FOREIGN DIRECT INVESTMENTS – CATALYST FOR ECONOMIC GROWTH IN CENTRAL AND EASTERN EUROPE

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Abstract:
Nobody can dispute the principle according to which, given an increased liberalization process, the capital will shift from the places in which it is excessive to places in which it is needed, in other words places in which it is granted a higher rate of return. Reducing the obstacles that lie in front of the investment flows has, as expected, generated an increase in the foreign investments' shifting speed. A contiguous problem that arises in this context is about their impact and effects on the investing companies, as well as on the host countries.
In a broader view, it can be considered that all these effects have a positive impact on the global activity, a growing number of firms finding themselves in the situation of carrying out operations in more than one national jurisdiction. From all of them, the biggest transnational companies (approximately 300) control more than 70% of the total foreign direct investments and, approximately, a quarter of the existing assets from all over the world.

Keywords: foreign direct investments, economic growth, Central and Eastern Europe

JEL Classification: E22, F21, O49, O52

INTRODUCTION

Transnational companies' activity and foreign investment flows are highly related to the microeconomic restructuring process in the host countries, in a sense that foreign direct investments have the ability to substitute a certain industrial policy, through the selection of the firms with the highest growth potential. Restructuring and changing the local companies' behavior have the tendency to happen very quickly, despite some factors that tend to put a break to this process, i.e. inadequate infrastructure and commercial channels, local firms' organizational problems, unclear legal framework, legislative instability, bureaucracy.

The microeconomic restructuring process generally focuses on several aspects, from which the most important refers to perfecting management methods in the field of labour organization, special divisions' development, accounting system, cost and quality control (Hanson, 2001).

On the other hand, foreign direct investments are seen as a true improvement feature of the local firms' competitiveness (Konings, 2001). The foreign capital flow directly influences the new branch's or new bought firm's performances, through technological and know-how transfers, thus resulting in more competitive firms on the national, as well as international market. Indirectly, the foreign direct investments have an effect on the local firms' performances through the created externalities, therefore being privileged those firms that have direct business relations with the foreign investors, or that are the latter's clients or suppliers.

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All the evolutions induced by the foreign direct investment flows at the receiving countries' level, generally show the existence of their direct relationship and contribution to the economic growth through four different channels: capital accumulation, technology transfer, access to the global market and job creation. Therefore, foreign direct investments constitute a further source of financing for property exchange and gross capital formation, directly contributing to capital

formation if the flows relate to investment financing or, indirectly, if investors, that became owners, facilitate technology transfer. On the other hand, foreign direct investments and, especially those in advanced sectors, induce more important shifts at the level of industrial specialization in the host countries, from traditional to more advanced sectors, which can only be of benefit for a country's development. Foreign direct investment flows further facilitate a larger access to the global market, due to the partnership between the direct investor on the foreign market. Furthermore, new company creation through foreign direct investments increases the job creation process.

Although there is a relationship between foreign direct investments and economic growth cannot be doubted, the complexity of the adjacent interactions raises a series of essential questions: Do foreign direct investments play a catalyst role or not? Can there be some "malign" effects of the foreign direct investments? By which factors is the foreign direct investments' contribution at a sustained growth process conditioned?

Regarding the foreign direct investments' role as a catalyst, this is not unanimously accepted, as there are some approaches that state that foreign direct investments do not significantly induce economic growth in the host countries *(Edwards, 2001*). The "malign" model for foreign direct investments is substantiated on the imperfect national and international markets' interaction. More precisely, foreign investors from international imperfect industrial markets, which benefit from a preferential access to the local capital and money markets, can obtain both benefits and capitals in such a way that the effect on savings and investments is at least unexpected: the gap is not surpassed but, on the contrary is amplified. The "malign" model of foreign direct investment flows also implies the bankruptcy of local producers, the extension of transnational companies' power on the local market and, repatriated profits. The impact on income distribution and social development is neither beneficial. Intensive technology brought by foreign investors, favours the "elite" of the work force, while the other workers are excluded, moreover if the labour market is rigid. On the other hand, the tight control of technological transfers, managerial competencies and exports, hinders the accomplishment of positive externalities in the host countries *(Nunenkamp/Spatz, 2003)*.

Given all these aspects, the only factors that could transform foreign direct investments in a source of economic growth, relate to the host country's characteristics, the most important feature being the adequate development of the economic sector. The host country's specific features, that consolidate the relationship foreign direct investments-economic growth, are usually grouped, under the sintagm "power of absorbtion" (*Carkovic/Ross, 2002).* First, as the economies have more human capital and a sufficiently high GDP per capita, they also have ability to obtain benefits from the technological transfer initiated by the foreign branches to the national companies. Second, if the host economies become more open to the international trade, then the imports of intermediary goods is less restricted. Third, the institutional development level (the legal framework, the size of corruption, public management quality, protection of the property right) is a condition for the technology and know-how transfer to the subsidiaries. Last, the underdevelopment of the financial markets hinder host countries from taking advantage of all the advantages brought by the foreign direct investment flows.

In order to take advantage of the positive externalities, the national countries need resources in order to finance the reorganization of the internal structure, equipment acquisition, management development, and hiring qualified personnel. The absence of funds or their high costs hinder the development of the national firms, thus they become unable to face the international competition and to beneficiate from the foreign presence in their country.

Another aspect that must be considered related to the foreign direct investments -economic growth relationship, regards the nature of the flows. The different forms of the foreign direct investment flows, in the initial phase or at maturity, can have an asymmetric impact on the economic growth because of their nature and fundamental characteristics *(Wang/Sunny, 2005).*

On an exact example, if we were to compare the "Greenfield" investments with mergers and acquisitions, their diverse character can be emphasized starting from the fact that "Greenfield" investments involve the creation of new units, allowing for capital accumulation, while mergers and

acquisitions, that imply the acquisition or takeover of existent firms, do not always allow for such an accumulation, but only in the case in which it is stipulated in the contract, or the sums allocated are spend in this direction. On the other hand, while acquisitions imply the closing of certain production lines or activities, or layoffs, "Greenfield" investments have an incontestable effect on the economy, because they create new production lines, new job opportunities, new consumers and new tax subjects. In what concerns the level of efficiency, the "Greenfield" foreign direct investments are much better ranked than acquisitions and mergers. Taking all these aspects into account, it could be recommended that, in order for the foreign direct investments to improve economic performances, the volume of the "Greenfield" investments surpasses the acquisition of the state owned control packs *(Hunya, 2002).*

Regarding the level of maturity of the investments, the ones that have reached maturity prove to be less volatile and capable to improve economic performances. As the foreign investment approaches the maturity phase in its life cycle, the less volatile it becomes and, there is a guaranteed long term effect on economic growth. Vice versa, the more close that the foreign investor is to the initial, opportunity exploring, phase, the more volatile it becomes and the economic growth is no longer guaranteed. So, the long term effect on foreign direct investments on economic performances of the host country depends on the volatility of the capital flows and, even more in the case of a weak financial sector and in the absence of connections of the foreign investor with the host country's economy.

Investors' motivations and the specifics of the sector in which they invest can induce asymmetric effects on economic growth *(Nunenkamp/Spatz, 2003)*. For example, "efficiency-seeking" foreign direct investments have a strong impact on economic growth because the technology and the know-how brought by investors can be internalized without any difficulties in the host country due to the reduced complexity. The investment itself creates important externalities on the local market, allowing for many export activities. Another category of investments, the "market-seeking" investments, are less favorable to development, despite their contribution to the level of production and spending. In fact, market oriented investments have the risk of eliminating the domestic competitors and of repatriation of huge profits, in the absence of exports.

The contribution of foreign direct investments to economic growth is also conditioned by the existence of a relationship between investment flows and technological gaps. In this direction one must distinguish between foreign direct investment flows that respond to technological gaps and the ones that either integrate in the company's global strategy, or respond to market attractiveness, or seek to compensate the disadvantage derived from commercial restrictions and the favouritism for national producers *(Carkovic/Ross, 2002).* Given these categories of flows, if for the first one it is expected to have a significant impact on economic growth, the others are less probable to have more than the medium profitability.

In the second half of the 90s, foreign direct investment flows have started becoming important capital flows for more and more countries in Eastern and Central Europe, allowing them to integrate in the world economy step by step. If, before 1990, foreign direct investments in these countries exceeded $1billion, in 1995 they reached a level of $14 billion and almost $70 billion in 2006 *(WID, 2007).* The percentage of the Central and Eastern European countries in the global foreign direct investment flows, increases from less than 1% before 1990 to 4% in 1995, which then decreased to 1,9% in 2000 and increased again starting 2001 (8,3% in 2006). The fluctuation can be explained through the growth of foreign direct investments between developed countries, until 2000, and their decline in 2001, in contrast with a relatively constant increase in the region. In Eastern and Central Europe, the average growth rate of the foreign direct investments, between 1986-2005, has exceeded 40% in most of the countries, like Bulgaria, Hungary, Romania and Slovenia *(WIR, 2007).*

ANALYSIS OF THE CORRELATION FOREIGN DIRECT INVESTMENTS – ECONOMIC GROWTH

As shown before, between foreign direct investments and economic growth there is a positive interdependence, as they influence each other, without being simultaneous. Given the evolution of this correlation it can be observed that the growth trend of the foreign direct investments, more prominent in the 90s, was accompanied by economic growth (table no. 1)

Table no. 1 The evolution of foreign direct investments and economic growth in Cen tral and Eastern European countryes between 1994-2006

	FDI flows ($ mil.)	Real GNP growth rate		FDI flows ($ mil.)	Real GNP growth rate
1994	6240	-8,02	2001	26.723,95	3,80
1995	14.721	-0,97	2002	31.145,84	4,65
1996	13.650	-0,60	2003	29.089,73	6,52
1997	18.285	2,33	2004	40.938,68	7,24
1998	22.284	-1,16	2005	55.657,45	7,40
1999	25.071	3,89	2006	53.532,76	6,79
2000	25.953	7,45			

Source: UNCTAD, World Investment Report, 2007

More precise, between 1994 and 1997, the interdependence between foreign inv estment flows and economic growth was more obvious in 1998, highlighting a breaking point, as the investment surplus did no longer lead to the acceleration of growth, but, on the contrary to its relaxation. In the region, economic growth was re-established in 1999, as the investments starting growing, reaching a maximum in 2000.

The year 2001 brought about a diminishing in foreign direct investment flows, accompanied by a slowdown of economic growth. Still, starting g 2002, we can observe certain stability in this correlation (a slight change in 2006), which defines more clearly this trend.

If we analyze this correlation for a more reduced group of countries (e.g. Romania, Bulgaria, Hungary and Slovenia) (1) there can be observed a series of evolutions and contrasting interactions (table no.2).

Table no. 2 Foreign direct investment and economic growth in Romania, Hungary, Bulgaria and Slovenia, between 1994-2005

	Romania		Bulgaria		Hungary		Slovenia	
	FDI flow	Real GDP growth rate	FDI flow	Real GDP growth rate	FDI flow	Real GDP growth rate	FDI flow	Real GDP growth rate
1994	342	4,57	105	2,86	1.143	2,96	129	4,95
1995	420	7,77	90	3,85	4.518	1,55	177	3,83
1996	264	4,52	108	-8,61	2.274	1,45	195	3,48
1997	1.215	-5,55	504	-4,84	2.166	4,75	375	4,70
1998	2.031	-4,33	537	4,73	2.037	5,09	249	3,57
1999	1.041	-0,67	807	2,99	1.977	4,39	180	5,58
2000	1.026	2.61	999	6,10	1.692	5,45	177	3,91
2001	1.157	6,18	813	4,78	3.936	4,10	370	2,67
2002	1.144	5,51	905	5,60	2.994	3,75	1.686	3,31
2003	2.213	5,33	2.097	4,99	2.162	3,20	337	2,51
2004	5.174	8,66	2.488	6,24	4.167	4,49	516	4,57
2005	6.483	9,77	3.862	6,5	7.619	4,5	496	4,65
2006	11.394	11,5	5.172	5,2	6.098	3,72	423	4,23

Source: *UNCTAD, World Investment Report, 2007; UNCTAD, National Accounts Main Aggregates Database, Statistics Division*

In Romania's case, the foreign direct investment flows appear to be very encouraging because of their contribution to economic growth in the last years, although in the transition period there have been some negati ve growth rates. A similar evolution can be observed in Bulgaria as well, while Hungary and Slovenia have a constant evolution, without extreme cases. Slovenia, with

average growth rates, was not a favourite destination for investors during the whole transition period, as well as in the last years.

Regarding the relationship foreign direct investment funds – economic growth, if in the case of Romania and Bulgaria a certain interaction is obvious, in Hungary, this correlation is less clear, while Slovenia appears to confirm the "malign model" of foreign direct investments.

The evolution of Hungary, regarding this correlation, can be explained by the fact that the foreign direct investments that have successively been accumulated until 1996, have been accompanied by market decreasing pace, while, between 1997 and 2001, the extraordinary growth to be sustained by the foreign direct investment accumulations until 1996. In other words, the effects of economic progress were not felt immediately, but with a few years lag, when the respective investments reached maturity.

The fact that the plus brought to the foreign direct investments, after 2002, tends to be accompanied by a new relaxation of growth, suggests a cyclical evolution. It is important to notice the fact that, in the case of Hungary, it cannot be identified a linear evolution, in which the accumulation of foreign direct investments immediately reflects an acceleration of economic growth (figure 1).

In what concerns the evolution of Slovenia, for the promoters sustaining the economic growth through foreign direct investments, it appears at least surprising. The periods in which growth and the reduction of foreign direct investment accumulation are accompanied by economic progress, or regress, were very short (1997, 2001, and 2002). Most frequently, we can observe an inverse interaction that appears to confirm the malign model of foreign direct investments (figure 2).

In the case of Romania, unlike the first years (1994-1996), when foreign direct investment accumulations were little significant and less correlated with economic progress, starting 1997, a stronger correlation between the two emerged.

The foreign direct investment accumulations have contributed, step by step, to the shift from negative to positive growth rates, with important leaps between 1998 and 2001. Even if 2002 has seen a decrease in this sense, the correlation foreign direct investments -economic growth, remained in the following years, close to the previously defined trend. In the future we could expect an acceleration of economic growth of 0,11% at a 1% growth of foreign direct investments (figure 3).

Given the negative growth rates until 1997 for Bulgaria, in only 2 years time period it reached a positive 5% growth rate, strongly sustained by the foreign direct investment accumulations, which, in this period have increased from 4% to10% in GDP. The following evolutions, with small variations (2001) have followed the same growth trend, a 1% growth in foreign direct investments leading to a 0,38% increase in economic growth (figure 4).

An explanation of the different evolutions is also related to the process of joining the European Union, Hungary and Slovenia belonging to the first wave of integration. One of the principles that lie at the basis of the European unification was that according to which the access to a large market will imply firm efficiency, in the sense of lower prices, competitivity and quality increase on the foreign markets.

Starting from this idea, the extension of the European Union to the Central and Eastern European Countries has created an adequate economic framework for newly integrated countries to interact with the old members of the union, especially through foreign direct investments, the specific competition, created through the market game and that has, at the basis, technical progress, innovation and research that create new products, new companies and industries, hence acting in the direction of economic growth.

Although the expansion of foreign direct investments in Central and Eastern Europe, starting from the end of the 90s, is obvious, its weight in the global flows, continues to remain little significant, and there are several explanations for the low performances in attracting new investment flows in the initial stages of the transition.

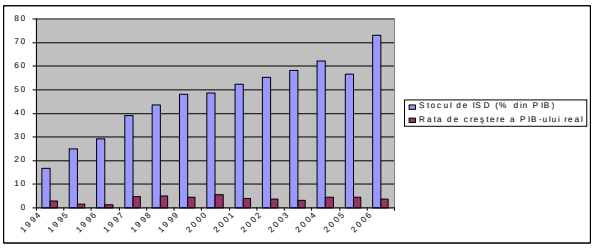

Figure 1. The FDI and economic growth in Hungary, 1994-2006

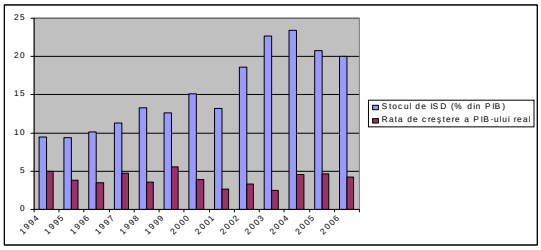

Figure 2. FDI and economic growth in Slovenia, 1994-2006

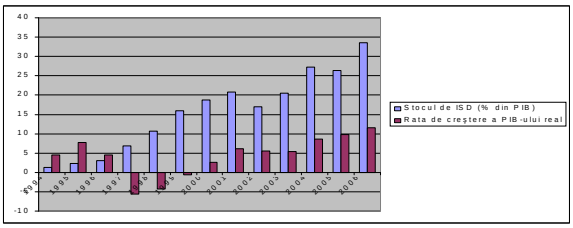

Figure 3. FDI and economic growth in România, 1994-2006

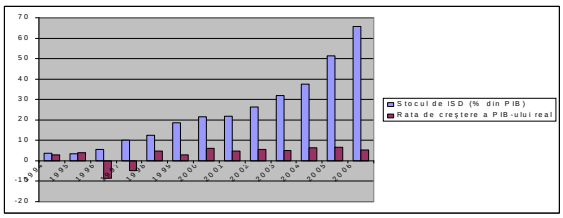

Figure. 4 FDI and economic growth in Bulgaria, 1994-2006

Source: *UNCTAD, World Investment Report, 2007; UNCTAD, National Accounts Main Aggregates Database, Statistics Division*

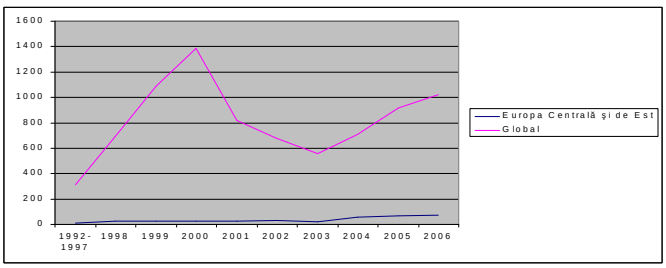

Figure. 5 FDI evolution at the global leveland Central and Eastern european countries 1992-2006 (miliarde de dolari)

CONCLUSIONS

First, the delays in the accumulation of significant foreign direct investments is explained through the dependency on the structures inherited from the socialist system (2), to w hich we can add the governmental actions oriented to the protection of domestic producers, in the wish to avoid the situations in which foreign investors put away the domestic companies or slow down their development (Ekholm, 2002).

Second, economic polic ies, not adapted to the new framework (frequent legislative changes, the lack of coherent economic strategies, economic and political instability), found in host countries, have driven away foreign investors.

Not last, the extreme situations, such as disi ntegration, war and ethnic conflicts, found in the case of former Yugoslavia, have had adverse and strong effects in what concerns the efficient resource allocation, wealth destroying, transformation and adaptation of institutions to a war economy, being, obviously negative signals for investors (3).

ENDNOTES

(1) The choice for this sample is justified by the fact that the four countries have a similar past, having experienced a centralized economy, however at different levels, with different natural re sources and different policies during transition. Moreover, we can distinguish between two pairs of countries: Hungary and Slovenia, on one hand and, Romania and Bulgaria, on the other hand, due to their belonging to the first and second wave of integratio n in the European Union. An interesting point to observe is given by the similarities and differences in performances and policies carried out in relation with the foreign direct investments.

(2) Because of teh rigidity of the systems that characterized a centralized economy, the shick associated to structural changes was huge and difficult to internalize (countries like Romania, Bulgaria and Albania have confronted

with significant problems , in the case of former Yugoslavia, the structural defficiencies were fewer, while the reestablishment of relations with Western Europe was more easy for Croatia and Hungary).

(3) The desintegration of teh former Yugoslavia, has meant a forced divisioning of the potential market in the eyes of the foreign investors. Generaly, in small host countries, the dimension of the market is not perceived in a positive way by the foreign investors.

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