CENTRAL AND EASTERN EUROPEAN COUNTRIES IN EUROPEAN UNION – IMPACT OF FOREIGN DIRECT INVESTMENTS

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Economic integration refers to trade unification between different states , and one of its most important aspects is liberalisation of capital movement. In this paper is presented a brief evolution of economic integration cases focusing on one of the most integrated economies – European Union. We concentrate on the participation of foreign investors in different economies and their impact, taking the example of Central and Eastern European Countries and their markets. Also , the level of influence that direct investments in capital markets entails on the Stock Exchange evolution is presented for the case of Romania .

Keywords: European Union, foreign direct investments, capital markets, CEEC
JEL classification: E20, E22, E44

1. Introduction

Economic integration refers to trade unification between different states by the partial or full abolishing of customs tariffs on trade taking place within the borders of each state. This is meant in turn to lead to lower prices for distributors and consumers (as no customs duties are paid within the integrated area) and the goal is to increase trade. The trade stimulation effects intended by means of economic integration are part of the contemporary economic Theory of the Second Best: where, in theory, the best option is free trade, with free competition and no trade barriers whatsoever. Free trade is treated as an idealistic option, and although realized within certain developed states, economic integration has been thought of as the "second b".The framework of the theory of economic integration was laid out by Jacob Viner (1950) who defined the trade creation and trade diversion effects, the terms introduced for the change of interregional flow of goods caused by changes in customs tariffs due to the creation of an economic union. He considered trade flows between two states prior and after their unification, and compared them with the rest of the world. His findings became and still are the foundation of the theory of economic integration.

The basics of the theory were summarized by the Hungarian economist Béla Balassa in the 1960s. As economic integration increases, the barriers of trade between markets diminish. Balassa believed that supranational common markets, with their free movement of economic factors across national borders, naturally generate demand for further integration, not only economically (via monetary unions) but also politically—and, thus, that economic communities naturally evolve into political unions over time.

The dynamic part of international economic integration theory, such as the dynamics of trade creation and trade diversion effects, the Pareto efficiency of factors (labor, capital) and value added, mathematically was introduced by Ravshanbek Dalimov. This provided an interdisciplinary approach to the previously static theory of international economic integration, showing what effects take place due to economic integration, as well as enabling the results of the non-linear sciences to be applied to the dynamics of international economic integration.

2. Recent examples of economic integration

The experience of economic integration, as currently understood, starts with the creation of the Union of South Africa (1910), which was further implemented in the Belgium-Luxemburg economic union, Benelux (1944), and the European Coal and Steel Community (1951).

Economist Fritz Machlup traces the origin of the term 'economic integration' to a group of five economists writing in the 1940s, including Wilhelm Röpke, Ludwig von Mises and Friedrich von Hayek. Economic integration was a foundational plank of US foreign policy after World War II.

The USA is also economically and politically integrated, as it has unified 50 different states (the US states), but the current political and economic structure was achieved via civil war, and not by steady peaceful development according to the stages of economic integration.

An example of recent unprecedented development of economic integration is the formation of the East Asian Free Trade Area (EAFTA): ASEAN has proposed that Japan (along with India and China) join EAFTA, and at first Japan declined to do so. China's consent to enter EAFTA has forced Japan to sign on, since otherwise Japanese goods would become cost-inefficient (more expensive) and hence loose competitiveness both regionally and globally.

Probably one of the most integrated economies today, between independent nations, is the European Union and its euro zone. The **European Union** (**EU**) is an economic and political union of 27 member states, located primarily in Europe. Committed to regional integration, the EU was established by the Treaty of Maastricht on 1 November 1993 upon the foundations of the European Communities.

The EU has developed a single market through a standardised system of laws which apply in all member states, ensuring the free movement of people, goods, services, and capital. It maintains common policies on trade, agriculture, fisheries and regional development. Sixteen member states have adopted a common currency, the euro, constituting the Eurozone. The EU has developed a limited role in foreign policy, having representation at the World Trade Organization, G8, G-20 major economies and at the United Nations. It enacts legislation in justice and home affairs, including the abolition of passport controls by the Schengen Agreement between 22 EU and 3 non-EU states.

The WTO is one of the engines of international economic integration, as it has been pushing the states around the world towards decreasing the tariffs: their average level sharply dropped from 45-50% in 1950s to 4-5% in 2000. Global economic integration de-facto will be in place when the level of tariffs equals 1-2%. Due to rapid development of the worldwide web the global competition pushes traders and the states worldwide to gradually decrease tariffs. The driving forces of trade which seeks maximization of profits and extra-cutting the costs may seem as being independent, but they all simulteneously push towards one same goal - global economic integration.

3. Foreign Investments in Central and Eastern European Countries after joining European Union

After the end of the traditionally not very intensive external relations between CEECs and EU before 1989/90, CEECs started to seek for stronger economic integration into the Western markets, terminating their rather strong orientation towards Russia. In addition to Trade and Cooperation Agreements with the EU, far-reaching Association Agreements, the so-called Europe Agreements (EAs), started to get into force. The first of the so far ten EAs with CEE countries have been signed at the beginning of the 1990s.

The integration of CEE countries into the European Union accelerated the integration of CEE capital markets into the international and European capital markets. The major economic factors behind this integration of capital markets are improved possibilities for risk diversification and for future returns which the CEE capital markets could offer to international investors.

International mobility of capital is extremely important for transition countries. Due to the general lack of domestic savings in these countries, capital inflows are necessary for complementing the finance of domestic investments and thus for growth and employment,influencing. the macroeconomic situation. For Estonia 26.4% of gross fixed capital formation has been financed by foreign direct investment in 1994 to 1998; a huge amount of foreign finance of domestic investments can also be found in Hungary (25.2%), Poland (16.6%) as well as in the Czech Republic (11.2%). The extent of capital inflows simultaneously depends on the progress in the process of transition. However, the import of large amounts of foreign capital increases a country's vulnerability to the fluctuation of capital inflows and its dependence on international markets and investors or foreign governments. This vulnerability decreases if short-term capital inflows are not denominated in foreign currency as well as if the majority of capital inflows is not (more) short-term FPI, but FDI -which in the case of transition economies seems to be closely linked to the success in the process of privatisation. Simultaneously, FDI inflows do not substitute but complement for domestic investment. In addition, the diversification of investment-related risks as well as the improvement of international trade conditions can be achieved by sound and prudent capital outflows.

In 2008, inward FDI flows in analized contries- Bulgaria, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia, reached a new record high, despite the global financial and economic crisis. The growth rate of inflows was high, especially in the first half of 2008. However, with the crisis deeply affecting several countries by late 2008, initial hopes that the region would prove relatively immune to the global turmoil evaporated. Inward FDI flows to the group in 2008 were unevenly distributed, four countries together accounted for the lion's share (77%) of the group's total inflows: Poland ($16.5 billion), Romania ($13.3 billion), the Czech Republic ($10.7 billion) and Bulgaria ($9.2 billion). As many companies scaled back or suspended their expansion plans due to the global financial crisis, FDI inflows into Poland and Bulgaria declined considerably in the end of 2008, but in the Czech Republic and Hungary they did not change significantly, despite increasing macroeconomic problems in both countries. For many years the automotive industry has been the key driver of strong FDI inflows to the new EU member countries, but the decline in euroarea car sales that began in the last quarter of 2008 has revealed the region's vulnerability on account of its heavy reliance on the industry.

Outward FDI from the region slow down in 2009. However some Russian TNCs with large cash reserves, but which are new to foreign expansion, expanded in early 2009 despite the financial crisis. For example, Surgutneftgaz bought 21.2% shares in the National Hungarian Oil Company, MOL, from the Austrian National Oil Company OMV for $1.4 billion, marking the first major acquisition abroad by that Russian company.

Table 1 FDI Inflow/Outflow for CEEC 7

YEAR	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**
FDI Inward															
Bulgaria	105.40	90.40	109.00	504.80	537.30	818.72	1,001.56	812.94	904.66	2,096.90	3,452.34	3,922.72	7,667.32	11,716.09	9,204.70
Czech Republic	868.31	2,561.83	1,428.44	1,301.37	3,717.90	6,324.00	4,984.40	5,638.90	8,492.80	2,021.60	4,978.80	11,602.80	5,459.40	10,436.50	10,730.60
Hungary	1,143.37	5,103.49	3,299.58	4,167.32	3,334.86	3,311.94	2,763.17	3,935.41	2,992.20	2,136.16	4,508.20	7,705.79	7,531.87	6,088.42	6,514.36
Poland	1,875.00	3,659.00	4,498.00	4,908.00	6,365.00	7,270.00	9,343.00	5,714.00	4,131.00	4,870.00	12,756.00	10,249.00	19,591.00	22,612.00	16,533.00
Romania	341.00	419.00	263.00	1,215.00	2,031.00	1,027.03	1,056.75	1,157.93	1,140.65	2,196.30	6,435.59	6,482.86	11,366.87	9,922.83	13,305.01
Slovakia	255.17	2,587.15	369.74	230.60	724.70	427.90	1,932.28	1,583.81	4,141.86	2,159.96	3,030.45	2,428.59	4,692.65	3,264.96	3,413.93
Slovenia	116.70	150.50	173.50	334.24	215.49	106.56	137.37	369.03	1,620.35	305.29	825.96	587.60	643.93	1,437.51	1,814.77
FDI Outward															
Bulgaria	0.18	-8.00	-28.50	-1.70	0.10	17.10	3.30	9.70	28.30	26.50	-217.00	307.60	174.90	273.60	732.50
Czech Republic	119.62	36.61	152.88	25.24	127.20	89.80	42.90	165.40	206.50	206.00	1,014.30	-18.80	1,467.10	1,619.10	1,899.50
Hungary	49.00	59.09	-3.64	461.49	278.13	249.98	620.28	368.01	277.98	1,643.04	1,119.41	2,177.95	3,873.83	3,737.04	1,660.85
Poland	29.00	42.00	53.00	45.00	316.00	31.00	16.00	-90.00	230.00	300.00	915.00	3,399.00	8,875.00	4,748.00	3,582.00
Romania	0.01	2.00	0.01	-9.00	-9.00	15.98	-12.90	-16.11	16.94	40.63	69.53	-31.09	422.76	277.84	-272.46
Slovakia	17.69	-41.40	56.53	95.22	146.60	-370.83	28.87	64.52	11.03	246.57	-21.14	149.51	511.37	383.97	258.04
Slovenia	-12.70	-10.00	7.00	30.94	-5.49	47.62	66.06	144.25	156.04	475.49	547.58	641.20	861.83	1,805.27	1,439.92

Source:UNCTAD statistics

4. Impact of foreign investments on Romanian Capital Markets

Taking into consideration the evolution of capital markets after integration in European Union, we must emphasize two factors that have influenced the growth of securities markets in the CEECs: the early development of a government debt market, and the method of privatisation chosen. Stock markets are generally more developed in countries where privatisation has been organised through the use of vouchers, such as the Czech and Slovak Republics. In the latter countries market infrastructure and regulation has been put in place after a rudimentary securities market had already developed (ex-post), in response to the needs of market participants. In other countries, such as Poland and Romania, the opposite was the case: privatisation occurred more gradually and through initial public offerings, after the necessary regulation had been put in place. In this ex-ante approach, with an emphasis on high fiduciary and disclosure standards, capital markets developed more gradually

However, not only privatisation played a crucial role. Also, the development of secondary markets in government securities was important, even if the primary purpose for policy makers has been the satisfaction of the government's borrowing needs. Secondary public debt markets provide liquidity to investors, incentives for financial market development and support interest rate liberalisation. In Hungary, for example, the existence of a liquid government securities market has contributed significantly to the growth of a wider securities market, and is considered as an important achievement in Hungarian financial sector reform.

In Romania, privatization of industry was pursued with the 1992 transfer of 30% of the shares of some 6,000 state-owned enterprises to five private ownership funds, in which each adult citizen received certificates of ownership. The remaining 70% ownership of the enterprises was transferred to a state ownership fund, with a mandate to sell off its shares at the rate of at least 10% per year. The privatization law also called for direct sale of some 30 specially selected enterprises and the sale of "assets" (commercially viable component units) of larger enterprises.

Financial and technical assistance continued to flow in from the U.S., European Union, other industrial nations, and international financial institutions facilitating Romania's reintegration into the world economy. The International Monetary Fund (IMF), World Bank (IBRD), the European Bank for Reconstruction and Development (EBRD), and the U.S. Agency for International Development (USAID) all had programs and resident representatives in Romania. Romania also attracted foreign direct investment, which in 2008 rose to $72 billion.

Romania signed an Association Agreement with the EU in 1992 and a free trade agreement with the European Free Trade Association (EFTA) in 1993, codifying Romania's access to European markets and creating the basic framework for further economic integration. At the Helsinki Summit in December 1999, the European Union invited Romania to formally begin accession negotiations. In 2002, the target date of 2007 was set for Romania, along with Bulgaria, for its accession efforts. This was confirmed in 2003 at the Thessaloniki Summit and then in early 2005 Romania and Bulgaria signed the adherence treaty to EU. They formally joined the EU on January 1, 2007.

Growth in 2000-07 was supported by exports to the EU, primarily to Italy and Germany, and a strong recovery of foreign and domestic investment. Domestic demand is playing an ever more important role in underpinning growth as interest rates drop and the availability of credit cards and mortgages increases. Current account deficits of around 2% of GDP are beginning to decline as demand for Romanian products in the European Union increases. Recent accession to the EU gives further impetus and direction to structural reform.

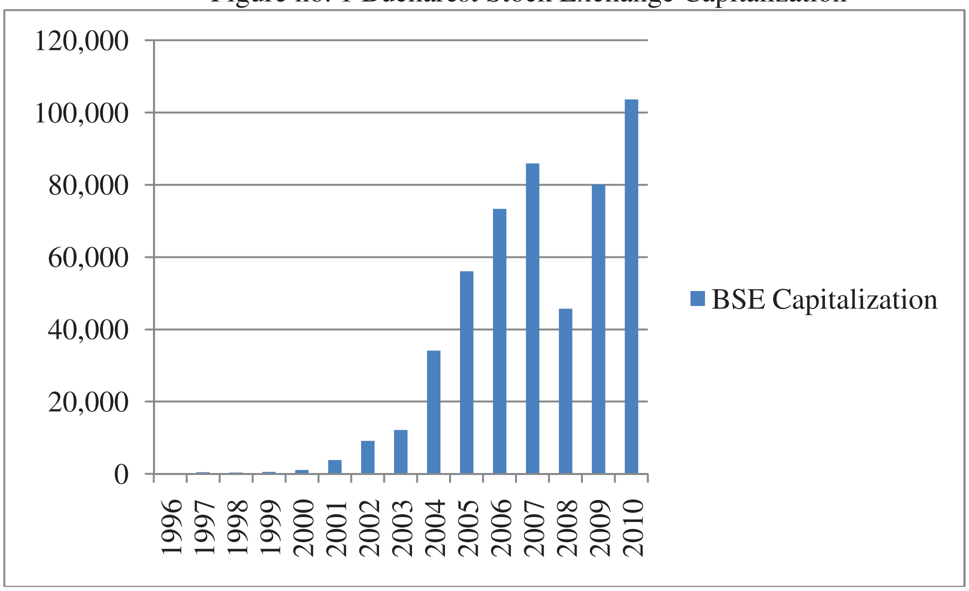
In Romania, the main regulated Stock Exchange is the Bucharest Stock Exchange. After a break for 5 decades, the Bucharest Stock Exchange was reestablished in 1995, first trading day is November 20, 1995, days that were traded 905 shares of 6 companies listed. Since reopening, the exchange has seen a continuous development. An important moment in the evolution of this scholarship is the merger with RASDAQ Exchange in 2004. Thus, in 2007 a total capitalization of the Bucharest Stock Exchange approached the threshold of $ 12 billion and represent over

17% of GDP, thereby decreasing the gap with the stock market the most advanced Central and Eastern Europe.

According to S & P, Romanian Stock Market registered a 69.7% annualized growth in the period before EU integration, 2002-2006. During this period, Romania has the highest return on capital markets, other countries located around the same level of 60% as Bulgaria, Kenya and Ukraine. After Romania's EU integration, Romanian capital market saw an annual increase of 15 to 25% in 2007.

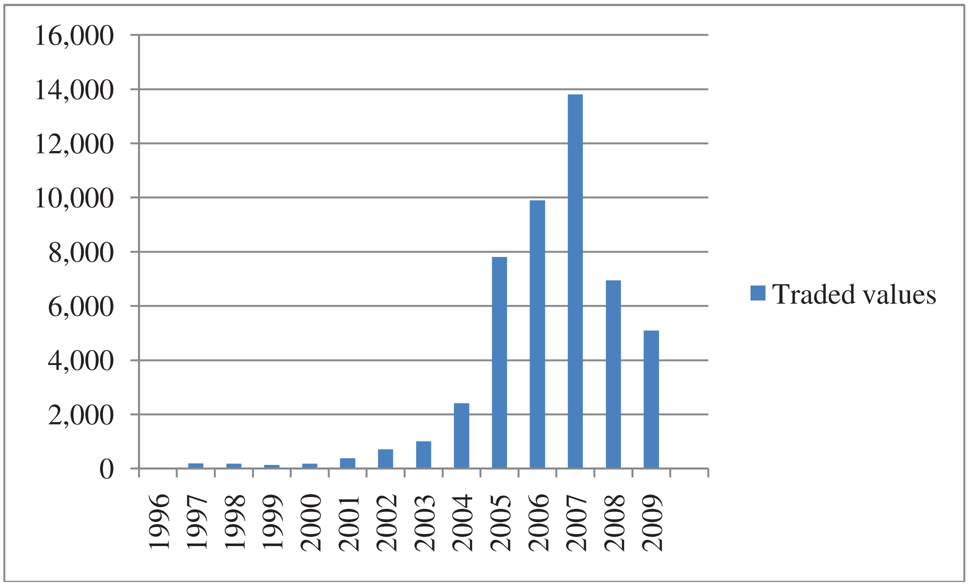
In October 2008 financial crisis caused the stock minimum both in developed markets and emerging ones. In 2008, accounted for BSE and to all participants on the domestic stock market one of the most difficult periods in modern history of capital market in Romania. After nearly a decade in which major indicators and indices of BSE have described an ascending trend, pronounced and sustained in recent years associated effects of accession of Romania to the European Union, 2008 was marked by the abrupt reversal of the upward trend of quotations and sensitive reduction of the overall stock market liquidity.

Figure no. 1 Bucharest Stock Exchange Capitalization



Source: Bucharest Stock Exchange

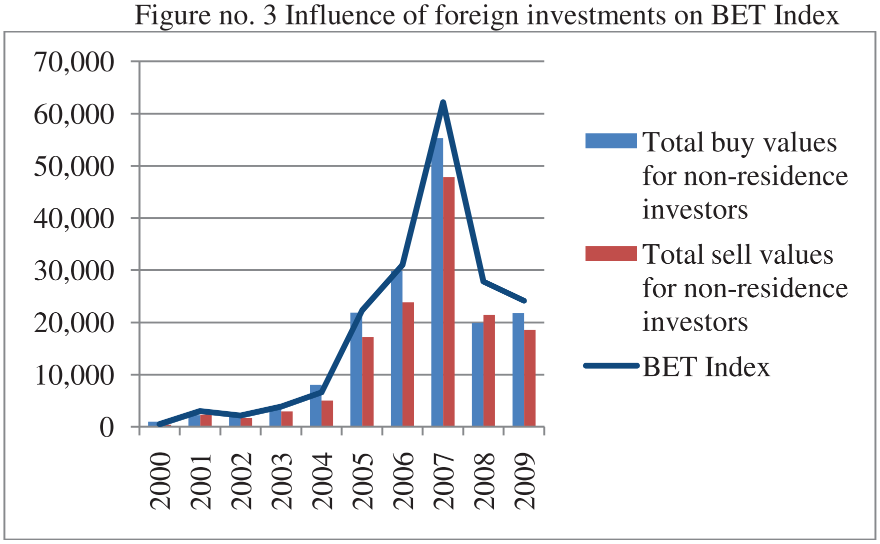
Figure no. 2 Traded values on Bucharest Stock Exchange



Source: Bucharest Stock Exchange

One of the most important element to influence market evolution is the foreign investors' behaviour. Starting with 2004 foreign investors are more and more attracted by Romanian capital market since it prooved to bring great returns and more stability in the perspective of a future integration in EU. Romanian capital market developments have naturally reflected in the investment funds with exposure in this market. For example, East Capital Balkan Fund-fund with the largest exposure on the Romanian market of all funds managed by East Capital (12.1% in Romania) - had a dramatic increase of 239.6% during 2004 to 2007.
Analyzing the corelation between foreign investments and BSE - BET Index evolution, one can easily distinguish a strong bond between the two variables. Year 2008 prooved the main vulnerabilities of this market against retiring of foreign institutional investors that caused a drop of 55% of BET Index.

Figure no. 3 Influence of foreign investments on BET Index



Source: Bucharest Stock Exchange

5. Conclusions

Economic integration refers to trade unification between different states by the partial or full abolishing of customs tariffs on trade taking place within the borders of each state. One of the most developed form of integration is European Union, Central and Eastern European countries taking the first steps to integration in 1993. Evidence prove that accession in EU comes with important foreign investments, situation that creates great benefits for an economy. Large amounts of inward FDI constituted the engine for a quick development in CEEC's economies. The recent crisis showed that large exposures that Central and Eastern European Countries have towards foreign investors can cause great turmoil once these funds exit the economy.

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