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## FOREIGN DIRECT INVESTMENT ANALYSIS OF THE SOUTH EASTERN AND CENTRAL EUROPE

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**Abstract:** FDI in the European transition economies in its most current report on the transition economies, EBRD 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. 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.

**Keywords:** foreign direct investment, analysis, South eastern Europe, Central Europe

### 1. INTRODUCTION

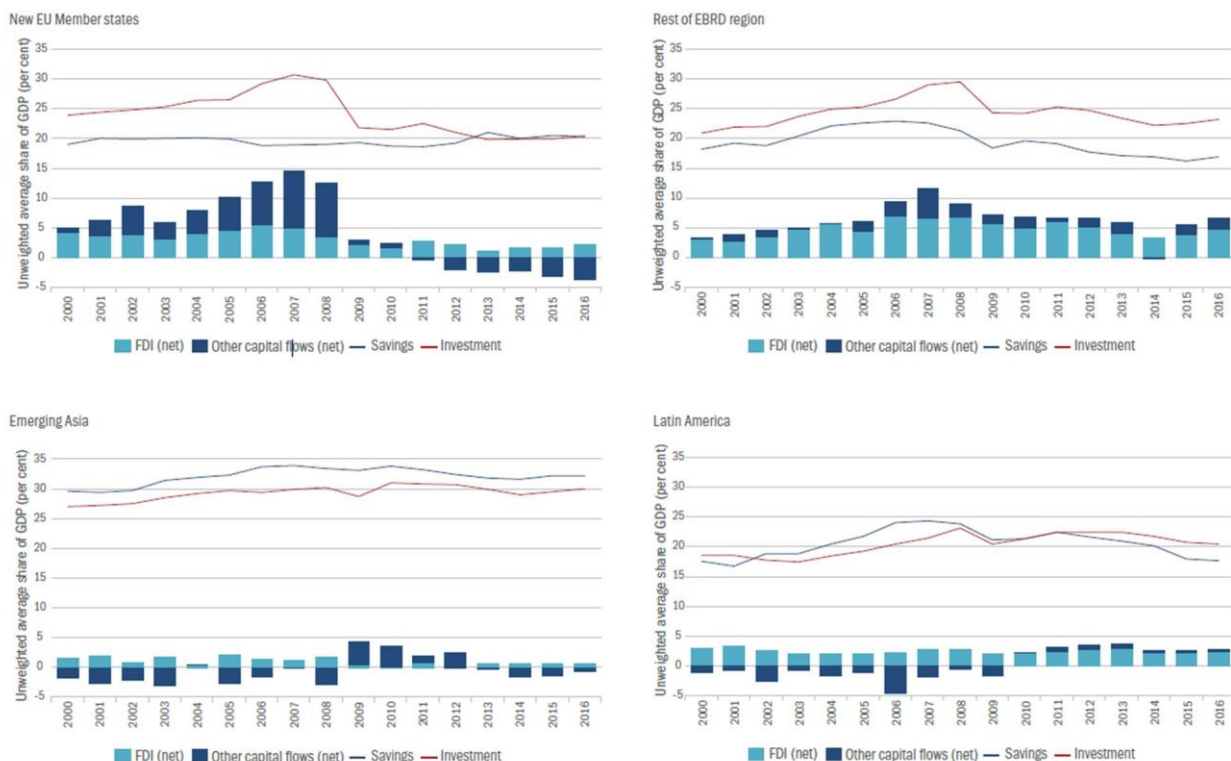
Yet, in order for FDI to be syphoned in these economies in transition, foreign investors needed assurance that the funds will be transferred safely and their acquired shares and property will be adequately protected. EBRD (2015) argues that the privatization of formerly state-owned banks and their consequent foreign ownership had served an extremely valuable role in providing such assurances and access to capital, but also added certain new vulnerabilities.

### 2. ANALYSIS OF THE FDI IN THE EUROPEAN TRANSITION ECONOMIES

Increased foreign ownership of banks played a very important role, both as a form of FDI in the financial services sector and as a channel for the financing of investment. Foreign banks' access to parent funding improved the availability of credit in the host economies and helped to reduce the adverse impact of local financial shocks, including the impact of the Russian crisis of 1998. However, this then increased the vulnerabilities that are associated with having a higher percentage of debt denominated in or indexed to a foreign currency. With FDI inflows reaching significant levels that even exceeded 30% of GDP on annual basis (in Bulgaria, for example), economic growth in the transition economies soared above the EU average. This came to a halt in 2008-2009, when the global financial contagion impacted the developed countries in the EU and their investors cut back on FDI projects in the transition states (EBRD, 2015). While the financial sectors in the transition economies turned out to be relatively more stable than in their developed counterparts (largely due to the reason that government fiscal and monetary stimuli for the housing sectors were substantially weaker in developing compared to developed economies), they also plunged into recessions (EBRD, 2015). Foreign direct investment declined sharply and even though foreign banks did not withdraw from the region, a credit crunch situation emerged, suppressing investment (EBRD, 2015):

Investment in the transition region has stood at close to 20 per cent of GDP since 2008 – a modest figure for middle-income economies. The fall in the rate of investment has been particularly sharp in the new EU member states,

which were more reliant on cross-border capital flows from the EU-15 economies for the financing of investment prior to the crisis (as well as being the countries where the credit crunch has been most pronounced). However, a broadly similar pattern has been observed in the rest of the region as well. At the same time, the increase in domestic savings (calculated as the sum of household savings, corporate savings and government savings) in emerging Europe has been very limited. Marked increases in domestic savings rates have mostly been limited to economies where levels of domestic savings before the crisis were particularly low – such as the single digit figures observed in Bulgaria and Lithuania.



The inability to reinvigorate foreign direct investment as a drive of economic growth has been primarily a result of low quality institutions (EBRD, 2015). The EBRD (2015) cites the World Bank’s governance and control of corruption indicators, which are rather unfavourable in the transition economies. The EBRD (2015) conducts a statistical research, in which a correlation between the quality of institutions in both home and host countries is found:

The results suggest that the quality of institutions in the country of origin does indeed matter. If a country of origin has relatively strong institutions (for example, a score of 0.5, as in the case of Poland or South Korea), a 1-standard-deviation improvement in the destination country’s control of corruption leads to an increase of around 30 per cent in bilateral investment flows. If a source country’s control of corruption is relatively weak (for example, a score of -0.5, as in the case of China or Russia), a 1- standard-deviation improvement in the destination country’s control of corruption leads to an increase of only around 15 per cent.

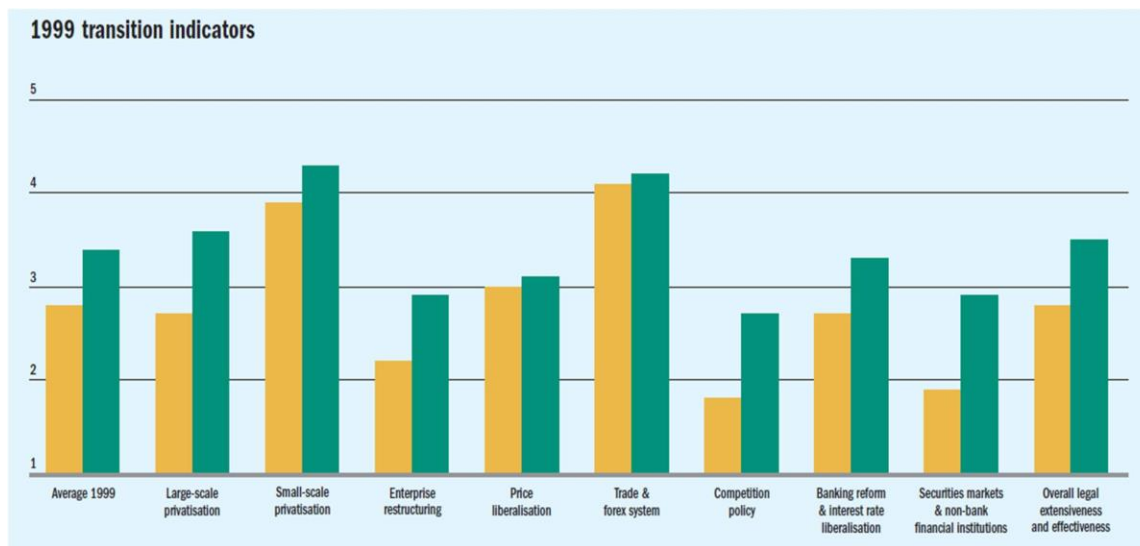
In fact, the EBRD (2012) report indicated that the inflows of foreign direct investment had been to a large extent caused by the economic conditions in the source country, rather than the economic conditions or other factors in the recipient state. In other words, as returns on bonds in the developed economies declined throughout the 2000s (owing to monetary policy, as well) and investment opportunities were massively exploited, many investors turned their eye towards developing and transition economies.

In other words, institutional improvements help attract more investment from countries with better institutions, while investment from countries with weak institutions may be unaffected or increase only slightly (EBRD, 2015). As transition economies rely on foreign direct investment mainly from developed economies, the quality and pace of reform in their own institutions is extremely important. Logically, successful foreign direct investment management also has a positive impact on institutional reform as it improves business practices, corporate governance, bureaucracy and administration effectiveness, bank reform, regulatory oversight, etc. (EBRD, 2015). This was also

confirmed back in the EBRD 1999 transition report, where the bank claimed that “foreign direct investment can be a crucial catalyst in the transition, but is more likely to be directed to countries with a strong reform commitment” (EBRD, 1999). Yet, by that time, many transition countries had still struggled with establishing solid democratic regimes and functioning market economies. Remnants from the socialist economy and political regime functioned as obstacles to reform – sometimes even willingly and purposefully (for example, the Bulgarian former socialist security agents re-organized quickly and even managed to win the first democratic elections). This had a profoundly negative impact on the ability to attract foreign direct investment that ran counter to the substantial potential to do so. The EBRD (1999) explicitly highlighted this: ...per capita foreign direct investment (FDI) inflows have been consistently lower in south-eastern Europe than in the more advanced transition economies in central Europe. Although the economic potential of the region continues to be significant, countries have differed in their willingness and ability to unlock this potential through structural and institutional reforms. The limited FDI inflows into south-eastern Europe compared with the more advanced countries of central Europe are due to fewer privatisation-related opportunities and a relatively less favourable investment climate. Throughout south-eastern Europe, the quality of the investment climate – especially relating to corruption and the public administration – registers in the bottom half of the economies in transition.

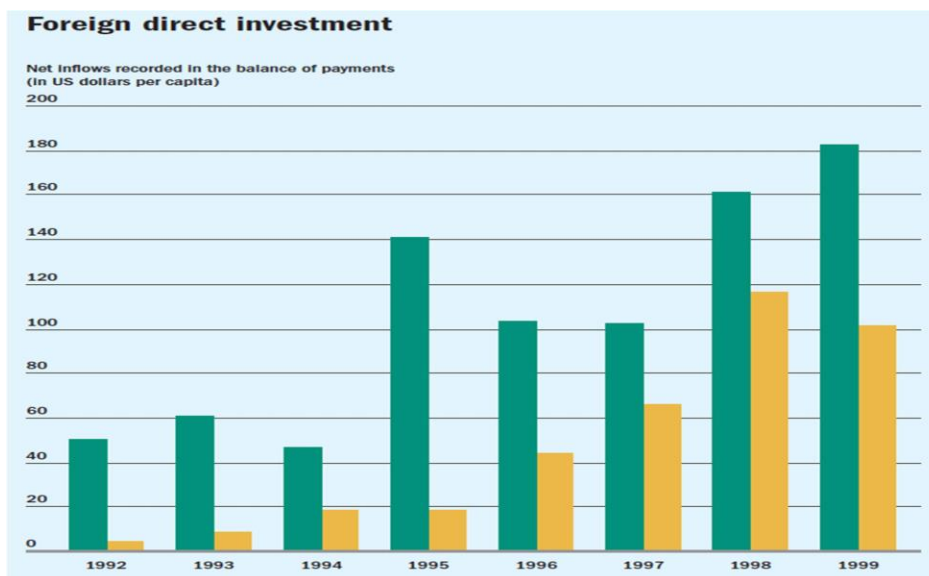
Favouritism that was inherited from the socialist regime persisted and foreign investors have been way and cautious because of a perception of cronyism and unpredictability in public policy in the transition economies (EBRD, 1999). These negative trends were further reinforced by the critically inexperienced central bank officials in this part of the world that handled clumsily monetary policy, often to disastrous results. This incompetence (hypothetically augmented with corruption in some cases) caused periods of hyperinflation in almost every transition economy during the 1990s. The hyperinflation in turned wiped out the little savings that were left after the fall of the socialist regime and were accrued in the early 1990s, dramatically decreased local purchasing power and destabilized public and private finances. While assets denominated in local currency became extremely cheap as well, foreign investors with less experience in managing portfolios in and entering developing economies were generally put off by these events (EBRD, 1999).

Interestingly, there had been also a divergence in the pace of reforms in transition economies that are closer and in Central Europe and the transition economies that are located in South-eastern Europe. The following graph clearly illustrates this, where orange is Southeastern Europe and green is Central Europe (EBRD, 1999):



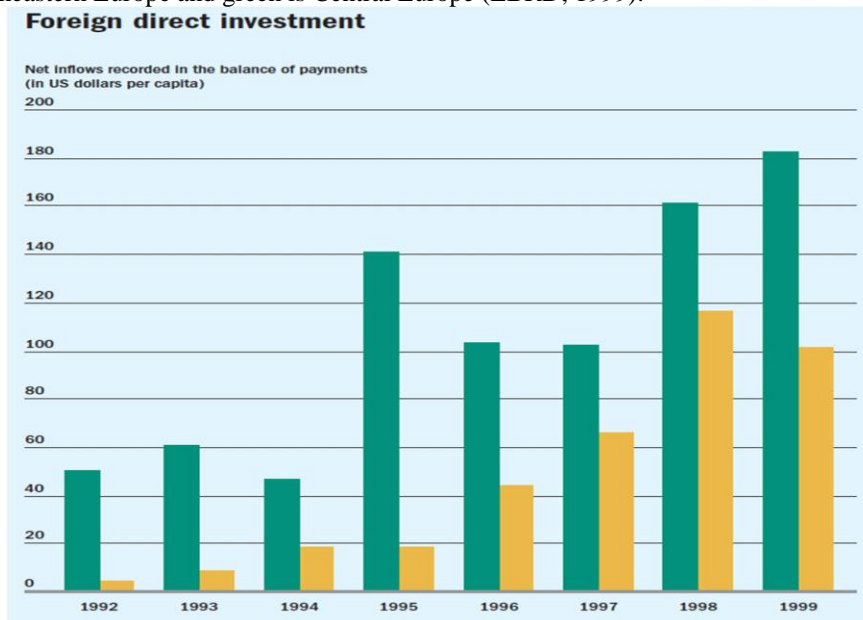
There is virtually not a single reform indicators that shows better performance in South-eastern European transition economies compared to their Central European ones. The difference is especially dramatic in enterprise restructuring, competition policy, banking reform and interest rate liberalization, securities markets and non-bank financial institutions. Some of these lagged reforms had been also causes for the triggering of hyperinflation of these countries. For example, the deliberately delayed restructuring and privatization of large state-owned enterprises in Bulgaria was fundamental in causing a consequent bank sector collapse and hyperinflation – politicians arranged these state-owned enterprises to be fully serviced by cronyist private companies and fully financed by state-owned banks. The gigantic non-performing loans that were a result of this scheme had been in turn chronically refinanced through the Bulgarian National Bank (the central bank) by freshly printed money. Ultimately, inflation started to

surge and lack of experience and competence in both the Ministry of Finance and the BNB caused a disastrous period of hyperinflation and bank collapse. These trends influenced significantly the flows of foreign direct investment, as shown by the following graph, where orange is Southeastern Europe and green is Central Europe (EBRD, 1999):



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Evidently, transition economies in Central Europe that implemented reforms faster and more effectively achieved higher foreign direct investment per capita flows, especially in the early 1990s. Ironically, transition economies in South-eastern Europe started to catch up in the late 1990s, when these countries endured a chain of dramatic hyperinflation periods that discredited the former socialist parties and left politicians with no choice but to implement pro-market and pro-private property reforms (often under the guidance of the International Monetary Fund and the World Bank).

### **3. THE BAD INVESTMENT CLIMATE**

The poor investment climate in many transition countries, especially in the CIS and south-eastern Europe, has inhibited the entry of new private firms (including FDI) and the expansion of small and medium-sized enterprises (SMEs). This has affected industrial restructuring in several ways. It has meant fewer outside opportunities for workers in declining industrial firms, making lay-offs socially more problematic. It has also weakened the degree of competition in the economy, reducing the incentive for existing firms to innovate and restructure. Lastly, it has deprived some large industrial firms of a solid base of efficient suppliers and distributors. This is especially true in the CIS, where SMEs continue to play a relatively minor role in industry. The above-stated implies certain conclusions concerning social policy that may not be a focus of this dissertation, but would be wise to highlight in the framework of this debate. Foreign direct investment has been traditionally viewed by the leftist parties in this region as somewhat dangerous for social stability, policy and economic prosperity, arguing that they cause unemployment (as foreign investors often liquidate outdated assets and restructure employment) and channel foreign influence in the country. However, both experience and economic theory proved the contrary – foreign direct investment boosts economic growth, increases general employment, channels good business practices and even bolsters corporate social responsibility practices that had been virtually non-existent in post-socialist economies (Parkin, 2015).

In fact, even the earliest EBRD reports noted that capital flows in the transition economies will have a substantial impact on economic growth and institutional reform, albeit this had not been a popular view in the nations themselves (EBRD, 1998). Having more experience in managing the transition and development of poorer economies, the economists in multinational institutions were convinced that foreign capital can “benefit the transition process by helping to fill the savings-investment gap that has characterized the transition, by lowering financing costs, and by setting standards, tightening financial discipline and raising the intensity of competition” (EBRD, 1998). In fact, the real risks that accompany solid foreign direct investment flows are far from what had been speculated with (as mentioned above). Substantial and rapid exposure to foreign direct investment may make the economy too dependent on these flows and thus increase its vulnerability to global macroeconomic shocks (EBRD, 1998). This risk is of greater magnitude for host economies that have not managed to establish solid foundations for macroeconomic and financial stability. In other words, an open economy that is prone to financial instability and receives substantial capital inflows may collapse if (or once) these FDI inflows cease abruptly (EBRD, 1998).

It is also important to note that the integration of transition countries to the international capital markets is a rather recent phenomenon, albeit they had been issuing debt to foreign holders during their socialist period (in fact, even the reclusive North Korea had done so). The integration into the global capital markets in the mid 1990s gave substantial boost to capital inflows and foreign direct investment. The EBRD (1998) noted that: ...by the end of 1998 on current projections, three-quarters of all private capital will have entered the region during 1996-98.

Foreign direct investment (FDI), responsible for a third of private capital inflows in 1997, has advanced gradually throughout the decade in line with the region’s transition profile. Other flows of finance, especially short-term forms, have seemingly tried to catch up with the reform process and have grown exponentially during 1996 and 1997. The slowly developed capital markets and unreformed banking systems meant that while investment opportunities had been plentiful, the cost of financing had been very high (EBRD, 1998).

Furthermore, while the physical and human capital stock in European transition economies had been relatively high compared to other developing countries, the centrally planned economy had allocated it inefficiently and even often absurdly (for example, Bulgaria had constructed one gigantic metallurgy and one gigantic chemical factory without disposing any of the necessary natural resources).

However, as mentioned above, structural reforms in different countries differed in pace and depth. The EBRD (1998) noted that privatization policies had had a profound impact on the ability of these economies in transition to attract foreign direct investment. For example, the Hungarian cash-based privatization program was responsible for most of the FDI inflows shortly after the change of political regime and in the period 1993-1995, privatization proceeds in Hungary accounted for 85% of foreign direct investment inflows (EBRD, 1998).

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