FOREIGN DIRECT INVESTMENT IN THE EUROPEAN TRANSITION ECONOMIES

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Abstract: In its most current report on the transition economies, EBRD (2015) points out that these countries had enjoyed a period of booming financial sectors, strong rates of growth and income that was gradually converging with the levels typical in the advanced economies in the European Union with cross-border capital flows playing an enormously important role in this process. The capital inflows mostly came in the form of foreign direct investment, often drawn by institutional reform and boosting in turn more institutional reform (EBRD, 2015). Foreign direct investment had been an unalienable and irreplaceable part of the strong economic growth momentum during the late 1990s and the 2000s in the transition economies due to one. simple reason – they lacked domestic savings to finance investment.
The socialist philosophy discouraged strongly savings as it argued that common people had to work hard, while the party would provide them with anything they need. In other words, they shouldn't have worried about being able to buy a house, a car, pay for school or university, go to a nicer vacation than last year, etc. All of these and many more were supposedly provided by the party and the government in exchange for obedience, political compliance and hard work. Consequently, people under socialism hadn't been piling up substantial savings, albeit some forms of savings plans in state-owned banks existed. As the socialist economies ultimately collapsed (largely due to this lack of savings and perverse stimuli that the philosophy had given to people that ultimately impacted economic life) and dragged down the socialist parties and political regimes, these states emerged in 1989-1990 with newly born market economies that had very few savings and very unstable banks. Without savings, they couldn't finance investment that was quintessential in order to refurbish their industrial capacity and bring it in adequacy to the needs of a market economy. This is exactly where capital inflows in the form of foreign direct investment came and have been so beneficial (EBRD, 2015).
Keywords: Foreign direct investment, European transition economy, factors,

1. INTRODUCTION

Compared to the definition of foreign direct investment, there is far lesser consensus concerning the factors that shape FDI flows towards and form a country. For example, Lewis (2000) puts an emphasis on what he calls "pull factors" that draw FDI towards transition economies. According to him, FDI is usually a long-term commitment and thus corporations with sophisticated shareholder structures usually make very careful considerations when entering such states. Lewis (2000) argues that the following factors are the most important ones when an investor considers entering a foreign economy: "past and present economic stability, current economic welfare, current economic capacity, level of human capital, wages, and technological capacity".

2. FACTORS OF FOREIGN DIRECT INVESTMENT

Other interesting factors are tariff and non-tariff barriers that exert influence over both international trade and foreign direct investment (Pugel, 2004). As 30% of international trade today actually occurs between group members located in different countries across the globe, the free movement of goods is also an important factor that foreign investors are likely to take into account (Pugel, 2004). In other words, if a foreign investor intends to realize an investment in a country and has plans that this investment continues or starts to produce goods and services that require inputs from or are sold on the international markets, then considering the tariff and non-tariff barriers that might hinder the movement of these inputs or finished produce (or both, actually) is a very important step in the decision-making process. The importance of these barriers is further increased by the fact that economic convergence at the international stage is occurring but with a slow pace and thus outsourcing and internationalizing supply chains in order to improve financials is going to continue to be a frequent and preferred corporate policy (Pugel, 2004). The basic logic behind the process is as long as substantial economic divergence is present across the globe, multinational enterprises will find it profitable to optimize production by extending supply chains through many countries and thus realize multiple foreign direct investment projects, boosting both international trade and FDI (Thompson, Strickland and Gamble, 2005).

Thompson, Strickland and Gamble (2005) shed some light on the "soft" factors that affect foreign direct investment, such as investor's and even general attitude and perception towards the host and home country. These factors might have not as direct impact as business regulations (for example), but are also very powerful by directing consumers', partners' and even politicians' behavior. For example, if a multinational investor A decides to invest in a country B, but the latter's nation is exhibiting signs of rising nationalism, then A's shareholders are likely to calculate that and assume that there is a probability that social attitudes may translate into political action and that may be directed against foreign investors. It is important to note that the stereotype of harsh autocratic regime being unhospitable and jeopardizing foreign direct investment is not always justified in reality (Pugel, 2004). In fact, some of the most powerful beacons for foreign direct investment are states that hardly "shine" in terms of democratic development (Pugel, 2004). One hypothetical advantage that may materialize is that the absence of (effective) democratic elections means that governors are able of pursuing sustainable policies that might actually be market- and investor-friendly (Pugel, 2004). For example, according to the CIA World Factbook (2015), the top countries by received Foreign Direct Investment Stock are the United States, the United Kingdom, Hong Kong, China and Germany. Of these five states, two are actually governed in an autocratic way – China and Hong Kong, while the latter is also topping the economic freedom indices, as well (Transparency International, 2015; World Bank Group, 2014). Of course, autocratic regimes are much more likely to lean the other way with their governors persisting in implementing policies and reforms that cement their own hold on the economy and are hostile to foreign investors and often international trade (Pugel, 2004).
Al-Sadig (2009) makes a lengthy analysis on the effects of corruption on foreign direct investment inflows with a number of interesting and even surprising conclusions. The author argues that "from a theoretical viewpoint, corruption—that is, paying bribes to corrupt government bureaucrats to get "favors" such as permits, investment licenses, tax assessments, and police protection—is generally viewed as an additional cost of doing business or a tax on profits." (Al-Sadig, 2009). Therefore, corruption is often expected to suppress the profitability and feasibility of investment projects and consequently make corrupt countries and/or regions more unattractive to foreign direct investments (Bardhan, 1997). Investors will take into account the costs of dealing with corruption and will weigh those when taking the decisions where to allocate their capital.

3. THE CORRUPTION FACTOR OF FOREIGN DIRECT INVESTMENT

However, it is interesting that the empirical literature on the influence of corruption on foreign direct investment does not ubiquitously support the above-mentioned hypothesis and suppositions. Al-Sadig (2009) notes that some empirical studies have found such negative relationship between corruption and foreign direct investment, but many others have failed to find any significant correlation. For example, Mauro (1995) argues that corruption has a negative impact on the level of investment and economic growth, while Tanzi and Davoodi (1997) put an emphasis on the negative impact on the quality of infrastructure and productivity of public investment. There has been also substantial investigation into the adverse effects on income inequality (Gupta, Davoodi, and Alonso-Terme 1998; Li, Xu, and Zou 2000) and on healthcare and education services (Gupta, Davoodi, and Tiongson 2000).
Yet, there are also hypotheses and analyses that point to possible positive effects of corruption in certain cases. One must not forget that public administration, regulation and policies are too often burdensome and needlessly expensive and time-consuming to comply with. Therefore, Bardhan (1997) argues that when too encumbering and rigid regulations are in place, corruption may actually increase bureaucratic efficiency by improving the speed of decision-making. This was rejected through empirical investigation by Kaufmann and Wei (1999), who showed that companies paying bribes are actually spending more time in negotiations and regulation compliance. On the other hand, two more recent studies argue that the effects of corruption depend heavily on the respective nation's regulatory quality, economic freedom and rule of law. For instance, Houston (2007) establishes that corruption "has positive effects on economic growth in countries with a weak rule of law, while it has negative effects in countries with sound institutions", while Swaleheen and Stansel (2007) find that "corruption enhances economic growth in countries with high economic freedom, while it hinders economic growth in countries with low economic freedom".
While the above may seem contradictory at first sight, one must not forget that high economic freedom is not always associated with powerful and functioning democracy and consequently high quality institutions and low corruption. For example, Hong Kong is the country with the highest rank on economic freedom in Heritage Foundation's index, but it is not a democratic country and ranks 17th in Transparency International's corruption perceptions index (where 1 is the least corrupt state). Estonia ranks 8th in economic freedom, but 26th in corruption. Chile ranks 7th in economic freedom, but 21st in corruption and is definitely a country with recurring problems in democratic institutions. A very interesting example is the one of Mauritius, which ranks very high in economic freedom (10th), but rather low in corruption – 47th, which is an averagely corrupt country.

There is also a number of contradicting empirical researches on the topic. For instance, Mody (1992) did not find any significant relationship between foreign direct investment flows and host country's risk factors such as corruption, but Hines (1995) examined the effect of the U.S. anti-bribery legislation (Foreign Corrupt Practices Act of 1977) on the operation of U.S. firms in countries where corruption is high and found that the Act indeed reduced US FDI flows into more corrupt countries after 1977. Abed and Davoodi (2000) researched the impact of corruption on foreign direct investment per capita in transition economies and found that countries with low corruption are indeed attracting more FDI stock, but when they controlled the findings for the structural reform index, they found that the latter has a far greater impact. Wei (2000) researched the effects of increasing tax rates and corruption level on multinational company activities and found that tax hikes and worsening corruption reduce inward foreign direct investment. Yet, in a similar research, but focused only on developing countries, Akcay (2001) fails to find any such negative relationship between corruption and the intensity of foreign direct investment. Akcay (2001) argues that tax rates, market size, labor costs and market openness are far more important factors that are taken into consideration when investors decide whether to allocate capital.

Readdressing the subject and question with an econometric model based on panel data from 117 host countries for the period 1984-2004, Al-Sadig (2009) finds that corruption indeed has a negative impact on FDI inflows, but it disappears when the test is controlled for the host country's institutional quality:

…a one-point increase in the corruption level leads to a reduction in per capita FDI inflows by about 11 percent. However, after controlling for other characteristics of the host country such as the quality of institutions, the negative effects of corruption disappear and sometimes it becomes positive but statistically insignificant. In fact, the results show that the country's quality of institutions is more important than the level of corruption in encouraging FDI inflows into the country. For instance, ceteris paribus, a country with sound institutions is able to attract as much as 29 percent more per capita FDI inflows than a country with poor institutions.

Al-Sadig's (2009) research is of significant importance as it shows that corruption must not be viewed and analyzed as an isolated phenomenon. Quite on the contrary, corruption is intertwined with other processes such as institutional reform, regulatory quality, quality of institutions, etc. These "soft" factors are tightly interrelated and should be analyzed multi dimensionally.

Poulsen and Hufbauer (2011), as well as UNCTAD (2014) argue that positive social and political attitudes in developing economies are improving the environment and creating opportunities for cross-border mergers and acquisitions, which are an important conduit for foreign direct investment flows. The UNCTAD (2014) write that "M&As can bring significant benefits to host countries in terms of transfers of capital, technology and know-how and, especially, increased potential for follow-up investments and business expansion […] But M&As can also bring costs, such as a potential downgrading of local capabilities, a weakening of competition or a reduction in employment". M&As are usually facing a hard time during periods of economic downturn as politicians are likely to convince voters that the world is a "us versus them" paradigm, where other countries and nations are guilty for creating the crisis and they must be defeated in order for the situation to improve (Huffman, Vernoy and Williams, 1991). This has been observed since 2009 as well, both during the recessionary period and the consequent years of slow economic growth and stagnation – even developed economies have become slightly more hostile to foreign mergers and acquisitions as political rhetoric that natural resources and "strategic" (whatever that means) sectors must be protected from foreign influence (Apps, 2009; Beattie, 2011). This phenomenon has been especially pronounced in sectors such as energy, mining and telecommunications, which peoples are more likely to perceived as important for national security (ECB, 2013; Blas, 2011; Kee, Neagu, Nicita, 2010; The Economist, 2012).

Currency exchange rates are also likely to have a significant impact on foreign direct investment flows (Schiller, 1997). This factor is relatively "hard", meaning that it can be accurately analyzed and quantified, as well as managed directly by policymakers. One of the ways that currency influences FDI is that when home country's currency depreciates versus the (potential) host country's coin, assets in the first become cheaper for investors in the latter (Schiller, 1997; Georgiadis and Grab, 2013). However, this logic cannot be stretched to the extreme or at least reviewed through unidimensional lens – if the host country's currency continues to depreciate, this might be an indicator for notable economic disturbance and ultimately discourage foreign direct investors, especially ones that hope to sell products and services at the host country's market (and thus rely on the host nation's purchasing power) (Pugel, 2004).

These fluctuations in the currency exchange rates are often the cause for the phenomenon that developing economies undergoing crisis, but closing on resolving their most critical problems often receive in this moment substantial foreign direct investment stock (Georgiadis and Grab, 2013). For example, some of Bulgaria's most successful cross-border M&As and privatization deals were realized shortly after the devastating hyperinflation of 1996-1997, after the country had managed to stabilize the money supply and had struck a partnership with the IMF, starting an ambitious pro-market reform program. Foreign investors noticed that the extremely weak local currency has

devalued local assets, but the country has undertaken a prospective reformist course of action, which will lead it on a path of economic growth – something that had indeed happened in reality as Bulgaria doubled and tripled the average growth rate for the European Union between 1997 and 2008.

4. CONCLUSION

The dependency on the natural resources rents may be stemming from the fact that in countries where the legislation is specifically designed to accommodate foreign capital it would be reasonable to assume that legislation governing the natural resources renting by the government should be less strict and prohibiting, inducing further investments. As far as fixed telephone subscription is concerned, the relationship might as well be a result of a statistical obscurity.

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