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## Determinants of Foreign Direct Investment Inflows in Central and Eastern European Countries

**JEL Classification:** E22, F18, F23

**Keywords:** FDI, Central and Eastern Europe, EU, determinants

**Abstract:** *In the paper the author tries to analyse the value of foreign direct investments inflow into certain Central and Eastern Europe countries and to assess determinants which cause these countries to attract large value of the foreign direct investments. Twenty countries of the aforementioned region were analysed. Ten of them belong to the European Union including three belonging to the Eurozone. Additionally, the paper contains presentation of the most significant determinants of the foreign direct investments based on investors' motives. In order to achieve the aforementioned goal, the author reviewed the literature on the subject paying special attention to the issues in question, and she presented the results of the survey focused on the FDI determinants in the economies which are the subject of this paper. The paper also contains results of two surveys conducted by the author in 2006 and 2012 regarding motives of the entrepreneurs who make foreign direct investments in the territory of the EU countries. Review of the theory, analy-*

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*sis of general empirical observations and own surveys of the author prove that the size of a market, the possibility to maximize profits and discounts and privileges for investors are the most substantial internal and external factors which encourage entrepreneurs to invest on foreign markets. Moreover, membership in the European Union and/or the Eurozone, as well as the warranty of macroeconomic stability of a country also pose a substantial advantage when an investor chooses the location for an investment.*

## **Introduction**

Foreign direct investments are deemed to be a significant factor accelerating the development of host countries. The investments are also a warranty of wealth for host countries, therefore attracting them is a substantial goal of each economy. An increase in the wealth of FDI host country or its economic growth is possible, however certain conditions must be satisfied in the field of a nature of inflowing investments and a policy of the host country. The goal of this paper is an analysis of the value of the foreign direct investments inflow into certain Central and Eastern Europe countries and rating of determinants which cause these countries to attract a large value of foreign direct investments. Additionally, the paper contains a presentation of the most significant determinants of foreign direct investments based on investors' motives. In order to achieve the aforementioned goal the author reviewed the literature on the subject, paying special attention to the issues in question, and she presented the results of the survey focused on the FDI determinants in the economies which are subject of this paper.

## **Methodology of surveys**

For the needs of this paper, the author reviewed literature on the subject, matter paying special attention to the issues in question, and she presented the results of the surveys focused on the FDI determinants and regarding the economies analyzed. The paper also contains the results of two surveys conducted by the author in 2006 and 2012 regarding the motives of entrepreneurs who make foreign direct investment in the territory of the EU countries. Totally, over 5,000 enterprises which run their business in Central Europe and Eastern Europe markets have been surveyed twice.

A superior goal of the survey is finding an answer to a question: what are the motives of entrepreneurs who made investments in the FDI form in the area of the analyzed economies?

## **Foreign direct investments – theoretical aspect**

Foreign direct investments result from displacement of international enterprises' activity – their expansion into foreign markets in order to enhance their competitiveness. Economists have been analysing the capital flows between particular economies for many years, trying to answer the following questions: why do enterprises, which have alternative forms for their business, such as export, license granting, franchising, chose the foreign direct investments? How can foreign entities effectively compete on foreign markets against local companies? What conditions must be satisfied by an economy in order to attract foreign investors? The answer to the last question is seriously correlated with the 'location factors' which persuade entrepreneurs to run economic activity on foreign markets. The 'location factor' term was implemented into the theory by A. Weber. Acc. to Weber, "it is one of clear advantages which characterizes an undertaking if the economic activity is run in a particular area or territory. The advantage means reduction on the production costs. The advantage results from the fact that a product is manufactured in a particular area or territory where costs are lower compared to any other area or territory" (Budner, 2004). Presently, new rules of the economic game cause the decision on the location of investments to depend on factors occurring in a particular investment location and in other, even distant places related to each other. However, it should be mentioned that in the literature on the subject the term - location factors - is frequently used as a synonym of the following terms: "location motives" or "location conditions". Budner (2004) and Kuciński (2009) implemented the "location advantages" term.

Apart from the variety of expressions and definitions of the location factor, the second significant issue is a list of factors which are deemed key ones for investment location. It is a dynamic list, since the weight of the location factors has been changing. Some of them have become less important, while others have become more and more substantial in the light of new circumstances. Dziemianowicz wrote (1997) that „location factors are not invariable and they do not pose a closed set”.

In case of foreign direct investments, the location factors are connected with enterprises' expansion motive, that is the capital flow on foreign markets. Since the essence of the FDI is defined in the economic literature in very different ways, authors of numerous definitions have made efforts to enumerate the most substantial factors determining this phenomenon. A review of the definitions results in a conclusion that there are serious problems when it comes to the determination of harmonized determinants and specification of their weights. According to Markusen (1995) the most

significant location factors for direct foreign investments are long-term trade relations between a trans-national corporation and a country which hosts investments, as well as a large 'openness' of a market and stability of its policy. Moreover, favourable macro-economic conditions in a country where an investor intends to run its business activity are significant as well. Another aspect of the FDI location determinants is presented by J. Rymarczyk (1996). According to Rymarczyk, a range of factors which have an impact on a decision to invest on a foreign market is very wide. This is the so called 'location theory', which divides such factors into four groups. The first group comprises of institutional and political conditions making up an investment climate in a particular country. They are defined, among others, by statutory regulations, decisions of fiscal nature, political stability, legal safety and social attitude towards foreign investments. In the second group, Rymarczyk enumerated cost factors, including access to the factors of production and their prices. The most frequently mentioned factor in this group is salaries and wages, which in growing countries are usually rather low. Consequently, they encourage foreign investors. Market factors pose the third group of determinants having impact on a decision to invest in a particular foreign country. The most frequently mentioned factor in this group is market size, its dynamics, as well as competition rate, export possibilities and external market protection. The fourth group of the Rymarczyk classification includes trade barriers such as duties, custom procedures, licenses, contingents, standards, national donations for domestic enterprises etc. The transport and a negative attitude of inhabitants towards foreign investors are deemed to be trade barriers as well. The above described factors were extended by Witkowska (1997) by the issues of supplies for an enterprise making investments directly in a particular country. Moreover, the access to raw materials necessary for production is appreciated by investors. Witkowska affirms that, apart from the abovementioned factors, the technological development in a host country is also very significant.

Other classification available in the literature on the subject was suggested by Przybylska (2001). She divided the factors which determine the attractiveness of a foreign market for foreign investments into two main groups. The first group comprises of determinants based on motives for the FDI, while the second group - determinants resulting from the investment climate in a host country. The first group includes the following types of determinants: market, cost and productivity. The second group, acc. to K. Przybylska, comprises of determinants describing the environment for foreign enterprises' operations such as – e.g. – political and economic stability, as well as the conditions connected with privileges for foreign enter-

prises' economic activity, that is the business environment and the investment risk rate.

E. Oziewicz (1998) separated 10 main motives for foreign investments and divided them into three categories:

1. *'cost' motives such as:* searching for trustworthy and cheap resources, cheap labour, safety of deposits (investment portfolio diversification), protection from loss arising from exchange rates.
2. *'profit' motives:* looking for new markets, a will to overcome trade barriers, different development rate which results in different profit rates, increase in the profit rate and the general profit level.
3. *mixed motives:* concentration and centralization process, control over foreign enterprise

Summing up the review of the theories focused on factors determining the foreign direct investments, it may be concluded that the entrepreneurs who make a decision on investments give consideration to both internal and external factors, namely the characteristic attributes of a domestic market and a foreign market.

### **Foreign capital inflow into the Central and Eastern Europe**

Since the 70s most of European socialist countries established formal and legal basis intended for direct capital cooperation with other countries. First regulations regarding foreign investments were established in 1972 in Hungary, later in Poland and Romania (1976), Bulgaria (1980), the Czech Republic (1986) and finally – the Soviet Union (1987). In each of the aforementioned countries a lot of efforts were made to attract foreign investments, such as: legal acts, tax releases, possibility to transfer profits and the capital to domestic countries and other (Bamber, Kiciński, 1990). Between the 80s and 90s it turned out that the historical political change in the Central and Eastern Europe resulted in a serious economic crisis. It was caused mainly by the will to replace the economic systems (planned centrally) with the one applied in Western Europe – capitalism. Restructuring programs caused mass unemployment, while opening of the domestic markets for foreign products resulted in the inflow of foreign products and elimination of the domestic ones. Finally, the situation of local enterprises became much worse (Szromik, 1993). Despite the negative effects of the transformation process, Central and Eastern Europe rejected the model of a political monolith and the economic model oriented to the economy of the former Soviet Union. Many economic relations, agreements, bilateral and multilateral arrangements, priorities and standards were no longer valid.

Capitalism emerged. Based on private property and individual initiatives, it 'implemented' hard and unfavourable economic and market, as well as and social circumstances. The change of political system and consequent privatization of the national property in this region of Europe made foreign investors become interested in cheap output market. Despite general capital deficit on the international money market, the authorities of the European countries had to encourage foreign partners to invest in Europe. Consequently, the efforts they made resulted in a quick growth of the trade between so called Eastern and Western Europe countries.

**Table 1.** Foreign direct investments in the world and in the Central and Eastern Europe countries 1985-2011

Years	World	Central and Eastern Europe	
	Investments [in millions USD]	Investments [in millions USD]	
	Inflow	Inflow	Share %
1985-1990	141.930	449	0,32
1991-1995	221.211	6.679	3,02
1996	386.140	13.547	3,51
1997	481.911	19.033	3,95
1998	686.028	22.479	3,28
1999	1.079.083	25.145	2,33
2000	1.392.957	26.373	1,89
2001	823.825	25.015	3,04
2002	651.188	28.709	4,41
2003	559.576	20.970	3,75
2004	742.143	59.469	8,01
2005	982.593	72.318	7,36
2006	1.463.351	107.245	7,33
2007	1.975.537	152.265	7,71
2008	1.790.706	164.432	9,18
2009	1.197.824	79.110	6,60
2010	1.309.001	77.428	5,92
2011	1.524.422	106.949	7,02

Source: own data based on the World Investment Report (1991-2012).

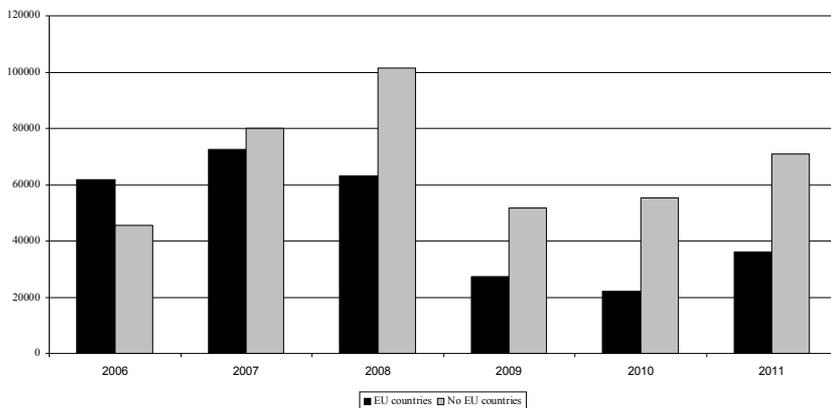
From 1985 to 1990 the average annual foreign direct investments inflow in the Central and Eastern Europe was equal to 0,3% of the global FDI flow. By 1997 the increase in the inflow of FDI was observed, up to 3,9% of the global FDI value. It proves a growing interest of investors in invest-

ments in this part of the world. In subsequent years the share in question was lower and lower, but in 2001 it went up again. A triple increase in the FDI value in Central and Eastern Europe took place in 2004, which could be a result of joining the European Union by some of the countries. The share of the region in the aforementioned period in the world foreign direct investments reached the level of 8%.

The record FDI inflow into the Central and Eastern Europe countries took place in 2008; the share of these countries in the global inflow reached the level of 9%. Main beneficiaries of the FDI, among the countries which are subject of the survey, were the countries which did not belong to the European Union. The inflow of the capital to the member states in 2008 reached nearly 40% of the FDI located by entrepreneurs in the region in question. The largest share in the FDI value in the territory of the Central and Eastern Europe (non-European Union countries) was held by Russia, in the territory of which 75 billion USD were invested. It was more than 45% of the general flows for this region and 75% of the capital invested in non-European Union countries. Analysis of the accumulated FDI value for the Central and Eastern Europe region proves that the highest amount of the foreign capital, by the end of 2011, was invested in the Russian economy (450 billion USD), in Poland (200 billion USD) and in the Czech Republic (more than 125 billion USD).

Figure no. 1 shows FDI inflow in the European Union countries. It may be easily observed that in 2006 the European Union countries were the largest exporter of the foreign capital in the Central and Eastern Europe. Since 2007 domination of the non-European Union countries has been observed, among others, in the Russian economy. In 2011 alone the foreign capital invested in Russia amounted to 52 billion USD and reached nearly 75% of the general FDI value invested in non-European Union countries.

**Figure 1.** Inflow of the direct foreign investments into the Central and Eastern Europe – European Union and non-European Union countries, 2006-2011 (in millions USD)



Source: own data based on the World Investment Report [1991-2012]

Using the FDI *per capita* rate to analyse the situation one may conclude that the first position in the region under examination is held by Estonia, where the accumulated investments value per inhabitant amounts to 13.000 USD. The Czech Republic comes second – 12.279, and Slovakia comes third – 9499 USD. The leader attracting the highest FDI value – Russia – acquired 3251 USD per inhabitant, which means the 12<sup>th</sup> place among the 20 countries under examination. The lowest foreign capital value per inhabitant is observed in Moldova – just 296 USD, which means 40 times less than in the territory of the leader.

### **Motives and barriers for investments in Central and Eastern Europe**

In the literature on the subject, the issue of motives and barriers of investment is dealt with by many researchers. Several survey researches have been conducted to verify the theses and show new tendencies in the analysed phenomenon.

In 1996, Institut der Deutschen Wirtschaft was commissioned by Bundesverband der Deutschen Industrie and Ost-Ausschuss der Deutschen Wirtschaft to conduct a survey research in which German respondents were asked to indicate motives and barriers for investment in Central and Eastern Europe (Beyfuß, 1996). The most significant motives given by the re-

spondents for their business activities in their respective areas were: creating new markets for their products, certainty of potential markets (big chances to succeed on a new market), low labour costs, certainty of existing markets and taking care of them as well as strengthening of competitive position through foreign manufacturing. Among the main concerns related to the said investments, the respondents specified (in the following order) unstable law regulations, the state's strong influence on companies' economic environment, remnants of centrally planned economy, bad conditions for performing business activities (complex and intricate law regulations and bureaucracy), low levels of productivity and lack of support from the authorities.

Another research on the determinants for direct foreign investments was carried out by Nunnenkamp and Spatz (2002), who used 28 emerging countries between 1987 and 2000 as a sample, and determined a strong relationship between the value of direct foreign investment and such indices as GDP per capita, investment risk index, levels of education in respective societies, restrictions on foreign trade, law regulations for the labour market or labour costs in the respective countries. It turned out that such factors as population, economic growth, entry/exit barriers and technological regulations of manufacturing are of no importance when decisions are taken by foreign business in relation to investing their capital in emerging markets. However, between 1977 and 2000, a significant influence of manufacturing costs as a decisive factor for choosing a location for investment was noticed in the researched countries.

Holland, Sass, Benacek and Gronicki (2000) analysed the literature on the subject connected with the factors decisive for an influx of direct foreign investment to the countries of Central and Eastern Europe and came to the conclusion that decisive factors are the size of the market and the development perspectives for the country. Campos and Kinoshita (2003) analysed 25 transforming economies of the region in 1990-1998 and concluded that the following factors play a decisive role in the acquisition of foreign capital: type of economic system, size of the market, low labour costs and abundance of natural resources. In addition, other important determinants listed by these authors were: the level of the country's openness to foreign trade, no bureaucracy – existence of the so-called „healthy institutions” and friendly pro-investment policy for foreign capital, which result in low barriers for starting business activities or investing financial assets. Similar research to Campos's and Kinoshita's was carried out by Garibaldi, Mora, Sahay and Zettelmeyer (2001), who analysed 26 transforming economies between 1990-1999, using an array of substantial variables. The analysed macroeconomic factors, structural reforms, legal and institutional frame-

works, conditions for setting up a business and investment risk in those countries. In the conclusions, it might be noticed that such macroeconomic variables as the size of the market, size of budget deficit, inflation rate, political system, extent of investment risk, implemented economic reform, economy's openness to foreign trade, availability of natural resources, investment barriers and bureaucracy all play a key role in the decision making on investment by foreign business entities.

In their analysis, apart from traditional factors such as: market potential, labour cost and the availability of skilled labour, Carstensen and Toubal (2004) took into account the level and methods of privatization. Market size and agglomeration effects are key determinants for French multinationals investigated in Disdier and Mayer (2004), but the differences between investments in Eastern and Western Europe are attributed to the quality of institutions in the host country. Bevan and Estrin (2004) examine bilateral flows from individual source countries to the host countries in Central and Eastern Europe. Unit labour cost, as well as host and source country size and proximity turn out to be significant, so they conclude that both market-seeking and efficiency-seeking investments are taking place.

In 2006 and 2012, the author of this paper carried out a research survey aimed at randomly selected companies operating in the European Union whose share capital is owned by foreign investment. In total, over 6000 companies from 27 member countries took part in the survey. The subject-matter of the survey referred to the businesspeople indicating the stimuli which had persuaded them to make direct foreign investments in the respective EU state. For the needs of this paper, only the results related to member states from Central and Eastern Europe shall be presented. In both surveys, the businesspeople were presented with specified internal and external stimuli which may persuade them to make foreign investment in a foreign market. The respondents' task was to choose those factors which were decisive during their foreign expansion and then to grade their importance (from very important to irrelevant). Among the internal stimuli, the author mentioned: searching for new markets, striving for reducing the manufacturing costs, company's advantages, aiming at profit maximization, imitation effect, acquisition of skills, expertise and knowledge, strategy adopted at the company, risk minimization in business activities through risk diversification, access to rare resources, low cost of investment undertakings, ability to bypass the trade barriers and economies of scale. The external stimuli specified by the author were: country's memberships in the EU, accession to the Euro zone, offering low prices of factors of production, investment encouragements and relieves, large markets, economic and political stability of the host country, increased competition in the domestic

market, unfavourable conditions for the sale of exported goods and granting licences to companies from other countries, investment climate, geographic location, convenient infrastructure, proximity to other existing markets and protection of intellectual property.

For the surveyed businesspeople, the most important internal factor which persuades the businesses to invest outside their host country, was the willingness to look for new markets for their products and profit maximization. The guest country should be characterized by a big market, attractive prices of factors of production and investment encouragements and relieves. In the second survey in 2012, one of the most frequently selected answers was economic and political stability of the host country. It should not come as a surprise due to the worldwide economic crisis and a deteriorating economic situation in many countries. It can be observed that since 2008, the business' approach to investment in the foreign markets has been more cautious, especially in the countries where such stability cannot be guaranteed. As irrelevant stimuli, the surveyed businesses mentioned the strategy adopted at the company and the willingness to reduce risk in business activities through operating in heterogeneous markets, and among the external factors, the businesses mentioned an increased competition in the domestic market and unfavourable conditions for the sale of exported products and granting licences to companies from other countries.

## **Conclusions**

International flows of the capital, including the FDI, seriously shape economic systems of particular countries and the global economy as well. For this reason, all countries trying to acquire capital for their economies, establish attractive conditions for investors. Entrepreneurs, at a specific moment of their economic activity, also make a decision on internationalization of their businesses. However, the expansion into foreign markets does not depend on a single motive but on a group of them. Such factors may be a result of internal situation of an enterprise, but they also may be external, originating from a host state.

Concluding the issue of determinants of the foreign direct investments based on available literature and own two surveys, it may be said that since the beginning of the system transformation of the Central and Eastern Europe countries the factors affecting the foreign capital inflow have been the same. A thesis could be made that such determinants are universal enough to say they are characteristic for the Europe region under examination, and for other economies as well. Despite the fact the surveys the author con-

ducted took only the European Union countries into account, other papers which regarded the non-European Union countries proved that the factors were characterized by similar hierarchy. In 2012 the analysed enterprises declared that the membership in the EU and the Eurozone is of average importance; still, among the largest beneficiaries of the FDI, are non-European Union countries, with Russia holding the first position. It can be explained due to the most substantial decisive criterion, which is the size of the Russian market, encouraging potential investors as a great market for their products. An analysis of the FDI *per capita* confirms that membership in the European Union and the Eurozone is significant for many entrepreneurs, since the ranking of such values is dominated by European Union countries. Most of the non-European Union countries are characterized by several times lower foreign investments rate per capita.

The Central and Eastern Europe economies are mostly characterized by a significant size of the market and attractive geographical location, which results in a growing inflow of the foreign capital into such countries. Moreover, such countries still offer much lower labour costs than the developed ones, which is additional advantage for investors. Among the Central and Eastern Europe countries which joined the Union, one may observe much lower labour costs compared to so called “old fifteen countries”. Man hour price between different European economies may be 20 times higher. Additional incentive for potential investors may be the fact that the transformation of economies is still in progress, and more accurately, the privatization process which enables the purchase of existing domestic enterprises frequently much below their real value. An inflow of the foreign direct investments into the Central and Eastern Europe countries is necessary since it positively affects the development and the economic growth of such countries, as well as enables the increase in the productivity, quality of manufactured products and rendered services because of flow of technology and new management methods. From the other side, the economic crisis in many European Union countries increased the economic activity risk in the territory of such countries, including the “old fifteen”. Central and Eastern Europe countries may be presently deemed to be more stable and subsequent years they may become serious beneficiaries of the foreign investments. They offer potential investors advantageous locations for their capitals and satisfy conditions expected by them. It enables them to accelerate the progressive convergence process with other developed economies and to extend the groups of the European Union countries.

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