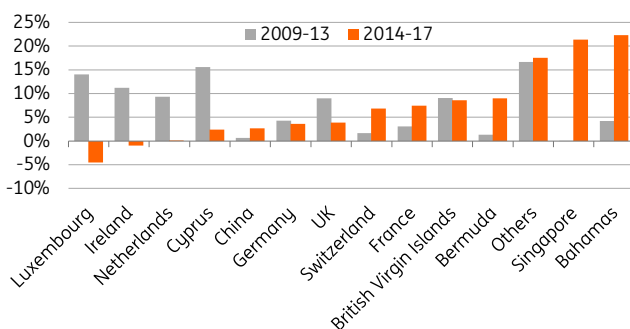
Dmitry Polevoy, Chief Economist, Russia & CIS

Inward FDI flows in Russia (US\$bn)



Source: CBR

Inward FDI by regional distribution (% share over period)



Source: CBR

Recovering after the 2014-15 shock, but upside remains

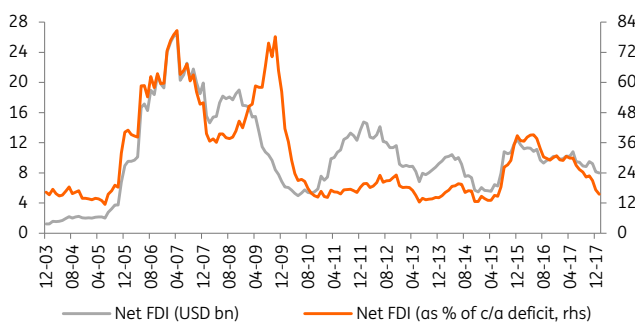
- FDI has recovered after the 2014-15 shock, but not fully
- Soft GDP outlook, sanctions and geopolitics have shifted the regional structure from West to East, and are likely to weigh on FDI further...
- ...but Russia remains top-2 CEEMEA market for many multinationals due to market size, prudent economic policies, stable RUB

The FDI topic has always been in the spotlight for Russia, deemed as suffering a lack of investments to diversify the economy. Yet, distinguishing 'real' FDI from money coming back from offshore zones, where it was parked before, is an issue. If still looking at inward FDI, after a solid recovery in 2010-13 following the GFC-driven drop in 2009, FDI fell sharply in 2014-15 due to a deterioration in the external backdrop. Plunging oil prices and sanctions eroded the GDP outlook and fuelled fears of capital controls, all driving the FDI drop in 2015. A prudent policy response and flexible RUB helped to restore some confidence, but not to the full extent and with an eye-catching shift in regional distribution from West to East. Yet, Rosneft privatization affected the 2016 print. The low growth outlook and geopolitical risks/sanctions weigh on FDI, yet many foreign companies still see Russia as a priority market in CEEMEA (after Poland) for the next three years (DT Global Business Consulting survey in Dec-17). Over 2016-17, 25-30% of corporations have reported capex plans to localise production/import-substitute and gain market share, and they plan to proceed in 2018. In 2014-17, mining (53%), manufacturing (19%), finance/insurance (16%) and trade (12%) took most of the FDI. There is likely to be a promising market in agriculture, consumer, pharma, construction materials and transport/machinery.

Turkey

Muhammet Mercan, Chief Economist, Turkey

FDI outlook since 2003 (12M rolling)



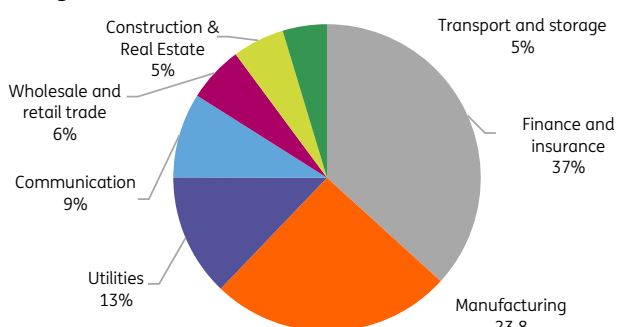
Source: CBT, ING Bank

FDI not in good shape currently

- Turkey's FDI stock is well below that of other CEE countries
- Logistics, transport energy, telecom and government support for infrastructure provides investment opportunities
- Long-term stability and reforms required to accelerate flows

The successful implementation of first generation reforms following the 2001 financial crisis supported an acceleration in FDI inflows in the early 2000s. Investment opportunities with a large market size and growth expectations based on population and income growth prospects as well as the potential to reduce production costs by competitively priced inputs and labour also contributed to the FDI outlook. But, the momentum has lost pace in recent years. In addition to usual factors (complex bureaucratic procedures, dependence on energy imports, geopolitical uncertainties), the most important factor that has weighed on FDI appetite towards Turkey is a shift in the investment climate. In other words, reasons adversely affecting the FDI outlook range from the lack of a level playing field between foreign investors and locals, tax policy, rigidities in the labour market and the domestic political developments as well as rising geopolitical sensitivities. The weak currency and rising/elevated inflation do not help either. But Turkey maintains efforts to make its investment environment more attractive and move up the ranks on the World Bank's Ease of Doing Business index. Improvement in the long-term investment climate and a strong structural reform programme is likely to increase FDI inflows sustainably. Logistics and transport due to geographic position, energy, telecom as well as government support for infrastructure offer opportunities.

FDI by sectors (btw 2002-17, % share)



Source: CBT, ING Bank

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