

THE SUSTAINABILITY OF FOREIGN DIRECT INVESTMENTS IN CENTRAL AND EASTERN EUROPEAN COUNTRIES

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ABSTRACT: Since the middle of the 1990s, advanced Central and Eastern Europe countries (CEECs) have attracted a considerable amount of foreign direct investment, primarily by multinational enterprises. The main advantage of CEECs countries was the low labour cost.

In the recent period of transition, the CEECs experienced erosion of some of their main location factors, the first of which being an increase in labour costs. As a consequence, FDI have been affected, because the investor are interested in obtaining the best price for the labor force. How can government intervention help attract FDI? Can FDI become sustainable?

KEY WORDS: sustainability, foreign direct investment, transition, GDP

1. FOREIGN DIRECT INVESTMENT FOR COUNTRIES IN TRANSITION

The transition period began in 1989 in most of the central European countries, as a consequence of the collapse of communist hegemony in the region. (Saul Estrin, 1997). In the previous years, economic progress in the socialist bloc had been at unusually low levels, and development was significantly below that of most western European countries. The countries in Central and Eastern Europe were rather different in certain key aspects. Some of them had high inflation, others had substantial international debt. Most of them were relatively open and exposed to a difficult trade shock when the communist trading block – CMEA - disintegrated.

Before 1989, the economies of the CEECs countries were integrated into the CMEA trading group, and that is why they failed to reveal national comparative advantages. Few consumer goods were made, and those were not produced to a standard that could satisfy, for example, the Western European countries. In generally, firms managed by engineers and, one way or another, every enterprise, were state owned. In most of the cases, the enterprises were quite large, while banking and service sectors were totally absent. In those years, “good” managers were those able to secure scarce inputs of raw materials, labor and capital so as to meet the exacting production targets every year, regardless of the production cost and quality. During the 1990s, because of the low investment in the region, the equipment of the enterprises was quite old and inefficient.

In order to change the production and consumption in the Western Europe’s direction, the CEE countries had to be restructured in various fields, from heavy to light industry, from industry and agriculture to finance and service, etc. As mentioned above, generally, enterprises were quite large, so as to achieve a real market economy; like in the western countries, the first step was to found numerous small firms in all economic sectors. In order to reduce energy and labor, new firms should have used new product lines and new production methods in accordance to environmental terms,. One of the most significant changes was that the firms should not be driven by supply, but by demand.

Transition has facilitated some significant components, which were identified to be the macroeconomic stabilization,

liberalization of the national economy and trade, privatization and establishing legal institutional structures. For a few part of the Eastern European Countries, the progress in some of these fields is notable in the first years of transition, and is summarized in the table below.

Table 1. Progress in privatization: share of GDP in the private sector

	1990 (per cent)	1995 (per cent)
Czech Republic	5	70
Hungary	19	60
Poland	27	58
Slovakia	6	59
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Source: World Bank

Liberalization and privatization stimulated changes at the macroeconomic level. In principle, the former provides the signals and information from the marketplace about the consumer desire, while the latter gives managers the incentives to pursue profitable restructuring. (Saul Estrin, 1997) For example, in Hungary, Poland, or the Czech Republic, the liberalization of both domestic and international markets was remarkably successful.

A brief survey of the Western literature on corporate governance revealed that outsider ownership, either through a capital market on Anglo-Saxon lines, or a Germanic system, would be preferred to the majority insider ownership. In general, this is true when significant enterprise restructuring is necessary, because insiders would not bring additional funds and expertise. It is crucial to emphasize the fact that involvement of foreign owners in the post-communist countries, as a source of outsider ownership, could be a tremendously valuable feature of the transition process.

Which are the motivational factors to invest in countries in transition? Western firms explain that the market size and expected growth are the most important determinants of investing in a region, but also the economic and politic stability is vital. Marton (Marton, 1993) discovered that in Hungary, for

example, one of the first steps was learning about the local environment and market, in order to be prepared for later opportunities. The low costs are another decisive factor that motivates firms to invest in CEECs countries.

Obviously, if there are advantages to invest in this region, there are also disadvantages. Here, we can mention the risk and the uncertainty, as well as the poor legal framework and weak infrastructure. Meyer (Meyer, 1995) also suggests that foreign investment is inhibited because investors cannot find suitable partners and suppliers able to provide inputs and services at the required quality level.

2. GOVERNMENT POLICY TOWARDS FDI

According to Christian Bellak and Markus Leibrecht (Bellak, 2007), governmental policies may be divided into regulatory and interventionist. Regulatory policies include the provision of public goods (as it would be the property rights). What is in fact the role of these policies? Regulatory policies can be considered a necessity to attract FDI, and of course to make them sustainable. The frequent changes came into effect in the categories concerning promotional measures, sectoral liberalization, and protection of property rights.

In contrast to regulatory policies, the economic justification of interventionist policies towards FDI is disputed. In this case, government intervention is justified if market fails, or undesirable distributional results occur. As a result, here are the four impacts of FDI on the host economy (Ekholm, 2002):

- Rents accruing to the host country (eg. lower unemployment)
- Competition effects at the industry level
- Effects on host county firms
- The impact on growth and restructuring.

Government may intervene in the market process by providing monetary incentives or by providing location factors where the markets do not provide this kind of factors. Also, government may also intervene if market forces lead to an undesirable regional distribution of FDI and hence to an undesirable regional distribution of jobs, income and wealth. (Bellak, 2007)

Rothsein (Rothsein, 2005) goes even further and separates interventionist policies into reactive and proactive. The reactive ones include measures to strengthen the existing locational advantage, for instance R&D incentives to promote product or process innovation, training of employees, creation of new education facilities. Pro-active policies include measures targeting new industries, generating new locational advantages, or attracting resources to new fields.

Empirical evidence shows that government action is not always successful. Furthermore, in some cases, governments intervene in the absence of market failure, or fail to act in the event of market failure. In general, the desirability of government action is linked to the government's ability. So, the government failure should be taken into consideration. Some reasons for government failure would be the fact that governments have limited information; they also have limited control over private market responses and the fact that legislation has limited control over the bureaucracy. FDI would have no positive external effect on the host economy – this is why any evaluation of policies towards FDI needs to include possible government failure. (Bellak, 2007)

In this case, interventionist policies towards FDI should avoid government failure.

3. SUSTAINABLE FDI

In our research, we did not find any clear definition of sustainable FDI. Anyway, we share Bellak's opinion (2007) that an investment is considered sustainable if it stays in a certain location in the long term, either because the location strategy of the multinational enterprises (MNE) for the exploitation of its ownership advantages changes, or the location policy of the government changes, or both. One of the essential requirements for FDI to be sustainable is that locational needs of MNEs are matched by the public services provided.

If a government wants to develop a strategy so that the FDI can become more sustainable, they first need to understand why enterprises choose a specific location. MNEs are considered to locate in a given place for different reasons, and here we can reveal proximity to market, proximity to other firms, industrial concentration and fragmentation. Of course, over time some of these factors may change.

The relative importance of each location varies, depending on which of their closely defined activities MNEs locate in the host country (Bellak, 2005). For example, customers are a relevant location factor for banks investing in the CEECs countries if the purpose of the FDI is to gain market share.

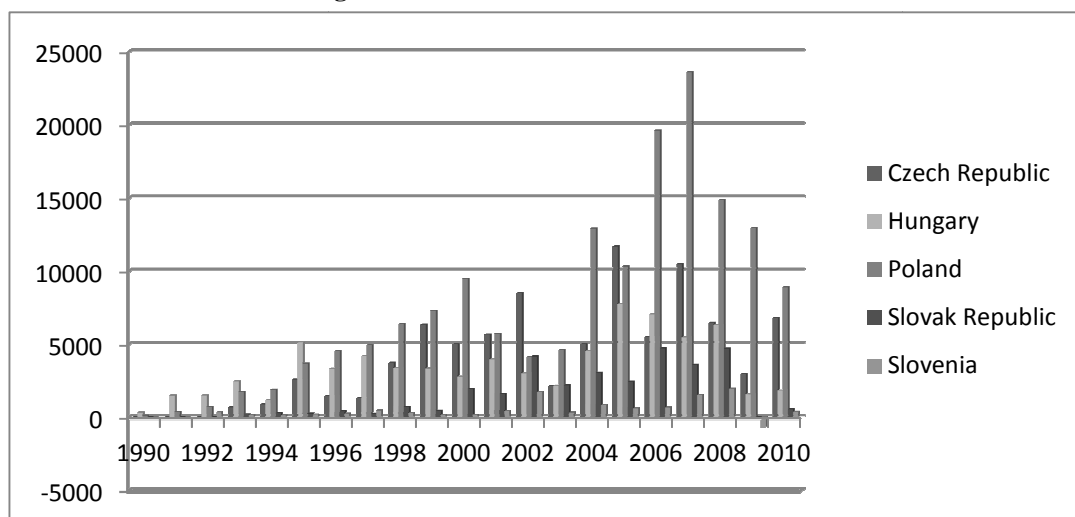
In Jakub Mikulasek's opinion (Mikulasek, 2007), in order to attract sustainable investment, it is necessary that FDI has to follow five steps. The first step and the most notable is to target the right partners or potential investors. After this, the second step is to develop and innovate your product at the macro level, at the micro level, and at the institutional level; in order for all these efforts to be successful, it is necessary that FDI cooperate with all the ministries. The third step is to be flexible, and to be able to change the strategy and the tools used. The next step is not to neglect "relationship marketing," that means to keep supporting the existing investors, continue to work with them and try to upgrade their investment in one's country. The last step is to integrate the positive effects of FDI and of the foreign investors in the local economy. We believe that this is exactly what has happened in Romania, and it is still happening in the CEECs countries after 1990.

4. CASE STUDY - THE RELATIONSHIP BETWEEN GDP AND FDI IN CEECS COUNTRIES

In order to establish the existing relationship between GDP and FDI in CEECs countries, we have used the OECD databases for 20 years, from 1990 to 2010. It is essential to mention that we considered the CEECs countries: the Czech Republic, Hungary, the Slovak Republic, Poland, and Slovenia.

In order to obtain relevant results, we have used SAS programme. We tried to find the linear regression equation that has the following form: $y=a+bx$ At first, we need to reveal the FDI evolution and the GDP evolution in the CEECs countries after 1990.

Figure 1. FDI evolution in CEECs countries

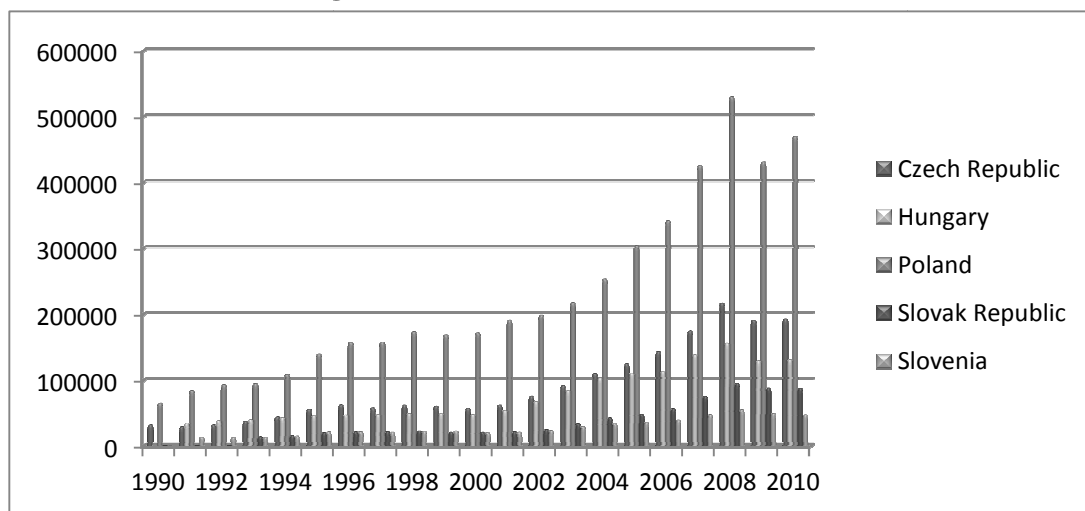


Source: Author's compilation based on OECD databases, www.oecd.org.

We can see from the figure that after 1990 FDI highly increased in most of CEECs countries (after 1990). The most "attractive" countries for investments were Poland and the Czech Republic, which in 2007 reached their highest point in

foreign investments. Although the other countries were not as successful as these two, we can see some improvements in their FDI.

Figure 2. GDP evolution in CEECs countries.



Source: Author's compilation based on OECD databases, www.oecd.org

The figure reveals that GDP, just like FDI, increased in most countries after 1990; the highest increase was also remarked in Poland and the Czech Republic. Having identified this, we wanted to know if there is any relationship between the FDI rise and GDP increase.

First of all, we wanted to see which looked for the impact of FDI upon GDP in every country. After using the programme, we revealed the following:

Table 2. The regression equation in CEECs countries.

	GDP	FDI	a	b	probability
CZ	25.267,41	1000	7088,41	18,17	0,0016
HU	100.749,86	1.000	83.652,00	17,10	0,01
PO	21.619,81	1.000	11.199,00	10,42	0,04
SK	30.976,03	1.000	17.221,00	13,76	0,03
SL	21.036.701,00	1.000	21.023.961,00	12,74	0,03
OECD	8.403.735,34	1.000	8.397.217,00	6,52	0,18
EU	4.704,16	1.000	4.862,81	-0,159	0,15

Source: Results obtained by authors in SAS programme.

• The Czech Republic - If FDI increase with 1000 u.m, than GDP increases with 18.170 u.m, so taking into consideration

also the given probability, we may assume that, for this country, the FDI have a very high impact on GDP.

- Hungary – If FDI increase with 1000 u.m, than GDP increases with 17.100 u.m, so we can conclude that for Hungary FDI had also a high impact on GDP.
- Poland – If FDI increase with 1000 u.m, than GDP increases with 10.420 u.m, so in Poland FDI have also an important impact on GDP.
- The Slovak Republic – the same situation occurs: if FDI increases with 1000 u.m, than GDP increases with 13.760 u.m.
- Slovenia – Also, the same situation: if FDI increases with 1000 u.m, than GDP increases with 12.740 u.m.

Having found this, we may conclude that for CEECs countries, FDI are very serious, and they actually have a significant impact upon GDP from every country.

For a better understanding of the existing situation in the CEECs countries, we thought that it would be interesting to solve the same equation for the OECD countries and for the European Union.

After doing this, we realized that in EU27, FDI have not at all the same impact on GDP as in the CEECs countries. Moreover, if FDI in EU27 increase with 1000 u.m, than GDP decreases with 159 u.m. This might happen because some of the investments are unprofitable, and also because not all the countries in the EU27 have the same development level. E.g.: it would be inappropriate to compare Germany with Greece.

By contrary, having analyzed the OECD countries, we note that if FDI increase with 1000 u.m, than GDP increases with 6520 u.m.

5. CONCLUSIONS

In this paper, we firstly pointed out what the “landscape” of FDI looks like for countries in transition. We have shown that even from the first five years of transition, 1990-1995 steps forward in privatization and liberalization were made. The next step was to explain what sustainable FDI means, and how FDI can be made sustainable by government intervention. FDI sustainability requires a match between location factors and value-added activities. Pro-active and reactive policies are needed to achieve FDI sustainability. Pro-active policies are geared to attract FDI, and therefore they affect sustainability, while reactive policies aim at making FDI more sustainable through distinct policy channels. It is necessary to mention that CEECs countries pursue a policy mix to attract FDI by providing general location factors like tariff reduction, capital

flow liberalization, creating incentives, and improving climate through infrastructure investment.

As a case study, we have discussed about the relationship between FDI and GDP in CEECs countries, and we have shown that they are strongly dependent. This means that CEECs countries should try to keep attracting investments in order to increase the life standard and in order to achieve almost the same development as the Western European countries.

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