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30 years after the fall of Communism: lessons learned for inward FDI

by

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FDI paved the way for the successful transition of East European countries into market economies. Starting from close to zero levels after the fall of Communism in the early 1990s, FDI inflows into the group reached a peak of $73 bn in 2007. The EU11 (11 CEE countries, members of the European Union: Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia, Slovenia (2004); Bulgaria, Romania (2007); Croatia (2013)), responsible for 8% of the entire EU's GDP, absorbed 15% of the total inflows into the Union during 2005-2008.[1] Importantly, that FDI was export-oriented, deepening integration within the regional market.

As elsewhere, the EU11 opened up to FDI, established investment promotion agencies (IPAs) and offered generous incentives. Foreign investors responded hesitantly and unevenly, as individual countries suffered from financial instability, debt burdens and recession that lasted between a couple (Estonia, Poland, Slovenia) and several years (in the others). Once stability was restored and economic growth resumed, FDI inflows grew rapidly everywhere until the Global Financial Crisis, then subsided in all countries, to then recover in some over the past four years.

MNEs are now omnipresent in almost all sectors and activities, and play the most important role in exports of manufactures: their shares of exports range from over 80% in Slovakia and Hungary; through 75% in Czechia and Romania; more than 50% in Bulgaria, Estonia, Poland, Slovenia, and Croatia; and over 40% in Latvia and Lithuania. Foreign firms in individual service industries—though generally less important than in manufacturing (except for telecommunications and information)—have contributed to modernizing services.

The EU11 have made remarkable progress in the three decades after the fall of Communism.The group's GDP (at purchasing power parity) per capita increased from 35% of the German level in 1995 to 63% in 2021, with progress experienced by all members, though unevenly. In attracting substantial export-oriented FDI, they have achieved in a short time what many developing countries have sought for decades—and only few have succeeded.

What explains this success?

At the outset, the EU11 had some advantages, such as high levels of education. Moreover, while the manufacturing base was obsolete, they had human resources adept at industrial processes. Importantly, the EU11 managed to implement, though at uneven pace, a set of policies that resulted in simultaneous improvements of key FDI determinants, in particular those that matter for export-platform investment.

- Initially, the EU11 removed a big obstacle to FDI—chronic banking crises—by letting in foreign banks that soon dominated the banking sector in all countries but Slovenia. The entry of foreign banks was accompanied by regulatory reforms, including prudential supervision. Thus, the EU11 used one type of FDI to improve determinants for other types of FDI.

- The EU11 turned state-owned behemoths in infrastructure services (also important for FDI) into viable companies, some by selling to foreign investors and some by turning them into joint-stock companies. Over time, most unbundled industries suitable for competition, regulated the remaining monopoly segments, separated ownership from regulatory functions, and established independent regulators.

- The EU11 all improved international logistics, crucial for export-oriented FDI, by investing in infrastructure, reducing obstacles to the movement of goods and facilitating shipments. As a result, the EU11, except for Latvia and Slovakia, significantly improved their positions in the Logistics Performance Index ranking. These improvements are mirrored in their recent relatively high scores for trade facilitation measures, ranging from 1.6 to 1.8 (out of 2).

- The EU11 strengthened governance and economic institutions, and all markedly advanced in the Fraser Institute's Economic Freedom ranking between 1990-1995 and 2010-2015. However, recently some declined in this and other similar rankings, mainly on account of populist governments.

- The EU11 continued to invest in education, in particular at the tertiary level, laying the ground for FDI upgrading. Graduates of tertiary institutions are commonly hired by

MNEs, many on the Fortune 500 list that have established thousands of affiliates in business services in the region.

- Although the EU11 countries improved on many fronts important for FDI, they are rarely among leaders in rankings. This suggests that simultaneously tackling many FDI determinants and bringing them up to decent standards is more important than making one or two perfect.

A big factor that facilitated large and better FDI flows into the EU11 has been their accession to the EU. The adoption of the EU's regulatory framework reduced the risk of investing, incentivized competition and lowered the cost of attracting FDI. EU funds contributed to improving the physical and institutional infrastructure. Free trade has triggered the relocation of industry from the West to the East, and FDI in the East by outsiders, stimulating large export-oriented FDI. This demonstrates the power of irreversible trade liberalization between high- and low-cost countries: the EU11's access to a large regional market has turned them, with FDI playing its part, into export platforms.

As similar tight integration arrangements are not likely among developing countries, a realistic policy lesson for them is to seek free trade agreements with large developed countries, possibly with loose rules of origin—apart from strengthening other FDI determinants, as the EU11 have done.

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[1] Author's own calculations, based on UNCTAD and Eurostat.

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