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Contents

The FDI location decision: does liberalization matter?

Antonio Majocchi and Roger Strange*

In this article, we address the question of whether market, trade and financial liberalization has an impact upon FDI location decisions. We use a sample of Italian firms which have made investments in seven Central and East European countries (i.e. Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia). The results confirm that market size and growth, the availability of labour, the quality of infrastructure, and agglomeration economies are all important determinants of FDI location. However, we also show that the choice of FDI location is positively influenced by the extent of trade, financial and (weakly) market liberalization, and negatively related to the openness to foreign banks. This study improves upon the previous studies in a number of aspects: it uses firm-level data from the very start of transition process in 1990; it includes various dimensions of liberalization, notably financial liberalization and openness to foreign banks, which have not previously been considered; and finally, it provides elasticity estimates that show the changes in the probability of FDI location in each country arising from further liberalization in each of the other countries in the region.

Key words: Location decisions, Economies in transition, Italian FDI

* Antonio Majocchi is Associate Professor of International Business at the Faculty of Economics, University of Pavia, Italy (tel.: +39 0382 98646, e-mail: antonio.majocchi@unipv.it). Roger Strange is Senior Lecturer at King's College London, United Kingdom (tel.: + 44 20 7848 4423, e-mail: roger.strange@kcl.ac.uk). The corresponding author is Antonio Majocchi. The authors gratefully acknowledge financial support from MIUR (FIRB 2003, DM2PMI).

1. Introduction

Since the early 1990s, many countries in Central and Eastern Europe (CEECs) have undergone substantial economic liberalization, and these developments have contributed to CEECs becoming popular destinations for foreign direct investment (FDI) by Western firms (Meyer, 1998; Kalotay, 2004) particularly those from the European Union (EU). These countries share similar economic and institutional legacies from their Communist pasts, and all are potential new markets and/or low-cost production locations. But liberalization is a multi-faceted process and involves, *inter alia*, market liberalization, trade liberalization and financial liberalization. The speed and extent of market, trade and financial liberalization have not been uniform across the CEECs, and their individual paths of transition to market economies have differed substantially. These observations raise the issue of whether market, trade and financial liberalization each have an impact upon inward FDI and, if so, which effects are the strongest.

This article addresses this issue by establishing the determinants of FDI location in seven CEECs[1] (i.e. Bulgaria, the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia), all of which have been involved in the process of accession to the EU and which together account for most inward investment in the region. The statistical analysis is based upon a sample of firms from just one country (i.e. Italy), which means that we do not need to control for possible country-of-origin effects (Grosse and Trevino, 1996; Chadee *et al.*, 2003) due to geographical and/or cultural proximity to Eastern Europe. We

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