ASSESSING FDI DETERMINANTS IN CEE COUNTRIES DURING AND AFTER TRANSITION

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Abstract: *The aim of this paper is to identify if the drivers of inward foreign direct investments' stocks in Central and Eastern European countries changed in the last 20 years, given two substantial economic evolutions encountered in this period: the transition process and the adhesion at the European Union. We are interested if foreign investors are attracted by the quality of institutions, the labour market or by the telecommunications infrastructure, expressed by 10 variables, in the 11 newest EU member states. Therefore, we use a fixed effects panel data approach during 1994-2013 which we apply in two stages. In the first stage, we find the variables that strongly influence FDI in each of the three groups of determinants. In the second stage, the panel data analysis is applied only for the variables previously find as significant for FDI, to which we add traditional FDI determinants, such as trade openness and GDP per capita. Also, the mentioned years are divided into two sub periods, the first representing the transition period (from 1994 until 2003) and the second one the years comprising the EU adhesion process (from 2004 until 2013). The results confirm that there are changes in FDI determinants in these countries. During 1994 to 2003, investors were mostly interested in the quality of institutions, the openness of the economies and the environments capable of growth, where the products can be sold. For the period starting with 2004, the analyzed countries are attractive mainly through their capacity of providing labour force with low costs and created resources, such as the development of the mobile networks. The results obtained are of particular importance for the public policy decision makers, as the changes in FDI determinants require the adaptation of public policies in the CEE countries in order to remain attractive for foreign investors.*

Keywords: foreign direct investment, transition process, European Union membership, panel data.

JEL classification: C23, F23, P20

1. Introduction

In this paper, we are interested in identifying the advantages of the Central and Eastern European (CEE) countries in attracting foreign investors, as foreign direct investments (FDI) are seen as an important source for economic growth. FDI are not only an inflow of capital, but also of technology, managerial expertise, industrial organization etc., as noticed by Negriţoiu (1996) or Dunning and Lundan (2008). In this respect, FDI could represent a vehicle for bridging the gap between the standard of living of these countries and the Western economies. We are interested in finding the actual determinants of FDI, given these countries' status as part of the European Union (EU).

Very frequently in the literature, these countries were treated as a whole due to a similar history in terms of economic and political regime and to the economic transformations that were carried on in the 1990s, required for adapting to the market economy. In 2004, eight out of the 11 countries analyzed in this paper became members of the EU, followed by other two in 2007 and recently by Croatia, in 2013. The adhesion process implied several

other requirements in terms of alignment with the rules and administrative procedures of the EU. FDI determinants in these countries are frequently assessed for the entire period – containing both the transition period and the one as an EU member state. This rationale is due to the need for expanding the period of analysis in order to have a healthy econometric analysis and also for covering the scarce data regarding the determinants of FDI in these countries. Still, in this period, the literature points to the changes in FDI motivations.
Based on the above, we consider that a distinction between the two periods is necessary for assessing FDI determinants in CEE countries, in accordance with the strands of the literature. The paper is structured as follows: in the next part, we point to distinctions find in the literature as regards the FDI determinants in transition countries. In the second part, we present the methodology employed, while in the next part we discuss the results. Several conclusions are drawn in the last part of the paper.

2. Literature review

The studies regarding FDI host countries location determinants are not as old as the first FDI theories. Yet, the dynamics of the economic activity made mandatory the incorporation of home countries' factors in FDI theories. A comprehensive analysis of the changes in FDI theories over time due to incorporation of location factors are described in Popovici and Calin (2014).
The transition process which occurred in Central and Eastern Europe had a special role in the development of theories related to FDI location determinants. The empirical studies in the former transition countries usually divided the factors influencing FDI into two groups: traditional economic factors and factors specific to transition countries (Lopez, 2009; Carstensen and Toubal, 2004; Vasyechko, 2012). For Carstensen and Toubal (2004), FDI determinants are grouped into traditional factors (such as the market potential of the host country, the trade costs, the unit labour costs, the share of skilled labour in total labour and the income tax) and transition determinants: the share of the private market, the political risk and the privatization method.
Traditional variables are not sufficient for explaining the FDI inflows in CEE countries. The authors conclude that transition-specific variables must be taken into account for better explaining inward FDI flows. Moreover, Kinoshita and Campos (2003) consider that FDI determinants in these countries must be grouped into traditional determinants (such as the market size and the cost of labour), new factors (such as the quality of institutions) and transition-specific factors (such as the initial conditions of the country). Analysing the studies on transition countries, the main determinants that are specific for the transition period are the performance in the achievement of the transition process and the dimension and the method of privatization.
The progress in the transition process is generally measured through the capacity to implement reforms which lead to greater civil and political freedom and to the replacement of the administrative economic system with one coordinated by the market. EBRD assesses this progress through eight indicators that measure the size of the privatization of state enterprises, the company restructuring, the price and trade liberalization, the infrastructure development, the legality of reforms, the exchange rate movements and the financial dimension. Several studies are using these indicators for assessing the progress in the transition process. Tondel (2001) concludes that the most attractive countries for FDI in CEE are those that are the most successful in the transition process. The transition index used by Altomonte (1998) is rather assessing the business environment based on the preferential treatment for the domestic companies, the influence of bureaucracy, the continuity of public policies and the enforcement of contracts. The more favourable is the business climate, the higher the level of FDI. Johnson (2006) uses a composite index to analyze the progress made by countries in transition, The author identifies a positive and significant relation between this index and the volume of inward FDI. An alternative to

these measures for the progress of transition to a market economy is the use of the private sector share in GDP. Every time the variable is introduced in the empirical analysis, the results indicate a positive and significant relation between FDI and the share of the private sector in GDP (Holland and Pain, 1998; Bevan et al., 2004; Carstensen and Toubal, 2004; Bellak and Leibrecht, 2005).
The privatizations of national companies represent a fundamental part of transition process, with the aim of increasing the efficiency of the companies. Johnson (2006) notices that privatizations are opportunities for attracting FDI according to the method of privatization used. Similarly, Holland and Pain (1998) and Carstensen and Toubal (2004) conclude that privatization method decisively determine the volume of FDI inflows in the host country. Therefore, the direct sale of national companies is more attractive than the privatization using vouchers, according to Holland and Pain (1998), who analyze the period during 1992-1996. Merlevede and Schoors (2005) extend the analysis to the years 1992-2000 and find a similar result. Yet, when analyzing only the countries in CEE, the privatization method becomes negligible for foreign investors, according to Johnson (2006), who investigates the period 1993-2003.
It is important to add that Holland and Pain (1998) also pointed out that the importance of the privatization method is possible to diminish due to the development of capital markets.
The study of Bevan et al. (2004), developed during 1994-1998, states that any other form of FDI penetration, such as greenfield investment or acquisition, is as advantageous in attracting foreign investors as the direct selling of national companies.
A possible explanation for this result is the fact that Bevan et al. (2004) deal specifically with countries in Eastern Europe to which are added Russia and Ukraine.
Another classification of FDI in this group of countries depends on the type of the foreign investment: horizontal or vertical. Christie (2003) and Geishecker (2004) support the existence of horizontal FDI in CEE countries, searching for potential and developing markets. In this case, FDI flows are determined primarily by the size and the growth of the host country. At the same time, there are vertical FDI, searching for locations with low costs for production factors. The reason for these types of FDI comes from the differences in the endowments with production factors between countries (Markusen and Maskus, 2002, Markusen et al., 1996). Besides this classification, Markusen provides the knowledge-capital model, which integrates both the vertical and the horizontal FDI. The main parameters of the model are trade costs, the differences between countries regarding the relative and absolute endowment with production factors and the obstacles to investments. The model points that the highest level of the host country welfare is achieved under complete commercial and investment liberalization. As regards the situation of the CEE countries, Geishecker (2004) points to the possibility of integrated FDI, both vertical and horizontal, as the main FDI determinants in the period of transition were the dimension of the market (assumed as a specific determinant for horizontal FDI) and the low labour costs (seen as a determinant for vertical FDI). The limits of the model lies in its lack of incorporating institutional and risk variables, also responsible for the FDI patterns (Geishecker, 2004). A positive impact for attracting FDI lies in the competitiveness degree of a country (Popovici and Călin, 2012a).
The entire period – both of transition and EU membership – was strongly influenced by the institutions, with the aim of designing a healthy economic framework. John H. Dunning, the author of the OLI paradigm, was the first to consider the resource structure, the size of the markets and the government policies as location determinants of FDI in the host transition countries (Vasyechko, 2012). The strengths of advanced transition countries lie in their openness to foreign investment, political stability, macroeconomic environment and regulatory framework, while weaknesses include a weak communication infrastructure, unnecessary bureaucracy and lack of transparency in public administration. Subsequently, the importance of institutions in attracting FDI especially in the CEE countries was tested and find significant in several empirical studies (such as Brenton et

al., 1998; Bevan et al., 2004; Popovici and Calin, 2013).

3. Methodology

Considering all the above, the main goal of our paper is to assess the differences in FDI determinants during the transition period and in the years of obtaining the EU membership. Secondly, we are interested in the type of FDI determinants and we assess if foreign investors are attracted by a high quality of institutions, a stable macroeconomic environment or by the labour market and better infrastructure. Our hypothesis is that the FDI determinants changed during the two periods already mentioned, which implies the need to adapt public policies in order to attract foreign investment. Also, we expect to find a strong impact of the variables expressing the quality of the institutions on foreign investors.

In this respect, we use a fixed effects panel data approach, which will be estimated by the method of least squares (OLS - Ordinary Least Squares) for the 11 newest EU member states (Bulgaria, Croatia, the Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovenia and Slovakia) during 1994-2013. We split the analyzed period into two sub periods: from 1994 until 2003 and from 2004 until 2013. The first sub period represents the transition years, while the second one the years as part of the EU. Although Bulgaria, Romania and Croatia joined later the EU, we can assume that the transition period is over for all the three of them, according to Brada et al. (2005) and to UNCTAD (2014) that no longer include them into the category of countries in transition. Moreover, Bulgaria, Romania and Croatia have increased their efforts for joining the EU in those years.

The general form of the estimated equation is:

$$Yit = \alpha + \beta it^* Xit + \gamma it + \varepsilon it , \qquad (1)$$

where Yit is the dependent variable, Xit represent the k-dimensional vector of regressors, α is the constant term, βit is the regression slope, γit is the specific effects corresponding to time periods, εit is the error term, i represent the cross-section units (i=1, 2, …, N) observed in each period t, where t = 1, 2, .., T. The use of the panel methodology is justified by the short period of analysis, as it allows maximizing the number of observations and also because there are some lacks in the data series, due to unavailability of official data. Our dependent variable is FDI inflows as percentage of GDP, as provided by UNCTAD. As the transition process is over, we do not consider that transition determinants are necessary to be taken into account; we are interested in the changes suffered in the other types of determinants. We employ 12 independent variables that we divide into three groups, expressing the quality of institutions, the telecommunications infrastructure and the labour market, as provided in Table 1. We have tried to compose the three groups from variables expressing the wide dimension of institutions, labour market and infrastructure, seen in the literature as FDI determinants. Given the period analyzed and the need for finding similarities or disparities among the determinants, we had to limit the number of variables. We are aware that, in some cases, the quantitative part of the determinants should have been more developed, and in other cases, we should have emphasized more the qualitative aspect. For example, it would have been better that the infrastructure group to contain also quantitative and qualitative variables expressing the transport infrastructure.

Table 1: Used variables

Name of the variable	Definition and unit of measurement	Data source
Dependent variable		
FDI	Inward FDI stock, % of GDP	UNCTAD
Independent variables		
I. Quality of institutions		
HI	The Index of Economic Freedom	Heritage Foundation
CPI	The consumer price indices, index base 2005	UNCTAD
DEF	The government deficit, % of GDP	Eurostat
DEB	The government debt, % of GDP	Eurostat
II. Labour market		
LB	Nominal compensation per employee, thousands euro	Ameco database
SC	Total enrolment in tertiary education, %	World Bank
UR	Unemployment rate, %	World Bank
RS	The number of researchers in research and development, per million people	World Bank
III. Telecommunications infrastructure		
MOB	The number of mobile cellular subscriptions per 100 people	World Bank
NET	The number of internet users per 100 people	World Bank
Control variables		
GC	GDP per capita, millions	UNCTAD
OP	Trade openness, expressing the share of exports and imports in GDP,%	Eurostat

Data were processed in order to obtain stationarity. The panel data methodology is applied in two stages. In the first stage, we find the variables that strongly influence FDI inflows in each of the three groups by using fixed effects panel data with period fixed effects. We will have three panels for each of the two analyzed periods. In the second stage, we will also apply the panel data analysis but this time only for the variables previously find as significant for FDI, to which we add traditional FDI determinants, such as trade openness and GDP per capita. As a result, we will identify the FDI determinants during transition and after the EU adhesion.

4. Results and discussions

For the period 1994-2003, we only find inflation with a significant impact for FDI in the institutions' group of variables. Interestingly, we find a positive relationship between FDI and inflation, meaning that a higher inflation is more attractive for FDI. We employed inflation as a variable for assessing the instability of a country. In similar studies using inflation, the variable is generally not significant for FDI (Kinoshita and Campos, 2003; Nonnemberg and de Mendonca, 2004; Pournarakis and Varsakelis, 2004; Bellak and Leibrecht, 2005). We can assume that inflation is less an indicator for the stability of a country, but more one that points to an environment capable of growth, where products can be sold. The period is characterized by high inflation rates, but also by important privatizations that can be seen as an important source of money for these countries. Not least, inflation allowed companies to sell products at higher prices, increasing the income and the profit of the companies.

As regards the labour market, only the variable representing the number of people in

tertiary education is significant, but having a negative relation with FDI. This point that foreign investors in these countries in the transition years were not interested in qualified labour force. The result is confirmed by the lack of signification between the number of researchers and the FDI inflows.
Finally, for the infrastructure group, we find a strong and positive relationship between the number of internet users and the FDI inflows, suggesting that developed communication infrastructure is more attractive for FDI. The estimations' results are presented in Table 2.

Table 2: The results of the panel data estimations in the first stage during 1994-2003

	Independent variable: FDI inflows, 1994-2003					
	Panel I: Institutions		**Panel II: Labour market**		**Panel III: Infrastructure**	
	Dependent variables		**Dependent variables**		**Dependent variables**	
Coefficient	CPI	0,485470*	LB	0,004776	MOB	0,042499
t-Statistic		3,671925		0,021030		0,516900
Coefficient	DEB	0,167045	SC	-0,818259	NET	0,104152***
t-Statistic		1,346992		-2,508528**		0,087300
Coefficient	DEF	-0,007583	UR	-0,029486	C	0,115773**
t-Statistic		-1,249705		-0,208474		0,032700
Coefficient	HI	0,077418	RS	-0,131995		
t-Statistic		0,216277		-0,740287		
Coefficient	C	0,125025*	C	0,251811*		
t-Statistic		5,991292		6,390539		
Adj. R squared		0,313301		0,149860		0,068357
Durbin Watson		1,901592		1,958438		1,880124

Note: * indicates statistical significance at 1%, ** at 5% and *** at 10%
Source: author's own calculations.

In the second stage, we employ only the significant variables identified below, to which we add the economic openness measured as the percentage of exports and imports in GDP and the GDP per capita. We find that only inflation and economic openness establish a significant and positive relation with FDI, signalling that investors are attracted by fewer restrictions on capital. The results are presented in Table 3.

Table 3: The results of the panel data estimations in the second stage during 1994-2003

Dependent variables	**GC**	**OP**	**CPI**	**SC**	**NET**	**C**
Coefficient	-0,714460	0,634621*	0,174156**	-0,438138	0,032974	0,207472*
t-Statistic	-1,079694	3,332623	2,309045	-1,640483	0,588096	3,647383
Adj. R squared	0,247307					
Durbin Watson	1,744078					

Note: * indicates statistical significance at 1%, ** at 5% and *** at 10%.
Source: author's own calculations.

For the period 2004-2013, we do not find significant variables for institutions' quality. The lack of significance may be due to significant changes in the institutions' quality as a result of EU adhesion but also of the economic crisis, taken into account the variables used for assessing the quality of institutions. Between FDI and nominal compensation per employee we find a negative relationship, pointing that low labour costs are attractive for foreign investors. On the contrary, there is a positive relationship between the number of mobile subscription and FDI, indicating therefore that a high level of mobile infrastructure development is attractive for FDI (see Table 4).

Table 4: The results of the panel data estimations in the first stage during 2004-2013

	Independent variable: FDI inflows, 2004-2013					
	Panel I: Institutions		Panel II: Labour market		Panel III: Infrastructure	
	Dependent variables		Dependent variables		Dependent variables	
Coefficient	CPI	0,767218	LB	-0,477739**	MOB	0,423261**
t-Statistic		1,533496		-2,702462		3,306772
Coefficient	DEB	-0,091224	SC	-0,159194	NET	0,092416
t-Statistic		-1,196167		-0,568811		0,655659
Coefficient	DEF	-0,008509	UR	-0,016568	C	0,009254
t-Statistic		-1,374565		-0,228083		0,533363
Coefficient	HI	-0,552599	RS	-0,160619		
t-Statistic		-1,273330		-1,054422		
Coefficient	C	0,031640	C	0,098212*		
t-Statistic		1,326671		5,425173		
Adj. R squared		0,642235		0,650424		0,672318
Durbin Watson		1,918813		1,778193		2,198286

Note: * indicates statistical significance at 1%, ** at 5% and *** at 10%.
Source: author's own calculations.

In the second stage, in which we employ only the previous significant variables, the GDP/capita and the economic openness, we find that nominal compensation per employee has a negative and significant relationship with FDI and a more developed mobile infrastructure is attracting more FDI, pointing to mixed horizontal and vertical FDI variables (see Table 5).

Table 5: The results of the panel data estimations in the second stage during 2004-2013

Dependent variables	GC	OP	LB	MOB	C
Coefficient	-0,113887	0,024944	-0,518992**	4,189708	0,048321**
t-Statistic	-0,339894	0,105255	-2,778675	0,048321**	2,666698
Adj. R squared	0,707008				
Durbin Watson	2,118621				

Note: * indicates statistical significance at 1%, ** at 5% and *** at 10%.
Source: author's own calculations.

We also find interesting differences in the level of adjusted R squared between the two analyzed periods, although we use the same determinants in the first stage of the econometric analysis. For example, the model for institutions quality is more suited for the period 2004-2013 than for the first period, having a higher adjusted R squared. The same is valid for the labour market group and the infrastructure group. This result could also mean that we are omitting variables that are specifically describing the transition period – such as the ones described in the literature as transition specific determinants.

5. Conclusion

Our results are partially confirming the ones identified in other studies in the literature. Transition countries were attractive for foreign investors mainly for the size of their markets, the cheap labour and the natural resources endowment (Holland and Pain, 1998; Bevan and Estrin, 2000; Carstensen and Touba, 2004; Kinoshita and Campos, 2004; Johnson, 2006 etc). However, the literature points to a change in FDI determinants for this group of countries. Lankes and Venables (1996) have certified the existence of market seeking FDI in the first half of the ninety decade. Subsequently, in the last half of the decade, foreign investors were searching for low cost labour (Bevan and Estrin, 2000). Grcic and Babic (2003) add the purchasing power of the local market, the macroeconomic stability, the infrastructure development, the abundance and quality of human and natural resources and institutional development to the fundamental determinants for the investment decision in CEE countries. Later, Kinoshita and Campos (2006) demonstrates

that no market size, neither low labour cost are significant for attracting FDI, once the quality of institutions and other variables related to policy formulation are taken into account.

Comparing the results obtained in the two periods in this study, we conclude that there are different FDI determinants, confirming our first hypothesis. The variables regarding the institutions' quality are only significant for the transition period in one of the models, mostly as a result of the variables employed. During 1994-2003, investors were mainly interested in open economies, for diminishing the transaction costs. The trade openness facilitates both the import of intermediate goods required for the production and the export of finished goods. At the same time, they are interested in an environment capable of growth, where their products can be sold.

For the period starting with 2004, the main advantages of CEE countries rest in their capacity to provide labour force with low costs. As the countries are already regionally integrated, their main advantage rested in cheap labour force and created resources – in our case, in developing their mobile networks.

The results obtained are of particular importance for the public policy decision makers. The changes in FDI determinants require the adaptation of public policies in the CEE countries. Paul et al. (2014) point that each of the CEE countries should apply a mix of policies aiming to improve infrastructure, increase the institutional quality, enhance the flexibility of labor market and keep a low level of taxes in order to attract FDI. In the short run, tackling infrastructure and institutions' quality is the recommended measure for increasing FDI inflows. A similar result is found in Popovici and Călin (2012b). The present study supports this result, as we found significant impact of infrastructure development and economic openness in attracting FDI. Also, Cho (2003) highlights the continuing need to improve the attractiveness of advantages related to localization, which requires complex and comprehensive policy approach. Even if this represents a challenge for policy makers in developing countries, the success in creating a favorable environment for business development are the keys for attracting investors.

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