Emerging Markets Queries in Finance and Business

Connections between FDI, Corruption Index and Country Risk Assessments in Central and Eastern Europe

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Abstract

Foreign Direct Investments (FDI) represent one of the most important avenues for an economic system to improve itself and to increase the level of competitiveness within and among its constituent parts – various economic agents. FDI generate a variety of effects inside the host-economies (it affects economic growth, regional development, sustainable development, etc.), effects that differ from country to country, according to several criteria (economic, political, social, institutional). In the same time, the amount of FDI varies from country to country, in accordance to their "attractivity" in the eyes of the international business community. There are several factors that influence this perception; this paper will focus on two of them – the corruption perception index - CPI (data from Transparency International) and the country risk assessment - CRA (data from COFACE). In other words, the present article will analyze the relations between FDI volume, corruption perception index and country risk assessments for Central and Eastern Europe in an attempt to answer the question if these two factors influence, in any way, FDI in the region.

Keywords: FDI, Corruption, Country Risk Assessments, Economic Development

1. Introduction

In order to ensure economic growth and competitiveness in various economic sectors, to be able to create new jobs, increase household incomes, promote exports and transfer of advanced knowledge and technology, countries mainly need FDI, which is the purpose of integration into the European economic system.

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An increased emphasis has been placed on assessments by which countries can be ranked for Corruption or Country Risk, assessments made by reliable sources like Transparency International, COFACE, Euler Hermes, The Economist Intelligence Unit, UNCTAD - United Nations Conference on Trade and Development and others.

Literature review:

There are two types of theories regarding the connections between our three main concepts (FDI, Corruption Index and CRA): those that consider that there are important correlations between the three variables and those who believe that there are no significant correlations between FDI, CRA and the Corruption Index. We can include in first category researchers like Habib and Zurawicki (2005), Pancras Nagy (1979), Michael McAleer (2010), Khalil et al. (2010), Gopinath (2008) and others.

The second category of theories consider that there are other factors that influence the FDI flows more than corruption, or that there are factors that only added to CRA and corruption can have a real impact on growth economies. Exponents of this point of view are Busse et al. (1996) with references on media impact, Kaufmann (1997a, 1997b) with studies about Ukraine and Russia, Drabek and Payne (1999), Kotov (2008) that concludes in his study that corrupt countries invest more than non-corrupt countries which are reluctant to invest in countries like Brazil, Russia, India and China, Cuervo-Cazurra (2008) discovering that in countries with transition economies (Former Soviet Bloc) petty corruption was positively related to FDI and others that places the emphasis on inefficient Government Institutions, national policies, or property rights.

The amount of FDI varies from country to country, in accordance to the interest of the international business community in investing. Country Risk Assessments (CRA) and Corruption Perception Index can influence the decision of investing in a foreign country.

1.1 Foreign Direct Investments

Foreign direct investment is the name given to the process where a firm / company from one country invests *capital* in a business / company existing or newly created in another country. (BNR Statistics 2012, p.5)

However, the Organization for Economic Cooperation and Development (OECD) calls direct investment (FDI) as more than just movement of capital - investment that adds to, deducts from or by which you can have a long-term interest and profit in a firm / company operating in the economy, capital - direct investment coming from a country other than the firms` / company receiving the investment and "implies that the investor exerts a significant influence on the management of the investee company".(International Monetary Fund (IMF), according to Moraru, 2013, p.124)

Types of FDI
- Greenfield refers to the establishment of companies - Greenfield investment;
- Mergers and acquisitions: full or partial takeover of companies by foreign investors;
- Business development: increasing FDI holdings in companies - foreign direct investment;
- Firm restructuring: through capital injection (equity) financing losses of direct investment enterprises by foreign direct investors. (BNR Statistics 2013, p.6)

FDI effects:
A) Direct effects (employment, commercial transactions growth, capital formation);
B) Indirect effects (transfer of technology and managerial skills to local firms);
C) Horizontal effects = horizontal spillovers (within the industry)
- Positive (diffusion of technology within the industry by: - job reallocation - imitation process - entry of international firms specialized in related services);
- Negative: competition or effect of "stealing market" (market / business stealing effect).
D) Vertical effects = vertical spillovers (between industries - organizing vertical supply chain):
- Upstream chain: local firms are suppliers of inputs for foreign companies (positive effect due to increased demand for inputs for local businesses and could lead to a reduction in average costs);

- Downstream chain: foreign companies are suppliers of inputs for local firms (it is also a positive effect).

Benchmark condition for the calculation of FDI (according to Jones &Wren 2012, p.9)

Foreign Direct Investments = Retained earnings (i.e. direct investors share of earnings/ losses) + Direct investors purchase less sales of enterprises `shares + Net increase in long and short term loans, credit and other amounts given by the direct investor to overseas enterprise - Overseas enterprise borrowing of money from host country or from their own resources in order to give to the direct investor in home country

Benchmark condition for the calculation of FDI is important in ensuring transparency in comparing international direct investment flows / values.

1.2 Country Risk Assessments as a determining factor of internationalization through direct investments

Country risk is generated by the interaction of political, economic, social and institutional factors, a country-specific complex reality, national macro-environment that affects any investment or foreign business located in that geographical area. Country risk level is also affected by world political and economic situation.

Country risk is the exposure to loss that may occur in a business with a foreign partner, caused by specific events that are at least partially under country governmental control and cannot be controlled by the investment decision makers that can only predict such events and avoiding risks by no investing, or opting for a form of internationalization adapted to the level of risk in the host country.

Country Risk Assessments (CRA) significantly influences the overall risk level of FDI as a fundamental prediction and evaluation tool in the process of transnational firms' internationalization through FDI. That is why the analysis involves allowing and getting decision makers a correct and complete evaluation of the relationship between potential risks and earnings of the business.

1.3 Corruption Index

The Corruption Index is a Perception Index used to classify countries by their level of abuse of power for private gain among Governmental Institutions and the integrity of people in a position of authority. The Corruption Perception Index (CPI) provides a metric regarding the perceived levels of corruption by country and is available for 180 countries. Countries are given a score that ranges from zero to ten, a *high score* meaning *low risk of corruption* and a *lower CPI score* indicating *high corruption risk*. (according to Smith & others, 2013, p.15-33)

Categories of corruption:
- Systematic corruption (high level Institutionalized corruption as social corruption that modifies national Laws, Legislative Norms in favor of specific private firms);
- Instrumental corruption ("big corruption" that happens and could affect a given social Institution and/or an entire economic sector);
- Incidental corruption (individual "small corruption" that doesn`t affect the majority of people from a country).

Corruption is not a new phenomenon and recent studies show that it has an impact on the flows of FDI. It can facilitate the volume of foreign direct investments by "greasing" the wheels of commerce in the presence of weak regulatory framework, or, as in most cases, impede the inflow of FDI because of transaction costs uncertainty.

2. Data and Empirical Methodology

The present article analysis the Foreign Direct Investments inflows in Central and Eastern Europe in connection with Country Risk Assessments and Corruption Perception Index. Main data were gathered from COFACE, Transparency International, UNCTAD Organizations, data published online, for the period 2008 – 2014. Based on theoretical and empirical research we want to see if there is a connection between Country Risk

Assessments and FDI inflows and also, between Corruption Perception Index and FDI inflows. Tables presented below will be compared based on changes reflected through years 2008 – 2013.

Table 1. Foreign direct investment (FDI) inflow overview, 2008 - 2013, by region and economy, Central Eastern Europe (Millions of Dollars)

Region/ Economy	Foreign Direct Investments Inflow						Total
	2008	2009	2010	2011	2012	2013	2008-2013
Moldova	711	208	208	288	175	231	1 821
Slovenia	1 947	-659	360	998	-59	-679	1 908
Serbia	2 955	1 959	1 329	2 709	365	1 034	10 351
Croatia	5 938	3 346	490	1 517	1 356	580	13 227
Slovakia	4 868	-6	1 770	3 491	2 826	591	13 540
Bulgaria	9 855	3 385	1 525	1 849	1 375	1 450	19 439
Romania	13 909	4 844	2 940	2 522	2 748	3 617	30 580
Czech Republic	6 451	2 927	6 141	2 318	7 984	4 990	30 811
Hungary	6 325	1 995	2 202	6 290	13 983	3 091	33 886
Ukraine	10 913	4 816	6 495	7 207	7 833	3 771	41 035
Austria	6 858	9 303	840	10 618	3 939	11 083	42 641
Poland	14 839	12 932	13 876	20 616	6 059	- 6 038	62 284
Switzerland	15 212	28 891	35 145	26 590	10 238	- 5 252	110 824
Germany	8 109	23 789	65 620	59 317	13 203	26 721	196 759

Source: Data from UNCTAD (United Nations Conference on Trade and Development, World Investment Report 2014), own computation.

- FDI net inflows are the value of inward direct investment made by non-resident investors in the reporting economy. (Source: The World Bank)
- Negative FDI net inflow means that divestment is greater than investment.

We can observe from data found in *Table 1* that there isn`t any discernable pattern in FDI inflow, nor by date or country (the inflow of FDI doesn`t increase or decrease by year for every country).

From the "Total "column, years 2008-2013, of the Table 1 we can observe that there are some countries with high values of FDI inflow, like: Germany (196 759 million dollars) – ranked first, Switzerland (110 824 million dollars) – ranked second, Poland (62 284 million dollars) - third, Austria (42 641 million dollars), Ukraine (41 035) and some countries with low or extremely low values of FDI inflow: Bulgaria (19 439 million dollars), Slovakia (13 540 million dollars), Croatia (13 227 million dollars), Serbia (10 351 million dollars), Slovenia (1 908 million dollars) and Moldova (1 821 million dollars). The other countries presented in the Table 1 have a medium value of FDI inflow (Hungary, Czech Republic and Romania – ranked in this order).

We find some unexpected high FDI inflow values for countries like Poland that gets ahead Austria and unexpected high FDI inflow values for Ukraine, a non – UE country, part of Transition Economies like Croatia, Serbia and Moldova, for the time period 2008-2013. Usually being part of European Union is a political and economic advantage for countries, especially when they benefit from central geographical positioning in Europe and have an attractive quality of life (the case of Austria), being ranked better than Poland (see Table 3 for Country Risk Assessment).

So, maybe there are other reasons for which countries seem more "attractive" in the eyes of foreign investors, more complex ones, that being the reason why the connections between FDI inflow, the Corruption Index and the Country Risk Assessment should be analyzed, at least according to Rose Ackerman (1999), Della Porta and Vannucci (1999), Gani (2007), or Wei (1997).

From Table 2 we can observe that the leading less corrupt countries are: Switzerland with a score of 87 out of 100 (or 8.7 out of 10), followed by Germany (score 79 or 7.9), then Austria (score 75 or 7.5) and Slovenia (score 62 or 6.2), for the time period 2008 – 2013.

Table 2. Corruption Perception Index, 2008 - 2013, Central Eastern Europe

	2008-2009			2010			2011			2012			2013	
Rank	Country	Score	Rank	Country	Score	Rank	Country	Score	Rank	Country	Score	Rank	Country	Score
71	Romania	3.8	69	Romania	3.7	75	Romania	3.6	66	Romania	44	69	Romania	43
72	Bulgaria	3.7	73	Bulgaria	3.6	86	Bulgaria	3.3	75	Bulgaria	41	77	Bulgaria	41
14	Austria	8	15	Austria	7.9	16	Austria	7.8	25	Austria	69	26	Austria	69
14	Germany	8	15	Germany	7.9	14	Germany	8	13	Germany	79	12	Germany	78
47	Hungary	5.1	50	Hungary	4.7	54	Hungary	4.6	46	Hungary	55	47	Hungary	54
54	Poland	4.8	41	Poland	5.3	41	Poland	5.5	41	Poland	58	38	Poland	60
49	Czech Republic	5	53	Czech Republic	4.6	57	Czech Republic	4.4	54	Czech Republic	49	57	Czech Republic	48
99	Moldova	3.1	105	Moldova	2.9	112	Moldova	2.9	94	Moldova	36	102	Moldova	35
64	Croatia	4.2	62	Croatia	4.1	66	Croatia	4	62	Croatia	46	57	Croatia	48
84	Serbia	3.4	78	Serbia	3.5	86	Serbia	3.3	80	Serbia	39	72	Serbia	42
27	Slovenia	6.7	27	Slovenia	6.4	35	Slovenia	5.9	37	Slovenia	61	43	Slovenia	57
54	Slovakia	4.8	59	Slovakia	4.3	66	Slovakia	4	62	Slovakia	46	61	Slovakia	47
140	Ukraine	2.3	134	Ukraine	2.4	152	Ukraine	2.3	144	Ukraine	26	144	Ukraine	25
5	Switzerland	9	8	Switzerland	8.7	8	Switzerland	8.8	6	Switzerland	86	7	Switzerland	85

Source: Own computation based on data from Transparency International

The Ranking in Table 2 is based upon studies about corruption in 180 countries between years 2008-2009, 178 countries surveyed in 2010, 183 countries surveyed - years 2011, 177 countries included in the Corruption Index for years 2012-2013
Score presented on a scale from 0 to 10, Meanings: 0 = Highly Corrupt; 10 = Very Clean, years 2008-2011
Score presented on a scale from 0 to 100. Meanings: 0 = Highly Corrupt; 100 = Very Clean, years 2012-2013

With just above medium score is Poland with approx. 55 points out of 100, then Hungary, approx. 51 out of 100, meaning medium corruption perception index, for the time period 2008 – 2013. The other countries score as follows for the same time period, 2008 - 2013: Czech Republic (score 47 or 4.7), Slovakia (score 45 or 4.5), Croatia (score 43 or 4.3), Romania (approx. score 40 or 4.0), Bulgaria (score 38 or 3.8), Serbia (score 37 or 3.7), Moldova (score 32 or 3.2) and the lowest score and most corrupt country, Ukraine (24 or 2.4). During the time period 2008 – 2013 there are no big changes in the score given to countries for corruption level within their economies and institutions.

Table 3. Country Risk Assessments, 2011 – 2014, Central Eastern Europe

Country/Region	Assessment Year 2011 -2012 Country Risk/ Business Climate	Assessment Year 2013 - 2014 Country Risk/ Business Climate
Romania	B/A4	B/A4
Bulgaria	B/A4	B/A4
Austria	*A2/ A2*	*A1/A1*
Germany	*A2/A1*	*A1/ A1*
Hungary	B/A2	B/A2
Poland	A3/A2	A3/A2
Czech Republic	*A3/ A2*	*A4/ A2*
Moldova	D/C	D/C
Croatia	*B/A4*	*B/A3*
Serbia	C/C	C/C
Slovenia	A3/A2	A4/A2
Slovakia	*A3/A3*	*A3/ A2*
Ukraine	*D/C*	*D/D*
Switzerland	A1/A1	A1/A1

Source: COFACE, own computation

A1=VERY LOW RISK; A2=LOW RISK; A3=QUITE ACCEPTABLE RISK; A4=ACCEPTABLE RISK; B=SIGNIFICANT RISK;
C= HIGH RISK; D=VERY HIGH RISK

Table 3 shows the same trend, Switzerland being assessed as a country with very low economic, political, social, institutional and business climate risk, followed by Germany, then Austria. Little has changed in the time period 2011 – 2014 for these countries regarding country risk and business climate risk. There is quite acceptable country risk and low business risk in Poland, Slovakia, Slovenia and Czech Republic with a little change for the last two ones` here, between the years 2013-2014, from countries with quite acceptable risk into countries with acceptable risk. The countries with highest degree of country and business climate risk are: Ukraine, Moldova and Serbia.

3. Findings based on gathered data

When *comparing Table 1 with Table 2* in the case of Romania, within the time period 2008 – 2011, in search of a connection between Corruption Perception Index and FDI inflow, we see that Romania is being

perceived as a medium corrupt country (scores changing very little from 2008 to 2011) but with impact on FDI inflows. As the country is perceived more corrupt and the Corruption index gets lower, FDI inflows decrease from 2008 to 2011. In 2012 Romania gets a better corruption score and in accordance with it FDI inflows grow in amount. There is a little discrepancy in 2013 when although the country gets a corruption score lower than the year before, 2012, the amount of FDI inflows increases. We may assume that the difference in corruption score from 44 in 2012 with a FDI inflow of 2 748 million dollars, to 43 corruption score in 2013, with a 3 617 million dollars FDI inflow, wasn`t an "alarm trigger" for foreign investors, Romania being a country with medium level of corruption.

Bulgaria doesn`t follow the trend of Romania, in 2011 registering the lowest corruption score for the country (3.3 corruption score), the amount of FDI inflows for 2011 surpassing the 2012 and 2013 amounts of FDI inflows, years when Bulgaria was perceived less corrupt than the year before (in 2011 - 1 849 million dollars FDI inflows, 2012 - 1 375 million dollars and 2013 - 1 450 million dollars FDI inflows). In case of Bulgaria, there isn't a connection between Corruption Perception Index and the amount of FDI inflows received by the country from 2008 to 2013.

Although better scored and perceived as almost "very clean" countries (Switzerland, Germany, Austria) gather a better total of FDI inflows from 2008 to 2013, there isn`t a real connection between corruption index and FDI inflows year by year when the actual score of corruption modifies to better or worse for the countries in discussion.

Also Poland (a medium level corrupt country) and Ukraine (a highly corrupted country) gather bigger amounts of FDI inflows from 2008 to 2013 than Austria (clean form the corruption point of view), or Slovenia.

Therefore, analyzing tables 1 and 2 we can conclude that there is no correlation or strong connection between a countries` perceived corruption and investment inflows to that country, these facts sustaining the opinion of some researchers about the influence and impact of only corruption on the volume of FDI flows in a country.

Comparing Table 1 with Table 3 in hopes of finding connections between Country Risk Assessments and FDI inflows between years 2011 – 2013, we find that Romania and Bulgaria have a similar country risk assessment/ business climate – B/A4, meanwhile, their FDI inflows are different – 30 580 million dollars Romania and 19 439 Bulgaria.

Moreover, Ukraine has a low CRA/ business climate – D/C for 2011/2012 and D/D for 2013/2014 but has a high FDI total: 41 035 million dollars. Even if we take into consideration not the total FDI but the investments flows for the years 2011-2014 we cannot discern a pattern for this country that will imply a correlation between FDI and CRA.

Further analyzing table 3 we can divide the countries in three broad categories: I. Countries with very little/little perceived CRA (Austria, Poland, Germany, The Czech Republic, Slovenia and Slovakia); II. Countries with acceptable/significant risk (Romania, Bulgaria, Hungary and Croatia) and III. Countries with high/very high risk (Moldova, Serbia, Ukraine). If we take a look at table 1, the FDI inflows, we will see that there is no unity among countries from the same CRA category from FDI's perspective. More than that, not even if we factor in a different denominator (the size of the country, which is an indicator –however inaccurate – of that economic system's absorption power) there is not a clear relation between the amount of money entering a country and its perceived risk index.

If we attempt a longitudinal analysis we can again divide the countries from CEE in three categories: I. Countries that registered an improvement in their CRA, however slightly): Austria, Germany, Croatia and Slovakia; II. Stationary countries – they kept their CRA over the years: Romania, Bulgaria, Hungary, Poland, Moldova, Serbia and Switzerland and III. Countries that registered a worsening of their CRA: The Czech Republic, Slovenia and Ukraine. However, when we look at the evolution of FDI inflow for these countries (table 1), there is no constant increase for the countries in category I, no stability for countries in category II and no constant decrease in FDI for the countries in category III.

Therefore, we can confidently say that, based on the data at our disposal, there is no discernable relation between FDI flow and CRA for the countries in CEE.

4. Conclusions

There are, as stated in the theoretical framework presented at the beginning of this paper, two types of theories regarding the connections between our three main concepts (FDI, Corruption Index and CRA): those that postulate that there are important co-variations between the afore-mentioned variables (this category is subdivided further into theories that suggest that CRA and Corruption index have an adverse effect upon the capacity of a countries' economic system to attract money from abroad and those who state that the effect can be somewhat positive, in the sense that in extremely corrupt systems "greasing the wheels" can speed things up and be the only way of doing business) and those that are of the opinion that there are no significant correlations between FDI, CRA and the Corruption Index.

Within this context, our analysis of our data seems to suggest (even strongly support) the latter. We were unable to identify any discernable pattern that links the three concepts together. At this point in our paper we must clarify a couple of things.

First, even if our data does not prove/support the existence of significant relations between FDI, CRA and the Corruption Index it does not prove the theories postulating such a connection wrong. In other words, what this study argues is that there are no correlations between these theoretical concepts within the analyzed data, with no attempts to generalize this conclusion to other information package.

Second, the data we analyzed is quite specific. It refers at a period of time that includes the onset of the current economic crisis, a factor that surely afflicted the FDI flows. More than that, it refers to countries that, for the majority of them, are either members of the same economic entity (EU) or are applying for membership. It is stating the evidence that the economic and financial flows among these countries is rather particular and influenced not only by the characteristics looked at when constructing indicators such as CRA or Corruption Index but by broader policies – EU policies. Even the relatively singular position of Ukraine (it has a high FDI influx but also bad scores for CRA and the Corruption Index) can be – partially- explained by its proximity to EU. Moreover, all these countries are part of a quasi-similar cultural system, in the sense that they are all European countries, not like the cultural difference that exists between, let us say, US investors and African host-countries. Third, we compared and analyze aggregated indicators, our intention being the creation of a factual-based platform for the discussion of the two types of theory mentioned above within the CEE context. In other words, if we were to correlate the individual characteristics that make up these complex notions the overall picture could be slightly different (for instance, in the case of Ukraine, one explanation of its high FDI inflow could be the influx into the country of Russian-based capital). Moreover, there are factors that influence the financial matrix between these countries that are historical, or have their origins in political rather than economic reasons. In conclusion, we can confidently say that there are no clear connections between FDI on one hand and CRA and the Corruption Index on another for the countries in CEE for the period of time analyzed within this study.

Acknowledgement

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