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Country Risk and Its Impact on Foreign Direct Investment Decisions: The Case of Bulgaria

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ABSTRACT

This paper examines the impact of country risk on Foreign Direct Investment /FDI/ inflows in Bulgaria. The paper attempts to answer the question: How important is actually country risk and to what degree it may impact foreign investment decisions? Based on a comprehensive analysis of the FDI inflows in Bulgaria and in other Central and Eastern European (CEE) countries over the period 1992 – 2006 the paper proves that foreign direct investments are of crucial importance to the process of transition from a planned to a market economy for the CEE countries in the global marketplace. Using the research data from a survey of 132 foreign companies invested in Bulgaria during that period we evaluate the specific impact of different country risk components on FDI decision making process from a Bulgarian perspective. Factors such as firm's size, type of investment and the sector to which it belongs play a decisive role in the company's strategy to enter a foreign country. What is more, the paper explores the specific obstacles /entry barriers/ and incentives for foreign investors in making long-term investment decisions in Bulgaria. As a result of this analysis, we identify the specific reforms and improvements in the Bulgarian business environment that the foreign investors expect in the next five years.

Keywords: country risk, transition economy, credit rating, foreign direct investment, multinational enterprise, decision making

JEL classification: F21, F23

Introduction

This paper examines the impact of country risk on Foreign Direct Investment /FDI/ inflows in Bulgaria. FDI in general refer to long-term cross-border investments with a substantial influence on the investing multinational enterprise. According to Hauser (2005) the principal difference between foreign direct investment and other forms of investments is that the purpose of foreign investment is to acquire lasting interest in enterprises operating outside of the economy of the investor. The investor's purpose is to gain an effective share in the management of the enterprise. The IMF suggests 10 percent of equity ownership to qualify an investor as a foreign direct investor.[1] The main feature that differentiates the foreign direct investor from the portfolio investor is the existence of a long-term relationship and a significant degree of influence on the management of the enterprise. According to Shaheen (2005), and following Jensen (2003), FDI is the investment of Multinational Enterprise's privately owned capital into a foreign country.

Any type of risk reflects on investor's decision of whether to invest or not, how, and when. What kind of risk is country risk? How can we define it? Is it precisely calculable probability, that could be easily integrated into the investment valuation equation, or it falls more into the uncertainly category? There is a huge variety of definitions of country risk in economic literature. For Meldrum (2000) many of the occurrences composing country risk are more or less attributable to uncertainties, rather than well defined statistical risks. According to White & Fan (2006) country risk is the unanticipated downside variability in a key performance indicator, or significant strategic target, which results from engaging in international business transactions. Hoti & McLeer (2002) define country risk as the likelihood that a sovereign state or borrower from a particular country may be unable or unwilling to fulfill their obligations to one or more foreign lenders.

FDI is an investment decision and as such, the investor needs to consider and obtain quantitative measure of risk before taking it, in order to incorporate risk into the investment equation. Country risk assessment evaluates economic, financial and political factors, and their interactions in determining the risk associated with a particular country. Country risk may be prompted by a number of country-specific factors or events.[2] According to White & Fan (2006) country risk can be decomposed into the following subcomponents: political, economic, financial and cultural risk. Hoti & McLeer (2002) restrict the sub-components up to political, economic and financial risk. Meldrum

[1] See International Monetary Fund (2003), p.6.

[2] Hauser (2005) suggests the usage of country risk indexes as a measure to country risk, whose goal is to offer investors condensed information about the level of uncertainty in host economies. The typical way of constructing an index is the usage of sub-indexes, measuring economic, financial and political risk. This enables the comparison between the levels of country risk in different countries. However, Damodaran (2003) points out some major pitfalls connected with the usage of indexes and suggest several ways of measuring the risk premium that a foreign investor would require.

(2000) separates country risk into six main categories – economic risk, transfer risk, exchange rate risk, location and neighborhood risk, sovereign risk and political risk. According to him some risk categories contain much higher degree of risk for Multinational Enterprises /MNEs/ than other, due to the longer time horizons, applicable to FDI.

How important is actually country risk and to what degree it may impact foreign investment decisions? To answer that question Hauser (2005) examines the impact of country risk on different types of FDI decisions: Greenfield investment versus acquisition, entry or no entry, timing of entry, and vertical or horizontal FDI. Hauser points out that a multinational enterprise has two ways to enter a foreign market – through acquisition or Greenfield investment. Previous studies (see Caves, 1996) on this topic signify that takeovers are less risky than Greenfield investments and appropriately yield lower rate of return. The more uncertain the environment, however, the more degree of control the investor would require. Following this logic, the decision of entry via acquisition or Greenfield investment could also be driven by uncertainty in the host country.[1]

When the impact of country risk on timing of entry comes into consideration, different theories suggest different responsible factors. Some authors (see Buckley & Casson, 1981) argue that the "optimal" timing of FDI depends on the differences in the costs structure of alternative market strategies, such as exporting and licensing, and market development via direct investment. Other authors analyze the optimal timing of FDI and find Ownership-Location-Internalization (OLI) advantages (see Dunning, 1993) to be determinants of the timing of market entry under uncertainty. Hauser (2005) compares the entry decision to an American call option. He presents the decision maker as having the right and not the obligation to undertake the investment at an exercise price which is the sunken cost of investment.

In respect to different types of FDI, a vertical FDI occurs if a multinational enterprise (MNE) geographically separates stages of the production process. A horizontal FDI takes place if the MNE produces the same goods or services in multiple countries in order to serve the local market. Aizenman & Marion (2004) study the impact of uncertainty on different types of FDI and show that higher volatility of supply shocks increases the expected profits associated with horizontal FDI and reduces the expected profits from vertical FDI. According to a recent research (see Levasseur, 2006) FDI responds to two large motivations. They can be market-seeking (local market-oriented) or efficiency-seeking (export-oriented). Local market-oriented FDI is set up by horizontally integrated MNEs in order to penetrate a market, increase their market share, diversify the source of sale, and minimize competition risk. Export-oriented subsidiaries are set up by a vertically integrated MNE in a host economy with the aim to lower production costs or to seek, secure and diversify resources.[2]

[1] Hauser (2005) has also constructed a model by which he derives an econometric specification of the investor's decision whether to enter the foreign market at all, and if yes, which mode of entry should be chosen.

[2] Blažić & Vlahinić-Dizdarević (2006) find that the horizontal model produces economies of scale for the multinational enterprise and is a major source of its advantage over domestic ones. The same research points out that vertical FDI occurs most frequently between countries with

It is clear that, as every type of uncertainty, country risk has a strong impact on FDI and should be incorporated in long-tem investment decisions of MNEs. But is country risk the only determining factor behind FDI? Janicki & Wunnava (2004) find that the key factors determining FDI inflows in Central and Eastern European /CEE/ counties are size of the host economy, host country risk, labour costs in host country, and openness to trade. The study proves that international trade is perhaps the most important determinant of foreign investment. This finding, namely that trade integration is the most significant of all variables, is supported by Deichmann (2001) earlier research, and is explained by the fact that trade and investments complement each other. Similarly, Bevan & Estrin (2000) argue that countries that are more liberal in their trade approach tend to export more, and this situation represents an attractive opportunity for foreign firms, especially ones which are considered export-driven.

Blaźić & Vlahinić-Dizdarević (2006) review other important determinants of FDI, but their study concentrates on Southeast European /SEE/ countries, in particular. According to them the most important FDI determinants, regardless of FDI type or country, include market size, prospects for market growth, degree of development of host country, location and the progress made in the process of transition. They find that larger economies provide larger economies of scale and spillover effects. Proximity to home country has been proven to be a major factor as well. The closer the geographical and cultural proximity, the greater the trade flows. It has also been documented that the progress in the general process of transition, especially institutional development, represents a very important FDI determinant.

This paper investigates the major factors (market and non-market) that determine the size and the quality of FDI inflows in a transition economy, such as Bulgaria. The study examines the specific impact of different country risk's components on FDI decision making process from a Bulgarian perspective. What is more, the paper explores the specific obstacles /barriers/ that foreign investors and foreign MNEs face during the establishment of their FDI projects in a transition country, such as Bulgaria. The rest of the paper is organized as follows. The next section presents a comprehensive analysis of the FDI inflows in Bulgaria for the period 1993 – 2006 and compares them with foreign investments in other CEE countries. Section 3 details the methodology used to study the impact of country risk on FDI inflows in Bulgaria. The survey includes more than 130 foreign companies that have invested in Bulgaria in that period, grouped in two categories depending on the size of their investment project(s). Sector 4 deals with reforms and improvements needed to make the Bulgarian business environment more attractive for foreign investments. The paper concludes with an analysis of the entry barriers and incentives for foreign investors in making long-term investment decisions in Bulgaria.

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different factor endowments. The stages of production are located in different countries to take advantage of the local resources or different factor prices.

FDI in Bulgaria: A Case Study

This study compares the size and the quality of FDI inflows in Bulgaria with foreign investments in other CEE countries. According to Levasseur (2006) FDI inflows are important engine for convergence of all CEE countries with their more advanced Western European neighbors, and are major determinant in their economic growth. Foreign MNEs also contribute to the upgrading of production capacities in those countries by carrying out technically demanding production functions. For this reason it is important for us to investigate the investment climate in Bulgaria and evaluate how attractive the economy is for foreign investments. It is certain that Bulgaria is offering unique advantages to foreign investors, coming in the same package with its unique disadvantages, obstacles, barriers and risks.

One of the most important determinants that have influenced the FDI inflows in transition economies is the process of privatization.[1] However, the FDI inflows in Bulgaria do not start growing until after the late 1990s. Even though the process of privatization began in 1990, by 1996 only 11% of the state assets were privatized. The low level of FDI inflows in the early period of transition until 1997 could be explained by the high investment risk related to overall instability in the country and the slow political, economic and institutional reforms. For the 5-year period between 1992 and 1997, the FDI inflows amounted to US$ 766.7 million, while for 1997 only, the FDI flows were US$ 636.2 million and they continue to increase.[2] According to Zafirova (2001) over 1/3 of the companies that have invested in Bulgaria during that period chose to take part in the privatization process, and 53% focused on building of new production capacity, and/or expanding of the existing ones. The third selected entry mode of FDI was acquisition of already private property and amounted to 22% of all transactions. Large FDI inflows entered our country via small number of deals with large foreign companies.

The investment climate in Bulgaria became more favorable after 1997 because of the Encouragement on Investment Act, which was introduced at that time. An important incentive for FDI is the fact that the Encouragement of Investment Act equally applies to Bulgarian and foreign investors. This is beneficial for foreign MNEs seeking to invest in the country, since they will not be discriminated and offered harder conditions in any way; they just have to provide more constructive conditions than the domestic investors. The new Encouragement of Investment Act (2004) sets forth preferential treatment measures for investment meeting certain criteria specified in this law as follows:

[1] Vlahinić-Dizdarević & Biljan-August (2005) find that the most important determinant that had influenced the choice of FDI destination in Southeastern Europe in the period 1996-2003 was the progress in privatization in these countries.

[2] According to Gertchev (2006) the average FDI flows for the period 1997-2004 amounted for 42 percent of the gross fixed capital formation, which was by far the highest ratio of the whole CEE region.

- The investment are to be for acquisition of fixed assets with the purpose of creating new operations or modernizing existing production of goods and/or services;
- New jobs to be created;
- The investment project to be implemented within 3 years.[1]

The continuous and rapid increase of FDI inflows in Bulgaria, especially in the period 1997-2004, is due to the progressive structural reforms and the increasing economic stability. For example, in 1995-1996, the net increase in FDI is still weak - it rises with 1% of GDP. However, in 1997-2004, the net increase is much higher, reaching 6% of GDP. As the World Bank Group (2004a) report states yet, the FDI per capita in the country has already surpassed the $500 mark, indicating that new FDI-driven investments are reaching a critical mass needed in order to have a sizable impact on Bulgaria's improved capacity to compete in external markets. Another factor that is important for attracting new FDI inflows in the country is that in 2005, before its accession to the EU, Bulgaria reduces its corporate tax from 19.5% to 15%. Moreover, the Bulgaria government announced a legislation that had simplified the acquisition of real estates by EU residents after accession but keep restrictions on agricultural and forest lands.

According to Eurocapital Finance (2006) report Bulgaria has as a whole a favorable regulatory environment for FDI. Foreign investors enjoy a low taxation of corporate profits (10% in 2007) and double taxation treaties with a number of jurisdictions. There are no restrictions on foreign currency transactions and the repatriation of profits. FDI inflows to the country has grown substantially the last three years, topping US$ 2.8 billion at the end of 2005 with the leading recipients of FDI in recent years being the energy sector, transportation and communication infrastructure.

In order to assess the size and quality of FDI inflows in Bulgaria we analyze them by type of investment, country of origin and by sectors.

FDI inflows by type of investment

The data in Table 1 shows that FDI from privatization is not the more significant type of foreign investment, except for the 2004 when the government sold to foreign investors the national telecommunication company BTK, as well as some of the electrical distribution plants. Moreover, the FDI from privatization depends on the government intentions and decisions, and disappears when the privatization process is finally completed.[2] That is why the Greenfield investment and the expansion FDI projects are more important for the economic growth and sustainable development of the country. According to the data in Table 1 since 1999 the FDI inflows, especially those from Greenfield investment and expansions, grow with a higher rate, amounting to

[1] See InvestBulgaria Agency (2006) report, p.1

[2] Another important point here is that through this process the amount of investment does not increase, but just the ownership of the already existing enterprises is transferred to private foreign investors. In addition, the privatized companies have to comply with the Privatization and Post-Privatization Control Act, first voted in 2002, and last amended in 2005.

more than US$ 1 billion for the year of 2000, and surpassing US$ 2 billion after 2003. In the third quarter of 2006, the total FDI inflows in Bulgaria reached the level of US$ 17.6 billion, of which 81.5% are in Greenfield investments and expansion projects.

[Insert Table 1 here]

In 2006, despite the rapidly growing FDI inflows, Bulgaria still occupies the fourth place in Southeast Europe, after Turkey, Romania, and Greece (see Figure 1). According to the Southeastern Investment Guide 2006 FDI flows in the region reached a historic record in 2005 of nearly € 20 billion.[1] This remarkable increase in FDI inflows is mostly due to the finalization and re-launching of some delayed privatization deals, more stables macroeconomic and business environment, and the low investment risk.

[Insert Figure 1 here]

The data on FDI inflows, when measured as a share of GDP, take in to account the size of the economy and indicate the relative importance of foreign investment in the country. Since all CEE countries, including Bulgaria, could be classified as small economies in economic terms, it is to be expected that foreign capital would represent an important part of the country's gross national product. The data for Bulgaria show that while in 1998 FDI inflows were only 4.4% of GDP, in 2006 they amount to 16.4% of gross national product (an increase of 53.7% compared to 2005). Although the country is still behind the other countries in the region in absolute terms of FDI inflows, Bulgaria is a leader in Central and Eastern Europe when the FDI inflows are taken as percentage of GDP (see Table 2).

[Insert Table 2 here]

The data for FDI inflow in per capita terms show that Bulgaria takes the fourth place in 2005 after Estonia, the Check Republic and Hungary (see Table 3). According to the Bulgarian National Bank statistics, in 2006 the country attracts € 4.015 billion, or US$ 5.058 billion, of foreign direct investment. This places the country second in the region after Croatia in terms of per capita FDI. Now, after the Bulgaria's accession in the EU, an influx of over € 11 billion from EU cohesion and structural funds in 2007-2013 is expected for improvements in roads and other essential infrastructure.[2]

[Insert Table 3 here]

[1] The total amount of FDI in the region is approximately € 60 billion for the period 2001 – 2005, making a threefold increase compared to the previous five-year period (see Southeast Europe Economic Forum, 2006).

[2] See Eurocapital Finance (2006) report, p.4.

FDI inflows by country of origin

According to the United Nations Conference on Trade and Development (2006) report the inward FDI flows to Bulgaria for the period 1990 - 2000 is the lowest, only US $301 million (see Table 4). Moreover, the outward FDI flows are negative, - US $4 million, which testifies for the huge trade current account deficit at that time. In the subsequent years, both the inward and the outward FDI flows in Bulgaria grow substantially. Despite that growth the other countries' FDI increase more rapidly. Considering the FDI flows in 2005, Bulgaria is last but one in the group of SEE countries, with Croatia being the last one and the other two countries being ahead. An exception is 2004 when Bulgaria is second but last, before the Russian Federation and Croatia. On the other hand, comparing just these four countries (Bulgaria, Romania, Croatia, and the Russian Federation), the FDI stocks of Bulgaria are the highest in the 1990s. However, from 2000 onwards, Croatia's FDI stocks surpass our country's FDI stocks, leaving Bulgaria again on the last place among those four countries. Regarding the inward FDI flows as percentage of GDP, Bulgaria is a leader both in the region and in Europe (see Table 4).

[Insert Table 4 here]

When FDI inflows is analyzed based on country of origin, the data show that in the period 1992 – 1999, the country that had invested the largest amount of capital in Bulgaria was Germany - 12.9% of the total FDI. The countries that follow Germany by the size of invested capital are Belgium, USA, and the Netherlands. However, after 1999, Austria and Greece begin to catch up with them, being among the top three countries in terms of total invested capital by the end of 2006. The UK invests the biggest FDI amount in 2006 – US$ 862 million, or 17.1% of total FDI. The followers are the Netherlands, which invests US$ 842 million, and Austria devoting US$ 554 million for FDI to Bulgaria. As Figure 2 shows the country that has invested the most for the whole period 1992 – 2006 is Austria (16.2 percent), followed by the Netherlands (10.1 percent), Greece (9 percent), and the UK (7.9 percent).

[Insert Figure 2 here]

FDI inflows by sectors

According to the World Bank Group (2004b) report, during the period 1998 – 2003, a large share of the FDI flows was in the services sector or inward-oriented activities, and only a small share is in the tradable sectors. Hence, FDI flows in tradables have not reached a sufficient critical mass to have a robust positive impact on productivity. On average, in same the period, about 60% of FDI in Bulgaria was located in services, with more than half of these flows in the financial sector, and only about 30% of FDI was in tradables, nearly all in manufacturing. To some extent this can be explained by the fact that some of the best opportunities in Bulgaria for foreign investors have been in sectors that

dominate the domestic market, such as banking, business services, and electricity distribution. This has resulted in a strong inward orientation of FDI. However, it also reflects impediments to outward-oriented investment.

A research of Blaźić & Vlahinić-Dizdarević (2006) on the distribution of FDI by economic activities, finds that most of the FDI in SEE counties have been concentrated in financial services, telecommunications and trade and manufacturing. Service-related FDI inflows into Southeastern and other transition countries have followed the trend of growth in services worldwide and in the region itself. At the same time the United Nations Conference on Trade and Development (2006) reports that not all FDI projects in the region have high-tech content. In some cases, low wages attract projects in low value-added activities as assembly manufacturing. For example, between 1998 and 2004, law wages in Bulgaria attracted US$ 226 million worth of FDI in 'cut and make' textiles, in which costumers provide all inputs expect labor. However, with the end of Multi-Fiber Arrangement /MFA/ quotas and Bulgaria's EU accession in 2007 foreign investors in textiles, such as Miroglio (Italy) and Rollman (Germany), can no longer rely on wage competitiveness alone, and are upgrading their factories from simple assembly to higher value-added activities.

According to Bank Austria Creditanstalt & UniCredit Group (2007) report, in 2006, the efficiency-directed FDI seek delocalization and re-export FDI represents around one third of total FDI stock in Bulgaria, while market-seeking FDI mostly focused on local needs in the services sector accounts for the remaining two thirds. Traditional sectors seem to be among the most relevant targets for FDI expansion, with food and beverages and textiles reporting a particularly strong presence of foreign companies. A big share of foreign direct investments, dedicated to manufacturing is oriented to the sectors, producing intermediate goods, like petroleum, chemical, rubber and plastic products, metallurgy and metal products, mineral products and other inputs for the construction industry, which is growing fast in the last two years.

The data in Table 5 supports these findings. According to InvestBulgaria Agency (2007d) report the largest share of the FDI inflows in 2006 is in the real estate and business services sector, amounting to US$ 1,579.6 million, which is 2.15 times higher than the inflows in 2005. The leading sectors of FDI inflows are followed by the financial intermediation with US$ 906 million, trade & repairs – US$ 559.9 million, construction – US$ 523.1 million, and metallurgy and metal products – US$ 502.8 million. Moreover, the investments in construction are 2.8 times more than those in 2005. Interestingly, metallurgy and metal products manufacture have brought inflows of almost 10% of the total FDI inflows for 2006 and are the leaders in the processing industries. The financial intermediation sector has attracted the highest amount of foreign investment (US$ 3,414.7) over the period 1998 – 2006.

[Insert Table 5 here]

Research Methodology

The research methodology of this study is based on a questionnaire used to collect information about country risk assessment and investment decision making process in Bulgaria. Our purpose is twofold: first, to study the impact of country risk on FDI inflows in the country, and second, to identify the specific obstacles /entry barriers/ that foreign investors and foreign MNEs face during the establishment of their FDI projects in a transition country, such as Bulgaria. The study attempts to identify the major factors of the business environment that foreign companies examine before entering the Bulgarian market. Previous research (see Bitzenis, 2006; Bitzenis 2007; and Blaźić & Vlahinić-Dizdarević, 2006) on FDI in transition economies finds that foreign MNEs examine the same factors to become familiar with the host country's business environment and have more successful investments. We do not share the same findings.

Sample design

As a first step of our research methodology, we have established criteria based on which to create the population for our survey on foreign MNEs in Bulgaria. With the help of the InvestBulgaria Agency (IBA) – an official partner of our research project – a list of 90 large companies that, according to the IBA statistics, have invested over BGN 10 million between 1993 and 2006,[1] has been created. These companies belong to the top 109 foreign investors in Bulgaria at the end of 2006 (ranked by the size of investment). According to InvestBulgaria Agency (2007d) report the total invested capital from these MNEs amounts to US$ 11,769 million (or 58.84%) of the total volume of the foreign investment in Bulgaria for the period 1993 - 2006. For the purposes of our study we extended the list to 132 foreign investors, adding another forty companies with the amount of invested capital at the end of 2002 between BGN 1.0 million and BGN 10 million. These 40 new foreign MNEs were not included in the IBA's officially published data of largest foreign investors in Bulgaria and data were collected from the Bulgarian Privatization Agency.

Our sample is very representative of the real economic situation in Bulgaria as it consists of companies investing significant amount of capital relative to the size of the Bulgarian economy. Each represents a significant percent of the total FDI inflows in the country. Examples of such successful foreign investors are the US Tishman Management Company which has invested by the end of 2006 more than € 200 million (or US$ 251.4 million) in Sofia Airport Center, and Mercury Group with € 80 million (or US$ 100.6 million) invested in a

[1] The foreign investors are grouped in three categories /class/, depending on the investment project's size. The class thresholds are set forth in the Rules on the Enforcement of the Encouragement of Investment Act (2004) as follows: first class - investment over BGN 70 million; second class - investment from BGN 40 million to BGN 70 million; and third class - investment from BGN 10 million to 40 million.

shopping center in Sofia. The sample is also representative because we managed to collect and analyze data in all the sectors of industry, trade and services. The questionnaire was initially developed following the methodology used by the La Trobe University, Australia[1] in a similar research study of the largest Australian companies investing aboard. The questionnaire was enriched and updated according to the specificity both of the Bulgarian business environment and the type of foreign investors.

The second step of the research methodology was to divide the foreign investors included in the sample in different groups following Bitzenis (2003) model regarding the possible reasons for and entry barriers to FDI in Bulgaria.. The companies were grouped based on the following characteristics - country of origin, type of investment (entry mode), and by sectors.

The sample includes foreign MNEs of different origin. Among the 132 companies twenty-five MNEs (18.9 percent) are of German origin, 15 foreign MNEs (11.4 percent) are from Austria, and 13 MNEs (9.9 percent) – of US origin (see Table 6). These are among the top ten countries that have invested the largest amount of capital in Bulgaria in the period 1992 – 2006. The total number of countries represented in our sample is thirty. Eighty-five percent of the projects implemented by the largest foreign investors from these countries are Greenfield and expansion projects. It is worth to mention the projects implemented by Solvay (Belgium), Shell (UK), American Standards (USA), Umicore (Belgium and the Netherlands), etc. Almost the same is the share of Greenfield and expansion projects (72 percent) implemented by the other 42 foreign companies in the sample (mostly small and medium-sized enterprises).

[Insert Table 6 here]

Figure 3 presents the distribution of FDI projects by type of investment, as implemented by the foreign MNEs included in the sample. Of 572 investment projects in total 466 (or 81.5 percent) are Greenfield and expansion projects, and only 101 (or 17.7 percent) are acquisitions, mainly through privatization. Bulgaria is placed second among SEE countries after Rumania when the total number of FDI projects is considered. The largest number of Greenfield projects (68, or 11.9 percent) was implemented in 2001. Only 19 new Greenfield and expansion projects were initiated in 2006 by the same companies. The total number of mixed projects (Greenfield plus acquisition) for the whole period is only five.

[Insert Figure 3 here]

Next, we distribute the FDI projects by sectors (see Figure 4). The largest share of FDI inflows is in financial intermediation sector (68 projects, or 11.9 percent), followed by food products (51 projects, or 8.9 percent), petroleum, chemical, rubber and plastic products (50 projects, or 8.7 percent) and trade and repairs (48 projects, or 8.4 percent). These four sectors have brought 10.9 percent of the total FDI inflows in Bulgaria for 2006. While the FDI projects,

[1] We thank to Prof. Colin White for providing us the questionnaire used in this research.

implemented by the top 90 foreign investors follow the same distribution, data for small and midsize MNEs in the sample show a different pattern. The preferable sectors of investments are petroleum, chemical, rubber and plastic products (31 projects), textile and clotting (23 projects), followed by wood products and paper (18 project), and machine building (15 projects). This can be explained by the fact that most SMEs set up their investment projects in sectors with low unskilled labor cost and lack of local competition.

[Insert Figure 4 here]

The Encouragement of Investment Act (1997) sets forth preferential treatment measures for investment projects meeting certain criteria specified in this law. One of these criteria is the new jobs created. The analysis of the projects implemented in the period of 2004 – 2006 by thirty of the largest foreign investors shows that 26 projects have been certified as projects of class 1, one project – of class 2, and 3 projects – of class 3 (depending on the size of the investment project as specified in the Regulations for Application of the Encouragement of Investment Act), with the amount of invested capital in the range of BGN 17 million to BGN 2,049 million. The total number of new jobs to be created by these projects is 12,253. The largest number of jobs (2,280) is expected to be created by Karfur Bulgaria's project for establishing a hypermarket and trade center in Sofia (see Figure 5).

[Insert Figure 5 here]

General questionnaire

The executives and top level managers of the surveyed companies were asked three groups of questions: 1) assessment of general country risk and its relevance, 2) the impact of country risk components on a firm's foreign investment decision making process, and 3) the incentives for foreign direct investment in Bulgaria and expected improvements. Each category consists of subgroups of specific questions. For example, the first section of the questionnaire for assessment of general country risk includes questions about the impact of different elements of the Bulgarian business environment on foreign MNEs' long-term investment decisions, the assessment framework of country risk within the company, and the relevance of different sources of information (e.g., credit rating agencies, economic research services and databases, etc.) on country risk assessment process. For the second group of questions the managers of foreign MNEs were asked to rate the impact of different components of country risk – political, economic, financial, and cultural risk, on their foreign investment decisions, on the scale from 1 to 5

The questions in the last section of the questionnaire relate foreign investors' decision making process with the major incentives for FDI in Bulgaria in order to be able to identify the types of motivations and entry barriers that foreign investors consider in deciding whether or not to invest in Bulgaria. The study also tries to identify the major improvements in the Bulgarian business

environment that the foreign investors expect. Finally, the questionnaire studies the specific modes of foreign market entry, the industry the foreign companies are operating in, and the type of market the foreign direct investments are oriented to.[1]

Needed Reforms and Improvements

According to a recent research conducted by Eurocapital Finance (2006) the overall business risk in Bulgaria is relatively low due to the lack of political violence in the country's recent history and its stable democratic system. The currency board brings additional stability in the country's currency, but access to capital in domestic markets is still limited. However, the uneven quality in the physical infrastructure is presented as a potential risk. The most important risk categories that may have an impact on FDI inflows in Bulgaria, according to the report, are security risk, political risk, legal & regulatory risk, macroeconomic risk, foreign trade & payments risk, financial risk, etc. Some of them, such as government effectiveness risk, are found to be high, and some others - infrastructure risk and labor market risk, are described as moderate. These estimates of country risk components and their impact coincide with the findings from our survey.

Nowadays, after the accession to the European Union, Bulgaria's trade policies are relatively liberal, which contributes to a favorable investment climate and to the possibility of accessing the global markets more easily. Since the exports are dominated by unskilled labor-intensive and resource-intensive commodities, establishing an export capacity beyond those commodities is not easy and is developing very slowly, despite the favorable trade policy environment. The portion of imports of equipment and up-to-date machinery is relatively small, which shows clearly the government policies' attitude towards the transfer of resources, in order to encourage the outward oriented FDI inflows. According to World Bank Group (2004a) report these factors are an indication that government policies are not supportive of competitive markets that would reallocate resources from sectors with low productivity to industrial sectors with a potential comparative advantage.

In order to improve its competitiveness, Bulgaria needs to implement a core reform agenda which includes:

1. Upgrading the transport network and trade facilitation system to reduce the costs of competing in external markets;
2. Upgrading skills to enable the development of export capacity beyond unskilled labor intensive exports;
3. Increasing labor market flexibility to facilitate the reallocation of resources from low to higher productivity activities in the economy;
4. Reducing regulatory complexity and improving the quality of institutions to attract FDI flows to outward-oriented sectors;

[1] As the data collection is still in progress, the final results from the survey will be presented during the 7th Global Conference on Business and Economics to be held in Rome, Italy, October 13-14, 2007.

5. Maintaining macroeconomic stability to provide an environment supportive of the private sector undertaking investments needed to compete in the global markets.

The EU accession offers good opportunities to Bulgaria for improving its reputation in front of the foreign investors, since those investors who decide to enter the Bulgarian market will be attracted mainly by the transport and energy sectors, and by the low labor costs. According to a recent survey conducted by Ernst & Young (2006)[1], Bulgaria occupies the fourth place in respect to the reputation the country has among the foreign investors with 44% support. The leader in the region in this category is Romania (58%), followed by Turkey (49%), and Greece (48%), while Serbia is on the fifth place with 26%. Yet, the survey expects that in three years Bulgaria will be already up on the second place among the countries in Southeast Europe, after Romania. If the reduction of the corporate tax rate from 15% to 10% in 2007 is taken into consideration, the country may even go up to the first place, since this reform significantly improves the investment conditions in the country.

In addition, the Ernst & Young (2006) survey lists the expectations of foreign investors for developments in certain areas of the Bulgarian economy in the next five years. One third of the interviewed managers hope for improvements in the transportation and the telecommunication infrastructure of the country; 27 percent of the investors recommend strengthening the political stability; 25 percent of the managers expect better conformity with the EU quality standards; and almost the same percentage of investors recommend more flexible administrative procedures and less bureaucracy. Only 12% of foreign investors relate their investment decisions with improvement of the quality of life in Bulgaria.

Conclusion

Factors such as firm's size, type of investment (entry mode) and the sector to which it belongs play a decisive role in the company's strategy to enter a foreign country. In making long-term investment decisions, foreign companies assess the economic and financial components of the country risk as the most important factors /determinants/ of their FDI decisions. Though the majority of foreign MNEs do not have a formalized/institutionalized system for assessing and monitoring the host country risk, the individual projects risk assessment is a major part of their foreign investment decision making process.

More that 110 large foreign companies have invested in Bulgaria during the period 1993 – 2006 with the total amount of the invested capital of US$ 20 billion. These companies are engaged in business activities that add value, crate additional jobs and higher wages, improve the quality and variety of products, and contribute significantly to the growth of gross domestic product (GDP) of the Bulgarian economy. The most important incentives for these companies to invest in Bulgaria are the opportunity for market growth, market size, efficiency, financial aspects, low skilled labor costs and avoidance of

[1] See Semkova (2007), p.51.

trade barriers. A large number of small to midsize MNEs that have invested in Bulgaria in the same period find low labor cost of unskilled workers, unsatisfied local demand, avoidance of trade barriers and links to neighboring countries as the most important factors in making long-term investment decisions. Other motives for foreign SMEs to invest in Bulgaria are their previous trade relations, lack of local competition at the time of investment, and unsatisfied local demand for products

The largest number of FDI projects in Bulgaria has been implemented in sectors such as financial intermediation, petroleum, chemical, rubber and plastic products, electricity, gas, and water supply, metallurgy and metal products, and mineral products Thus, we can conclude that a considerable share of FDI inflows in Bulgaria is committed to the sectors concentrated on satisfying local market needs. Traditional sectors also continue to be among the most relevant targets for FDI expansion, with food and beverages and textiles sectors showing a particularly strong presence of small foreign companies. These findings are in compliance with the previous researches, related to the distribution of FDI by economic activities, according to which most of the FDI in Southeast European countries have been concentrated in financial services, telecommunications and trade, and manufacturing.

The study shows that factors such as incoherent and unstable legal system, crime and corruption, bureaucracy and poor infrastructure discourage foreign investors and decrease the competitiveness of the Bulgarian economy. However, the continuing economic growth and political stability are good signals that in the years to come Bulgaria will enjoy sustainable growth and development, and will continue to attract a significant amount of inward FDI. Now, after the Bulgaria's accession to the European Union, an influx of over € 11 billion from the EU cohesion and structural funds is expected for improvements in infrastructure, transport and other relevant sectors. This places Bulgaria among the countries in the region with the highest amount of FDI inflows.

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Table 1 *FDI inflows by type of investment*

Year	Privatisation		Greenfield + Expansion		Total by year
	USD million	%	USD million	%	USD million
1992	0.0	0.0	34.4	100.0	34.4
1993	22.0	21.5	80.4	78.5	102.4
1994	134.2	63.6	76.7	36.4	210.9
1995	26.0	16.0	136.6	84.0	162.6
1996	76.4	29.8	180.0	70.2	256.4
1997	421.4	66.2	214.8	33.8	636.2
1998	215.6	34.8	404.4	65.2	620.0
1999	226.7	27.7	592.1	72.3	818.8
2000	366.0	36.5	635.5	63.5	1,001.5
2001	19.2	2.4	793.7	97.6	812.9
2002	130.0	13.4	839.7	86.6	969.7
2003	364.1	17.4	1,732.8	82.6	2,096.9
2004	1,216.0	35.3	2,227.4	64.7	3,443.4
2005	0.0	0.0	2,883.7	100.0	2,883.7
2006	267.5	5.3	4,790.6	94.7	5,058.1
Total	**3,485.1**	**18.2**	**15,622.8**	**81.8**	**19,107.9**

Source: InvestBulgaria Agency (2007a)

Table 2 *FDI Inflows as a percentage of GDP, by country*

Country	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
Bulgaria	4.4	7.1	8.1	5.9	5.9	10.5	13.9	10.8	16.4
Romania	4.1	3.0	2.8	2.9	2.5	2.7	7.2	6.6	9.3
Estonia	10.2	3.9	6.1	5.6	2.2	8.3	8.3	21.2	12.5
Lithuania	9.5	4.8	3.0	3.3	4.8	0.9	3.4	3.9	2.8
Check Republic	6.4	10.5	8.9	9.0	11.2	2.6	4.6	8.9	4.7
Slovakia	1.2	3.5	9.8	7.3	16.3	1.8	2.3	4.2	5.9
Croatia	4.3	7.4	5.9	7.9	4.9	6.8	3.5	4.5	7.1
Latvia	5.4	4.8	5.3	2.0	4.1	3.0	3.9	4.0	8.5
Hungary	6.2	7.5	2.6	4.0	3.8	3.2	3.9	4.2	3.2
Ukraine	1.9	1.4	1.4	2.0	1.7	2.9	2.6	9.4	4.8
Poland	4.0	4.7	5.8	3.1	2.2	2.1	8.5	3.2	3.7
Slovenia	1.1	0.3	0.4	1.9	8.0	0.5	2.5	1.6	2.2
Russia	1.0	1.7	1.0	0.8	1.0	0.3	2.6	1.9	2.2

Source: 1998-2000: Bank Austria Creditanstalt; 2001-2006 - Bulgarian National Bank

Table 3 *FDI inflows per capita, in USD*

Country	Population, million	1998	1999	2000	2001	2002	2003	2004	2005	2006	Total
Bulgaria	7.7	81	106	130	106	126	272	447	375	657	2,300
Czech Republic	10.2	350	604	479	532	806	230	457	1,076	649	5,182
Croatia	4.4	210	326	242	347	250	435	304	389	679	3,180
Slovakia	5.4	47	131	356	278	713	110	312	368	605	2,919
Estonia	1.3	383	146	221	225	105	504	371	2,166	1,522	5,642
Hungary	10.1	283	345	117	196	239	250	301	458	359	2,548
Slovenia	2.0	113	30	35	185	874	-63	190	274	411	2,049
Poland	21.6	167	188	247	148	107	110	133	253	327	1,678
Lithuania	3.4	281	138	93	107	182	44	280	255	212	1,593
Latvia	2.3	143	139	164	65	151	131	184	275	709	1,963
Romania	23.0	95	46	46	52	50	68	168	300	507	1,331
Russia	143.5	19	22	18	17	24	8	41	100	151	401
Ukraine	46.9	16	9	9	15	14	28	29	165	108	393

Source: Bulgarian National Bank, Bank Austria Creditanstalt, and Author calculations.

Table 4 *FDI flows by country and by year, in USD million and in percentage*

FDI flows							**as a percentage of gross Fixed Capital Formation**			
		1990-2000	**2002**	**2003**	**2004**	**2005**	**1990-2000**	**2003**	**2004**	**2005**
		(annual average)					*(annual average)*			
Bulgaria	*inward*	301	905	2,097	3443	2,223	18.1	54.3	68.1	35.1
	outward	-4	29	27	-217	316	0.0	0.7	-4.3	5.0
Croatia	*inward*	544	1,213	2,133	1262	1,695	13.1	25.2	12.5	15.4
	outward	51	539	108	348	187	1.2	1.3	3.5	1.7
Romania	*inward*	656	144	2,213	6517	6,388	9.4	17.4	39.9	28.1
	outward	2	16	39	70	-13	0.0	0.3	0.4	-0.1
Russian Federation	*inward*	423	693	1,424	1,715	7,808	5.2	13.8	11.7	45.2
	outward	8	-5	13	4	275	0.0	0.1	0.0	1.6
Southeast Europe	*inward*	1,603	3,877	8,457	13,283	12,445	10.7	26.8	33.2	25.4
	outward	55	589	174	201	496	0.0	0.7	0.6	1.2
SEE and the	*inward*	5,569	12,911	24,192	39,577	39,679	6.2	16.9	20.9	17.0
Independent States	*outward*	1,401	4,687	10,731	13,973	15,056	1.9	7.6	7.6	6.6
World	*inward*	49,5391	617,732	557,869	710,755	916,277	7.6	7.3	7.7	9.4
	outward	49,2566	539,540	561,104	813,068	778,725	7.7	7.4	9.3	8.3
FDI Stocks							**as a percentage of GDP**			
		1980	**1990**	**2000**	**2004**	**2005**	**1990**	**2000**	**2004**	**2005**
Bulgaria	*inward*	0	112	2,257	9,220	9,173	0.5	17.9	37.8	34.3
	outward	0	124	87	0	127	0.6	0.7	0.0	0.5
Croatia	*inward*	0	0	3,523	12,602	12,516	0.0	19.1	36.7	33.3
	outward	0	0	825	2,159	2,127	0.0	4.5	6.3	5.7
Romania	*inward*	0	0	6,480	20,523	23,818	0.0	17.5	28.0	24.2
	outward	0	66	136	294	242	0.2	0.4	0.4	0.2
Russian Federation	*inward*	0	0	3,875	9,606	17,209	0.0	12.4	14.8	21.1
	outward	0	0	170	196	466	0.0	0.5	0.3	0.6
Southeast Europe	*inward*	0	112	15,083	51,261	56,562	0.2	16.6	29.1	26.7
	outward	0	191	1,170	2,500	2,625	0.2	1.3	1.4	1.2
SEE and the	*inward*	0	121	70,306	222,486	255,713	0.2	15.9	23.8	21.2
Independent States	*outward*	0	191	22,054	111,624	126,345	0.2	5.1	12.1	10.6
World	*inward*	561,403	1,789,303	5,802,933	9,544,887	10,129,739	8.5	18.3	23.3	22.7
	outward	571,226	1,791,092	6,471,435	10,325,240	10,671,869	8.6	20.5	25.2	23.9

Source: United Nations Conference on Trade and Development (2006).

Table 5 *FDI in Bulgaria by sectors, in USD million*

No	Sector	1998	1999	2000	2001	2002	2003	2004	2005	2006	Total by sector
1	Financial intermediation	150.5	97.8	4494	122.6	133.8	501.9	238.9	813.8	906.0	3,414.7
3	Real estate and business activities	111.9	134.5	116.5	121.7	229.2	485.1	364.7	255.3	559.9	2,378.8
2	Trade and repairs	33.7	39.7	2.8	13.2	56.5	182.2	141.9	572.4	1579.6	2,622.0
4	Petroleum, chemical, rubber and plastic products	41.0	165.2	72.1	-9.5	6.5	169.7	-3.1	662.6	293.6	1,398.1
6	Electricity, gas and water supply	1.8	4.6	19.7	2.4	66.9	8.1	925.5	12.0	247.1	1,288.0
5	Telecommunications	23.2	14.1	14.9	236.8	205,.0	127.3	401.6	180.4	-159.8	1,043.4
7	Construction	2.4	19.8	47.9	17.4	33.1	5.1	55.0	232.0	523.1	935.7
13	Metallurgy and metal products	13.2	72.2	17.1	81.0	-18.9	66.6	54.1	-118.5	502.8	669.6
8	Mineral products (cement, glass, etc.)	150.6	71.8	7.4	27.7	0.7	76.8	97.5	97.3	71.2	601.0
9	Food products	31.5	32.7	11.7	37.4	20.1	87.6	67.6	-6.6	13.7	295.7
11	Hotels and restaurants	17.6	16.9	26.0	17.9	7.9	27.9	15.2	61.7	79.7	270.8
10	Textile and clothing	4.4	25.1	27.3	57.7	9.3	84.3	45.7	-3.8	20.0	269.9
12	Machine building	21.3	18.0	64.7	13.2	37.6	1.1	13.8	35.9	50.9	256.5
14	Wood products, paper	37.3	24.9	38.1	2.9	17.0	69.9	-0.6	2.3	20.6	212.4
15	Transport	6.2	-11.7	10.1	5.9	8.1	45.1	29.2	43.5	53.3	189.8
16	Electrical eng., electronics, computers	11.5	5.9	28.6	28.2	17.9	29.5	-0.7	15.3	7.6	143.8
17	Mining	0.0	2.7	0.0	4.9	10.4	21.7	19.1	24.2	2.0	85.0
18	Agriculture, forestry and fishing	6.5	2.1	7.3	0.5	1.2	2.6	-1.9	5.1	16.0	39.5
19	Leather and leather products	0.7	0.0	21.2	0.1	0.5	-0.2	-2.5	3.0	0.5	23.4
20	Vehicles and other transport equipment	-0.9	1.7	0.0	5.1	2.2	2.1	-0.5	0.1	2.8	12.6

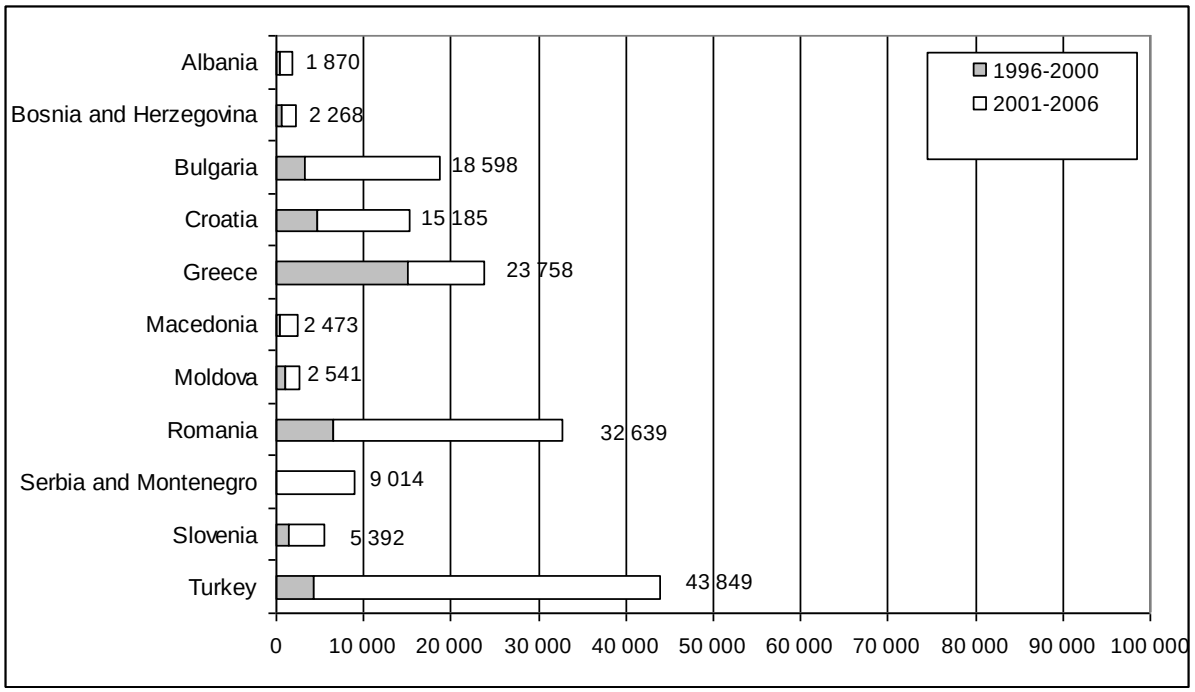
Source: InvestBulgaria Agency (2007b)

Table 6 *Foreign companies by country of origin, 1993 -2006*

Country of origin	Top 90 companies (more than BGN 10 million)	Other companies (less than BGN 10 million	TOTAL
Germany	17	8	**25**
Austria	13	2	**15**
USA	7	6	**13**
Greece	7	2	**9**
Cyprus	1	4	**5**
Italy	6	2	**8**
Great Britain	4	1	**5**
Turkey	2	4	**6**
Belgium	4	2	**6**
Switzerland	5	1	**6**
The Netherlands	2	1	**3**
Czech republic	2	1	**3**
France	3	0	**3**
Spain	2	1	**3**
Luxemburg	2	0	**2**
Sweden	2	0	**2**
Russia	2	0	**2**
Hungary	1	1	**2**
Japan	1	1	**2**
Denmark	1	0	**1**
Iceland	1	0	**1**
Canada	1	0	**1**
South Korea	1	0	**1**
Malta	1	0	**1**
Slovakia	0	1	**1**
Panama	0	2	**2**
Lebanon	0	1	**1**
Slovenia	1	0	**1**
United Arab Emirates	1	0	**1**
Ireland	0	1	**1**
	90	**42**	**132**

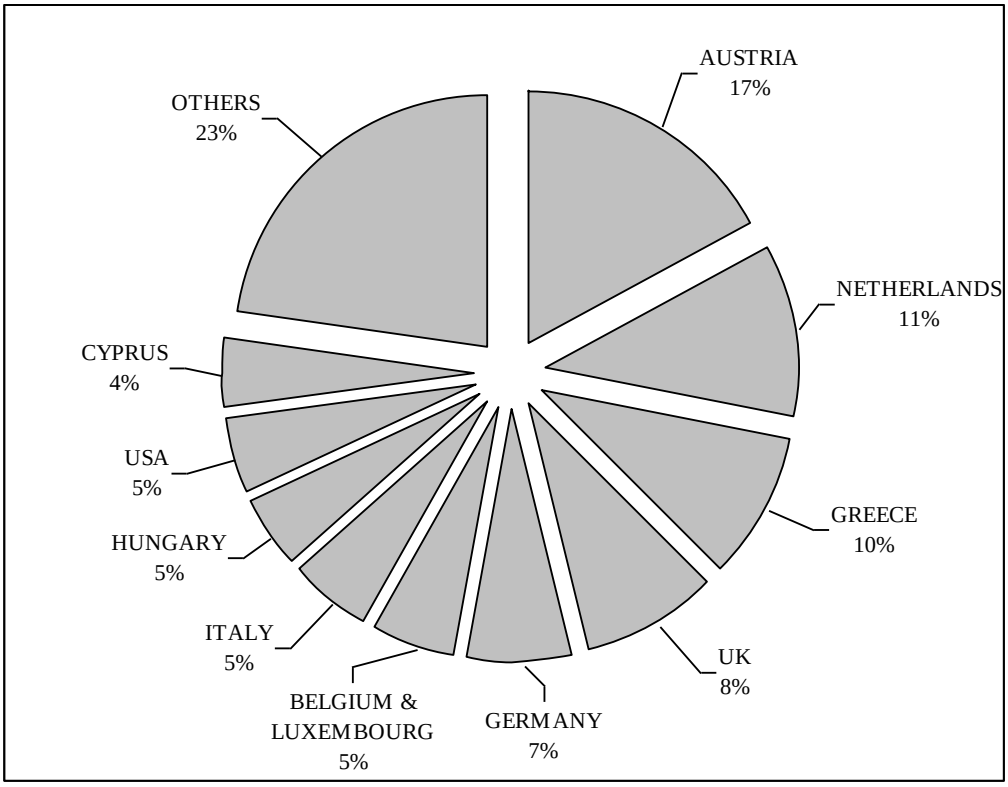
Source: InvestBulgaria Agency and Author calculations.

Figure 1 *Total FDI inflow in Southeast Europe, in USD million*



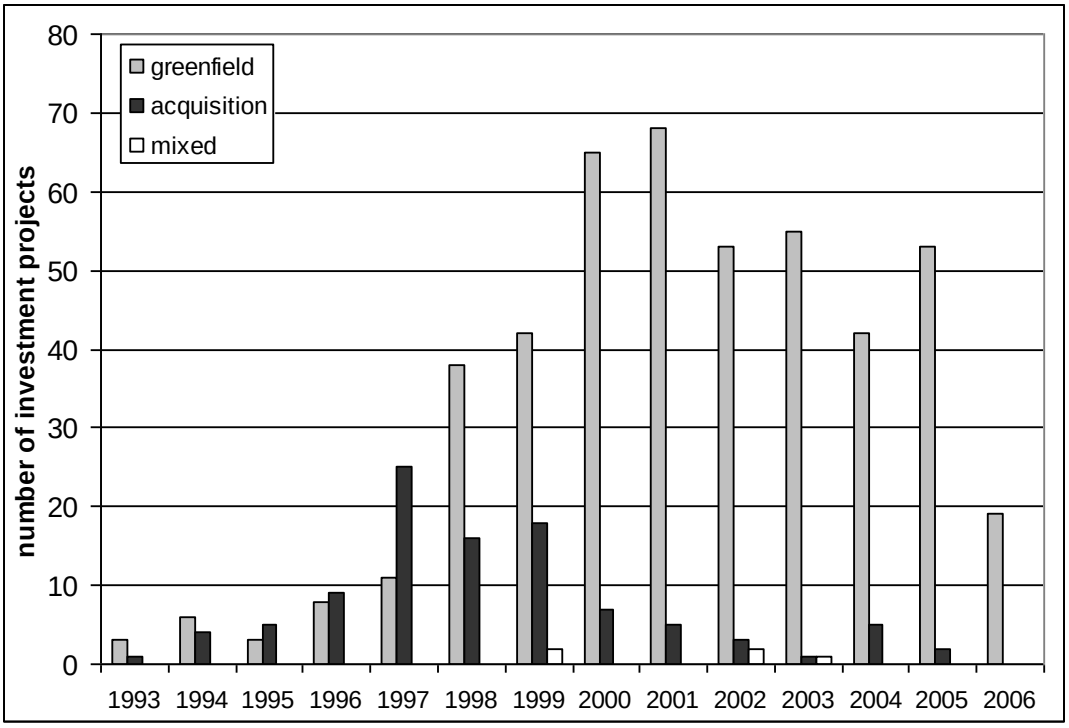
Source: SEE Europe Investment Guide (2006) and Author calculations

Figure 2 *FDI inflows in Bulgaria by country of origin, in percentage*



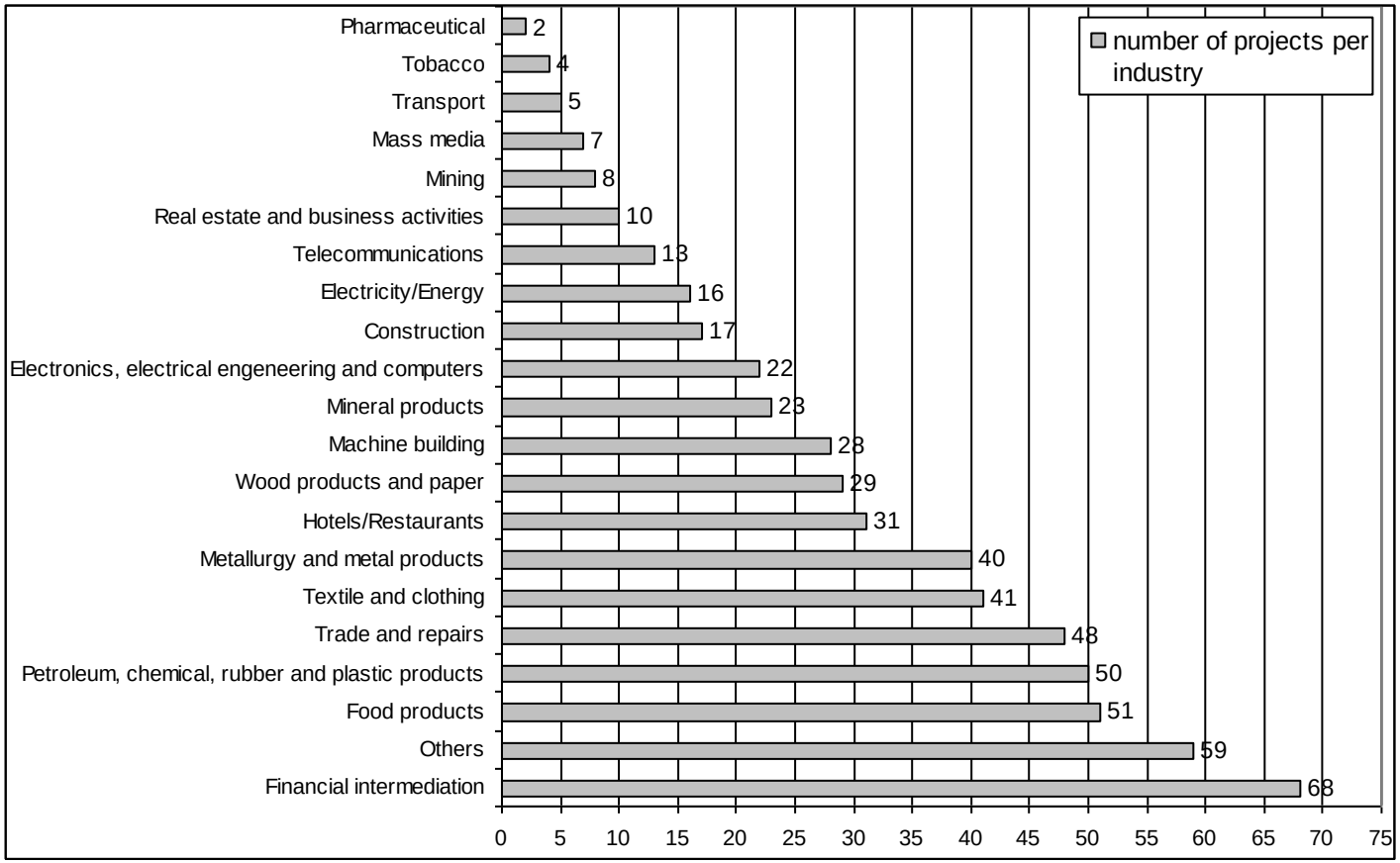
Source: InvestBulgaria Agency Report (2007c)

Figure 3 *FDI projects by type of investment, 1993-2006*



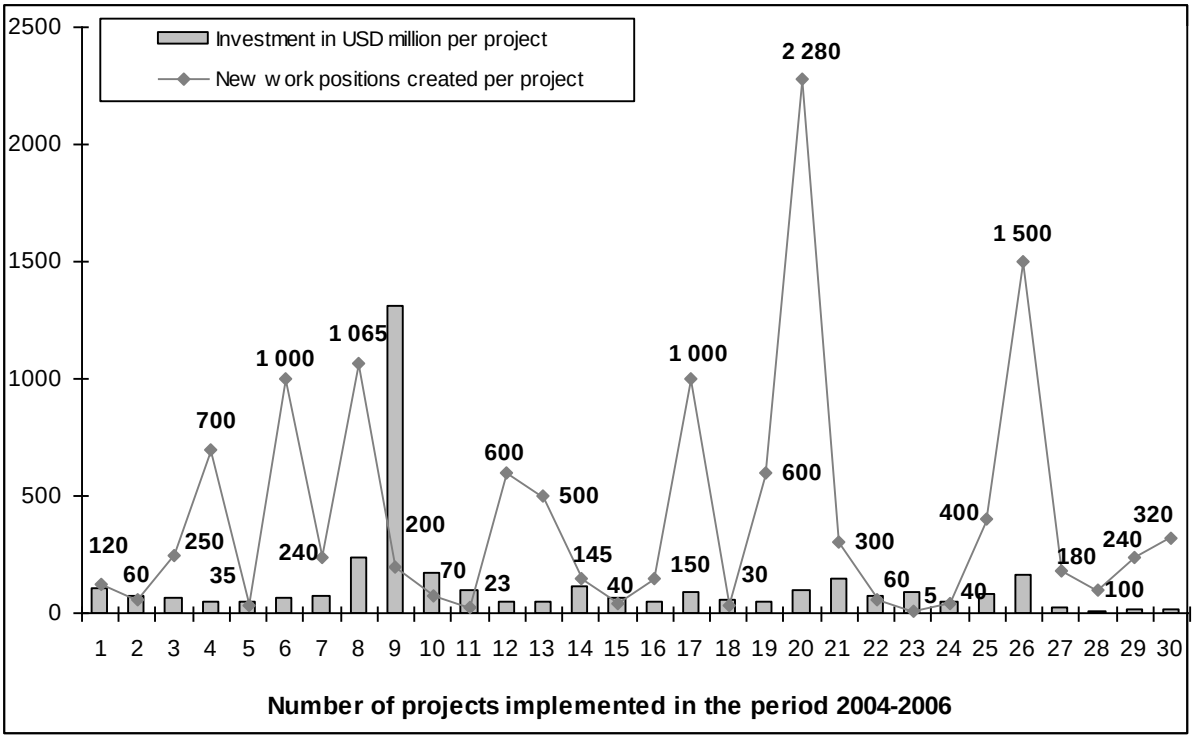
Source: InvestBulgaria Agency and Author calculations

Figure 4 *Total FDI projects by sectors, 1993-2006*



Source: InvestBulgaria Agency and Author calculations.

Figure 5 *New jobs created by FDI projects, 2004-2006*



Source: InvestBulgaria Agency and Author calculations