Mixed news for EU-10 as investment disappoints and labour costs increase

By Anna McLauchlin

THE investment climate in the new member states may not be as rosy as some expect, the latest report from the Economist Intelligence Unit (EIU) has warned.

Fears of corruption and poor infrastructure could hinder foreign direct investment (FDI), while tougher EU business and fiscal rules threaten growth. Governments will have to work hard to keep their markets attractive.

In its latest *Regional Overview* for eastern Europe, the EIU admits that accession to the EU has provided the "anchor" for governments in the ten new member states to make their markets more attractive.

In the run up to the 1 May accession, politicians were desperate to push reform through and adopt the necessary regulatory environment.

Growth in the region has outstripped most of western Europe in recent years and, for the next few years, the EIU expects the annual growth rate to reach at least 4%.

This is thanks in part to the economic recovery of its wealthier neighbours boosting exports, healthy FDI and strong domestic consumption.

This year has been a particularly strong one as a result of softened monetary and fiscal policy, strengthening demand in the rest of Europe and a surge in consumer spending ahead of accession because of fears that prices would soar afterwards.

Poland is currently experiencing the best growth rates, with gross domestic product (GDP) rising by 6.5% in the first half of 2004.

For the whole year the EIU expects 5.5% growth for Poland (the European Commission projects 5.8%).

Growth in Slovakia is expected to reach 3.5% in the same period (the Commission expects nearly 5%) and Hungary 4.1%.

But the EIU warns that 1 May has not been a watershed for investment as many expected. And the improved risk climate and positive impact of joining the EU's internal market on FDI could, it argues, be offset by the more punishing elements of EU regulation, higher wages and the possibility that policymakers will lose the pre-accession momentum to make their markets more business-friendly.

During the first half of 2004, FDI inflows into central Europe grew by 16.3% in dollar terms compared to 2003, but less than 10% in euro.

The booming Baltic countries – Estonia, Latvia and Lithuania – fared slightly better with a 26.6% rise in FDI from last year (in dollar terms), but that is largely because they were late to begin the privatization process.

In 1999-2003, FDI flows to all new member states accounted for less than 4% of total FDI into the 'old' EU-15.

Increasing labour costs in the new member states seem to be a particular problem, with cheaper labour costs in Asia stealing potential FDI.

An EIU survey, *World Investment Prospects 2004*, published earlier this year found that the new EU countries are losing out to India on wage costs and skilled labour force and to China as an R&D investment location.

The EIU still expects FDI to be "robust", even after the remaining privatizations are completed.

But it estimates that figures could be one-third higher if wage costs were closer to the €270 per month average in eastern Europe. Wages in central Europe range from €1,080 gross per month in Slovenia to €360 in Slovakia (2004 figures).

Global consultant AT Kearney has also found that investor interest in the new member states is slipping.

In its October 2004 FDI Confidence survey, investors cited poor infrastructure (67% of respondents) and corruption (60%) as well as rising costs (53%) as the main threats to investment.

Photograph: Reuters

Polish Foreign Minister Wlodzimierz Cimoszewicz signed the EU constitutional treaty in Rome, but his country has fallen eight places in terms of popularity for foreign investment during the past year, which includes the 1 May accession date

Poland has fallen most out of favour, dropping from fourth most popular country for investors in 2003 to twelfth. Hungary fell to 19th from 17th while the Czech Republic fell to 14th from 13th last year.

The next FDI surge, the EIU says, is set to come when the new member states join the euro. Frontrunners Estonia, Lithuania, Slovenia – which have already joined the exchange rate mechanism – and Latvia are expected to be first in line for the renewed boom.

But joining the euro will require many governments to impose a tougher fiscal policy, which is likely to curb growth.

Poland's recent growth, for instance, has been given a shot in the arm by looser fiscal policy, but the Commission projects a 5.9% budgetary deficit for 2004 – almost 3% higher than the level needed to join the single currency.

The report warns that growth is also being driven largely by domestic consumption, which could wane as governments rein in their budgets and wages grow more slowly.

High levels of unemployment (such as those in Poland and Slovakia) could also curb consumption.

But the EIU still expects the investment climate in the new member states to improve "at a fairly rapid pace over the medium term".

For Poland and Slovakia, the EIU has raised its expectations for the business environment from 'moderate' in 1999-2003 to 'good' in 2004-08. And the 'business environment scores' for the Czech Republic and Hungary have risen from 6.55 and 6.58 out of ten to 7.3 and 7.17 for the same periods.

The EIU estimates that it could take new member states six decades to match average GDP enjoyed in 'old' Europe'.

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Ratings agency verdicts 'help new members to reform'

By Pete Sweeney

THE opinion of the private risk-assessment industry, which grades economic performance and predicts risk for those investing in sovereign currencies, can apply economic and political pressure to the new member states.

Moody's, one of the largest ratings firms, believes that the agencies have a positive role to play yet admits that "reforms and restructuring also require painful changes that entail unpleasant social costs, such as temporary increases in unemployment".

The economic consequences of a downgrade in the accession states may be over-amplified by investor nervousness and drastic capital flight.

In *Do Credit Rating Agencies Add to the Dynamics of Emerging Market Crises?* Roman Kräussl, of the Centre for Financial Studies in Frankfurt, claims that bad news has more market impact than good news. "The empirical results are significantly stronger in the case of government's downgrades than positive adjustments," he writes.

Moritz Kraemer, Standard & Poor's (S&P) director for European sovereign credits, is bullish on the accession process. "It constrains governments," he says, "which you may think is bad."

But he adds that it diminishes the risk that a given government will go "walking off in the completely wrong direction". Accession, he says, strengthens institutions and makes them more predictable.

Despite expressed concerns about "weakened fiscal discipline" in the accession countries, S&P is nevertheless upbeat on their prospects. The agency recently upgraded Slovenia and Estonia's ratings, and revised Poland's outlook from negative to stable.

A report by Moody's likewise argues that accession economies can be rated higher, simply because of accession. "Economic and social institutions should be strengthened through harmonization with those of the EU," claims the report, allowing them to fend off destabilizing capital flows and consequently allowing Moody's to rate them "at a level that could be up to several notches higher than that indicated by their fundamentals".

But the influence of rating agencies raises concerns. When he was a Greek MEP, Giorgos Katiforis called the industry a "duopolistic" split between Moody's and S&P and, in a report to the European Commission, expressed concerns about the "predominantly American character" of the two firms .

Katiforis also questioned the agencies' competence to assess European conditions and called for them to be regulated by the EU.

SOVEREIGN DEBT RATINGS IN ACCESSION COUNTRIES (DATA PROVIDED BY FITCHRATINGS.COM)

Country	Long term foreign currency	Short term foreign currency	Long term local currency	Country ceiling	Upgrades & downgrades	Long term rating alert
Cyprus	A+	F1	AA	AA	Stable	Outlook positive
Czech Republic	A-	F2	A	A+	Rating upgrade June 03	Outlook stable
Estonia	A	F1	A+	AA-	Rating upgrade July 04	Outlook positive
Hungary	A-	F2	A+	A+	Stable	Outlook negative
Latvia	A-	F2	A	A+	Stable	Outlook positive
Lithuania	A-	F2	A	A+	Rating upgrade July 04	Outlook positive
Malta	A	F1	AA-	AA-	Outlook upgrade November 04	Outlook positive
Poland	BBB+	F2	A	A	Rating downgrade May 04	Outlook stable
Slovakia	A-	F2	A+	A+	Rating upgrade September 04	Outlook stable
Slovenia	AA-	F1+	AA	AA+	Rating upgrade July 04	Outlook stable