EUROPEAN NEIGHBOURHOOD POLICY AND FDI: EASTERN DIMENSION

Krzysztof FALKOWSKI[*], Joanna STRYJEK[**]

Abstract: *The paper (1) analyses the volume, dynamics and structure of inward FDI flows to six transition economies in Eastern Europe, covered by the Eastern Partnership initiative under the EU's European Neighbourhood Policy (i.e., Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine), and (2) explores the potential role played in these flows by factors related to the advancement of the countries' transition process. The results of the study indicate that inward FDI flows varied greatly across the countries in question over the period 2004-2014, and depended mostly on (1) the countries' progress in introducing market reforms, (2) their stability and the democratization of the political systems (having regard also to the geopolitical situation, both internal and external), and (3) general conditions for doing business in them.*

Keywords: *FDI; FDI determinants; EU; European Neighbourhood Policy; ENP; transition; transition economies*

Introduction

The aim of the paper is to analyse the volume, dynamics and structure of FDI capital flows (flows as well as stocks) to six transition economies (i.e., Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine) in years 2004-2014, as well as to explore the potential role played in these flows by the factors, which are related to the advancement of the countries' transition process, i.e.: (1) progress achieved in implementing market reforms, (2) advancement in transition of political systems, and (3) general conditions for doing business. All the transition economies in question represent the so-called Eastern Dimension of the European Neighbourhood Policy (ENP); for the purpose of this paper they are called Eastern Dimension countries (EDCs).

Many theoretical models sought to explain FDI flows in the world economy. They include approaches referring to: neoclassical trade theory (i.e., Heckscher-Ohlin model); behaviour theory; product life cycle; market imperfections; product differentiation; oligopoly markets; institutions; OLI (Ownership–Location–

[*] Ph.D., Warsaw School of Economics, Poland, e-mail: kfalkow@sgh.waw.pl
[**] Ph.D., Warsaw School of Economics, Poland, e-mail: joanna.stryjek@sgh.waw.pl

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Internationalization) paradigm; new theory of trade; and others (for a detailed overview of theories on FDI determinants see, e.g., S. Assunção *et al.*, 2013).

The abovementioned theoretical approaches, as well as other theoretical models, compete to identify factors conductive to attracting FDI inflows. The factors indicated by the models have been verified by numerous empirical studies. However, the empirical research has not resulted in the selection of one model, better reflecting the reality than others. On the contrary, as I. Faeth (2009) indicates, the empirical evidence strengthens the idea that different models, which aim to explain FDI determinants, do not necessarily replace each other – rather each of them finds some support through regression analysis. That is why FDI should not be explained by a single theoretical model, but more broadly by a combination of factors derived from a variety of models (Faeth, 2009).

As far as empirical studies on FDI determinants in (selected) transition economies are concerned, they examine the importance of a wide range of factors, such as: host country GDP and GDP per capita, labour costs, productivity, tax burden, market potential, market institutions (e.g., market stabilizing institutions, market creating institutions), foreign exchange, the distance between source and host country, the level of openness of an economy, private sector share, service sector share, advancement of reforms in infrastructure sector, risk credit rating, corruption, natural resources, cultural proximity, and others – for a detailed review of the empirical studies on FDI determinants in transition economies see, e.g., B. Dauti (2015). Although the literature on FDI flows to transition economies is extensive, the empirical studies are hardly ever based on data for individual EDCs (Armenia, Azerbaijan, Belarus, Georgia, Moldova and Ukraine). This paper focuses on the abovementioned group of countries and explores the significance of the potential FDI determinants, related to the advancement of the countries' transition process.

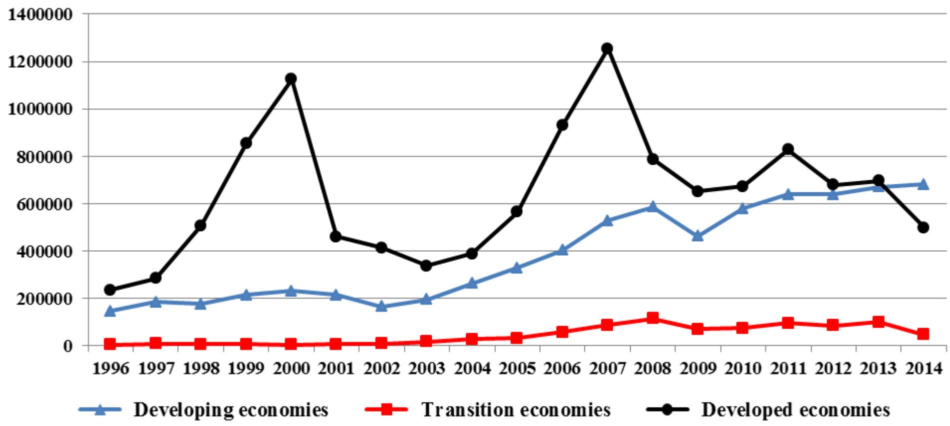
The thesis of the paper is that FDI capital flows to the ENP's Eastern Dimension countries varied greatly across the countries in question over the period 2004-2014, and depended mostly on (1) the countries' progress in introducing market reforms, (2) their stability and the democratization of the political systems (and also the geopolitical situation, both internal and external) as well as (3) the general business environment.

The argument is structured as follows. The first section serves as an introduction and presents FDI determinants identified in the literature on transition economies. The second section provides an analysis of inward FDI flows to the EDCs during the 2004-2014 period. In the third section, a study of the role played in the abovementioned flows by the factors indicated in the thesis of this paper is presented. Conclusions follow.

1. The inflow of FDI to the ENP's Eastern Dimension countries (2004-2014)

The European Neighbourhood Policy was launched at the time when the conditions for the inflow of FDI to its EDCs seemed to be exceptionally favourable, especially as far as the investment originated from the EU member states was concerned. The EU's eastward enlargement of 2004 made some of the EDCs (i.e., Ukraine and Belarus) immediate EU neighbours, and thus created important transportation and logistical advantages for the EU's investors. Additionally, that was just the beginning of a rapid global expansion of FDI, which reflected the investors' optimism towards capital investments.

Figure 1. Inward FDI flows to the developing, transition and developed economies in 1996-2014 (USD at current prices and current exchange rates; in millions)

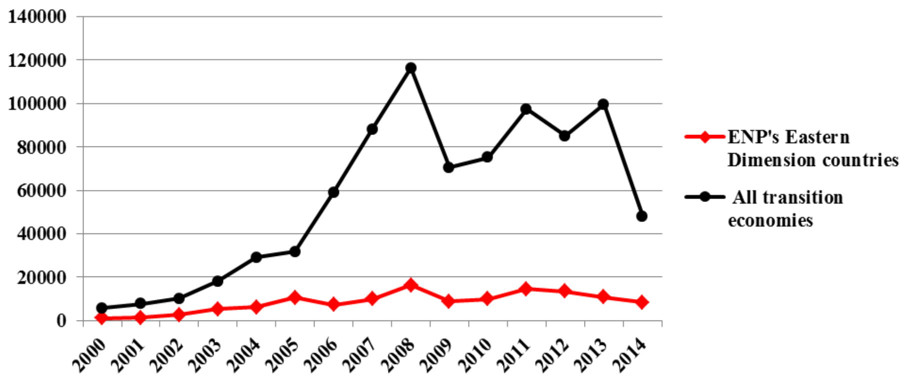


Source: Author's representation based on data from UNCTAD, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April 2016).

Figure 1 presents FDI flows to the developing, transition and developed economies over the period 1996-2014. Admittedly, for each of the abovementioned groups of countries, the year 2004 constituted the beginning (or a continuation) of an upward trend as far as the inflows of FDI are concerned. The trend lasted until 2007 or 2008 (depending on the region) and was closely related to the onset of the global economic crisis. It was particularly strong in the transition economies, more gentle in the case of the developed economies, and much less prominent in the developing economies (the strength of the trend in the transition economies is hard to notice in Figure 1 because of the scale of the figure, but it is clearly visible in Figure 2). In consequence, in 2007 the inflows of FDI to the transition economies were almost 5 times higher in comparison to the year 2003. However, interestingly, the upward trend observed in the transition economies overall was not reflected in the total FDI inflows to the EDCs (Figure 2) as there was a drop in the inflows of FDI to the EDCs in 2006. It was caused by a decline in FDI inflows to two most popular (at that time) FDI destinations among the EDCs – Ukraine and Azerbaijan. The decline was so large that it determined the results achieved by the EDCs overall, despite the increases in FDI inflows to Georgia, Armenia, Belarus and Moldova (Figures 2 and 3).

The above data indicate two important features of the EDCs when it comes to FDI, that is, the countries neither accurately reflected the world's FDI trends nor were similar to each other as far as the inflows of FDI were concerned. In other words, the EDCs represent such a heterogeneous group of countries in terms of their inward FDI that they have to be analysed individually.

Figure 2. Inward FDI flows to the transition economies and to the ENP's Eastern Dimension countries in 2000-2014 (USD at current prices and current exchange rates; in millions)



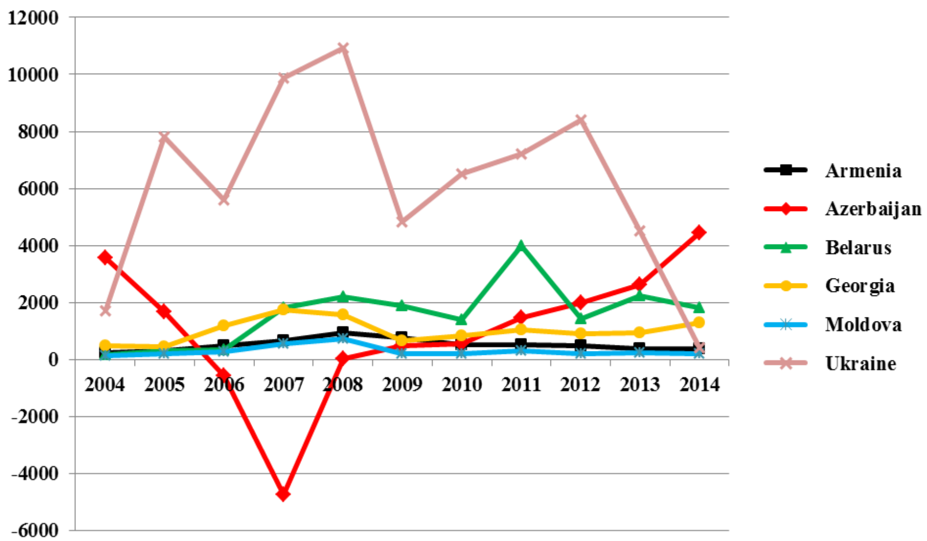
Source: Author's representation based on data from UNCTAD, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April, 2016).

Figure 3 presents FDI inflows to individual EDCs over the period 2004-2014. In 2004, Azerbaijan was the most popular FDI destination within the group of countries in question, and it attracted FDI amounting to USD 3556.1 million (Figure 3). This was a record result for that small economy in its history, and the result was achieved due to large oil-related FDI inflows. The second leading FDI destination in 2004 was Ukraine, attracting FDI worth USD 1715 million (Figure 3). The list of companies with major FDI projects in Ukraine included not only oil companies (i.e., Russian Lukoil and British Regal Petroleum) but also manufacturers of consumer goods, construction materials, retailing and telecommunications firms (UNCTAD, 2005, p. 76). Although the value of FDI inflows to Ukraine was pretty high in comparison to most of the other EDCs, it was relatively small in relation to the size of its economy, measured in terms of the

Gross Domestic Product (GDP) – see Figure 4. From this perspective, Azerbaijan was the undeniable leader in that year, and it was followed, respectively, by Georgia, Armenia and Moldova (Figure 4).

In 2005, two major changes took place in the inflows of FDI to the EDCs: (1) a significant decrease in the value of Azerbaijan's inward FDI flows (by over 50% on a year-on-year basis), and (2) a sharp (i.e., by over 350%) increase in the value of Ukraine's inward FDI flows (Figure 3). Due to the changes, Ukraine became a leader among the EDCs in terms of the value of FDI inflows. The biggest deals at that time in Ukraine were made (1) in the iron and steel industry – the purchase of Kryvorizhstal by Mittal Steel (Netherlands/United Kingdom), and (2) in the financial sector – the purchase of Aval Bank by Raiffeisen International from Austria. Nevertheless, concerning the inward FDI-to-GDP ratio, Azerbaijan managed to keep its leading position. It was followed by Ukraine, Georgia and Moldova (Figure 4).

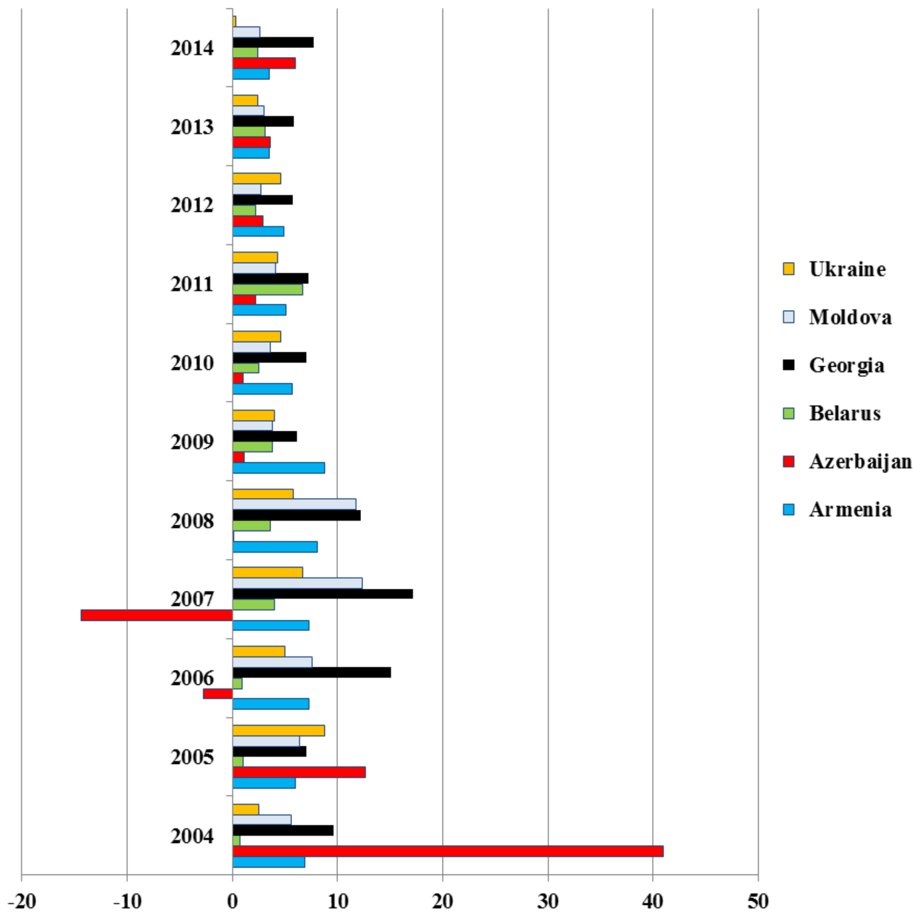
Figure 3. Inward FDI flows to individual Eastern Dimension countries of the European Neighbourhood Policy in 2004-2014 (USD in current prices and current exchange rates; in millions)



Source: Author's representation based on data from UNCTAD, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April, 2016).

In 2006, the map of inward FDI flows to the EDCs changed again. As it was already mentioned, the overall inward FDI flows to the EDCs decreased, despite the fact that the overall global FDI inflows kept increasing. The drop was caused by two countries: Azerbaijan and Ukraine. In Azerbaijan, the value of disinvestment by foreign investors exceeded the value of the capital newly invested in the country (Figure 3), and in Ukraine the inflow of FDI decreased by over 28% (on a year-on-year basis). Over the same period, inward FDI flows to the other EDCs increased. The increase was small in almost all the cases, with the exception of Georgia. In Georgia, inward FDI flows reached the level of USD 1170 million, increasing by over 150% (on a year-on-year basis). In consequence, as Georgia's economy is small, the country took the leading position as far as the FDI-to-GDP ratio was concerned; it was followed by Moldova, Armenia and Ukraine (Figure 4).

Figure 4. Inward FDI flows to individual Eastern Dimension countries of the European Neighbourhood Policy in 2004-2014 (percentage of GDP)



Source: Author's representation based on data from UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April 2016).

Over the period 2007-2008, most of the EDCs attracted relatively high interest of foreign investors in comparison to the previous years. In terms of value, FDI inflows reached the highest level in Ukraine (almost USD 11 billion in 2008); the country attracted large FDI projects, e.g., in the banking, real estate and construction industries (UNCTAD, 2008, p. 67). In terms of the inward FDI-to-GDP ratio, Georgia maintained its leading position (hosting, e.g., Kazakhstan's investment in the oil industry), and all the other countries improved their results, with the exception of Azerbaijan (in 2007, the value of disinvestment by foreign investors significantly exceeded the value of the capital newly invested in Azerbaijan, and in 2008 the inflow of FDI to the country was very small – see Figure 3).

In 2009, inward FDI flows to the EDCs plummeted, which, to a large extent, reflected growing uncertainty among foreign investors over the spread of the economic crisis in the world economy. In 2010, the overall FDI inflows to the EDCs remained on an almost unchanged level. The only country to show the first signs of recovery was Ukraine, in which the inflows of FDI increased by 35%, due to, *inter alia*, the revival of cross-border acquisitions by Russian companies (UNCTAD, 2011, p. 64). Over the following two years, there was a recovery of the overall inward FDI flows to the EDCs. However, while there was a strong increase in FDI inflows to Belarus, Ukraine, Azerbaijan and Georgia, the inflows for the remaining EDCs (i.e., Armenia and Moldova) declined and remained at a low level until 2014 (Figure 3).

In Ukraine, political uncertainties halved FDI inflows in 2013 (in relation to the previous year), partly due to a number of divestments taking place particularly in the banking sector (UNCTAD, 2014, p. 71). The withdrawal of capital from Ukraine by investors (based mainly in Russia and in Cyprus) continued in 2014, and – in consequence – inward FDI flows to Ukraine fell by over 90%, reaching the lowest level in 15 years (UNCTAD, 2015, p. 67).

Although the regional conflict between Russia and Ukraine increased political risk in all the transition economies of South-East Europe, the Commonwealth of Independent States (CIS) and Georgia, some of the EDCs managed to attract higher FDI inflows in 2014 than in the previous years (Figure 3). The most successful in this regard was Azerbaijan, attracting investments primarily in the oil and gas industry.

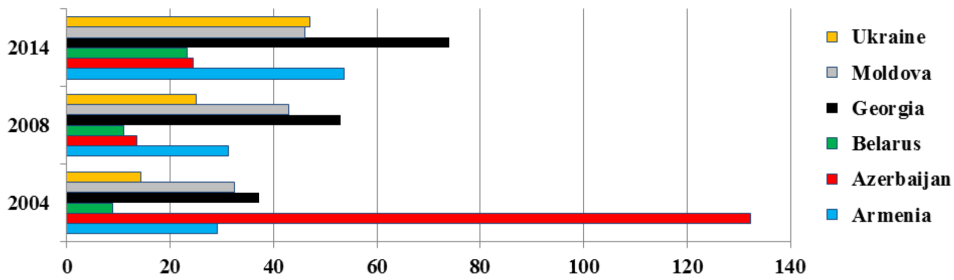
The inflow of FDI to a given host economy is regarded as potentially beneficial. This is mainly because it constitutes a source of additional investment capital resources and can help host countries stimulate economic development (by enabling the transfer of technology, knowledge, managerial know-how, etc.). For these reasons, the launch of the ENP, as the fruit of cooperation between the EU and its less developed neighbours, was expected to increase the inflow of FDI (originated from the EU member states) to the EU's neighbouring countries. As regards the EDCs,[1] these expectations, in most cases, met the reality. However, the share of the EU's investment in the total FDI inflows to the individual EDCs varied

[1] Excluding Belarus due to the lack of data.

widely across the countries in question. In 2004, the share was the highest in Armenia (53.2%) and Ukraine (51%) – see Annex 1.

Since the launch of the ENP, there has been the largest increase in the share of FDI flows from the EU member states in Moldova, where it increased by almost 33 percentage points (p.p.). As far as the other countries are concerned, the share rose by 19 p.p. in Ukraine, 9 p.p. in Georgia and 7.5 p.p. in Azerbaijan. The only country to slightly decrease this share was Armenia (by 1.5 p.p.), but, as it was indicated before, the share was already high in Armenia in 2004 (see details in Annex 1).

Figure 5. The ENP's Eastern Dimension countries inward FDI stocks (% GDP)



Source: Author's representation based on data from UNCTAD, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April 2016).

Table 1. Transition economies: inward FDI stocks (% GDP)

Country	2004	2008	2014
Albania	11.54	22.27	33.77
Armenia	29.06	31.24	53.61
Azerbaijan	132.27	13.53	24.54
Belarus	8.89	11.00	23.29
Bosnia and Herzegovina	22.52	32.61	40.87
Georgia	37.23	53.04	73.93
Kazakhstan	51.86	44.24	62.92
Kyrgyzstan	26.32	26.84	48.43
Montenegro	-	0	110.59
Republic of Moldova	32.48	42.86	46.00
Russian Federation	20.70	12.99	20.29
Serbia	-	38.40	65.16
Tajikistan	12.11	16.71	20.23
FYR Macedonia	38.60	41.69	45.39
Turkmenistan	16.24	24.31	53.58
Ukraine	14.29	24.98	47.11
Uzbekistan	9.15	9.74	14.48

Source: UNCTAD data, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April 2016).

Table 2. European Union member states: inward FDI stocks (% GDP)

Country	2004	2008	2014
Austria	23.58	34.09	41.46
Belgium	0	164.10	98.53
Bulgaria	39.00	82.64	83.50
Croatia	26.78	40.33	52.01
Cyprus	49.56	60.64	250.45
Czech Republic	48.13	48.12	59.14
Denmark	46.41	29.48	24.21
Estonia	83.30	63.95	74.48
Finland	29.16	29.44	49.35
France	18.96	19.21	25.60
Germany	18.19	17.82	19.30
Greece	11.88	10.75	8.49
Hungary	59.68	56.24	71.74
Ireland	107.57	68.79	150.05
Italy	12.88	13.71	17.33
Latvia	29.66	31.70	45.56
Lithuania	28.21	27.04	30.50
Luxembourg	222.60	227.65	258.52
Malta	67.20	1317.30	1645.85
Netherlands	84.38	73.22	76.81
Poland	33.32	29.65	44.80
Portugal	37.70	40.27	46.76
Romania	26.88	31.11	37.34
Slovakia	65.36	52.45	53.35
Slovenia	20.92	21.52	25.80
Spain	38.10	36.02	51.40
Sweden	51.78	54.25	56.38
United Kingdom	32.22	33.43	56.37

Source: Author's representation based on data from UNCTAD, UNCTADstat database, http://unctadstat.unctad.org (accessed 2 April 2016).

According to the statistics, until the end of 2014, the most active EU's investor-countries in the EDCs were Cyprus and the United Kingdom (UK). However, it should be highlighted that a considerable (but difficult to determine accurately) part of Cypriot investments in the EDCs originated *de facto* from Russian investors based in Cyprus. The investors move their businesses to Cyprus to take advantage of the country's financial facilities and favourable tax conditions. In consequence, such a small economy as Cyprus became the EU's leader in terms of FDI outflows to the EDCs. At the end of 2014, the shares of Cypriot investments in the EDCs' inward FDI stocks (originated from the EU) achieved the levels of: 43% in Belarus, 40% in Ukraine, 20% in Armenia, 14% in Moldova and 9% in Georgia (Annex 2). As regards the investors from the UK, at the end of 2014 the above indicated shares reached the levels of: 39% in Azerbaijan, 26% in Georgia, 7% in Armenia, 6% in Belarus and Ukraine, and 4% in Moldova (Annex 2). The shares of the other EU's investor-countries are presented in Annex 2.

Over the period 2004-2014, the ratio of inward FDI stocks to GDP increased in almost all the EDCs (with the exception of Azerbaijan). In 2014, the ratio ranged from highs of about 74% in Georgia and 54% in Armenia, to 23% in Belarus (Figure 5). The results of the best performing EDCs should be considered as very good in comparison to all the other transition economies, as both Georgia and Armenia belonged to the top 5 countries in this regard (the FDI-to-GDP ratios in the other top 5 transition economies were as follows: Montenegro – 111%, Serbia – 65%, Kazakhstan – 63%; for the data relating to the other transition economies see Table 1). Furthermore, the results achieved by most of the EDCs should be also regarded as good in comparison to the neighbouring EU members; for example, in 2014, the ratio of inward FDI stocks to GDP achieved the level of 83.5% in Bulgaria, 45% in Poland and 37% in Romania (for the data relating to the other EU member states see Table 2).

2. Determinants of FDI flows to the Eastern Dimension countries

At first, a general observation should be made for transition countries. Namely, in countries which, by definition, take active steps to bring about a successful and effective change of their political and economic system towards becoming a pluralist democracy (the desired effect of political transition) and establishing a market economy (the desired effect of economic transition), their investment attractiveness, in particular for foreign capital, depends mostly on three main factors (Lankes and Venables, 1996; Lankes and Stern, 1998; Barrell *et al.*, 1999; Holland and Pain *n.a.*; Resmini, 2000), which are as follows:

i. progress achieved in implementing market reforms;
ii. advancement in transition of their political systems (including their democratization progress); and
iii. general conditions for doing business prevailing in them.

Hereinbelow, a synthetic analysis of correlation between these most important determinants of investment attractiveness of transition countries, as listed above, and the value of FDI capital (including also from EU countries) invested in EDCs is presented. To this end, accumulated foreign investments (as on 31 December 2014) – total FDI stocks – in these countries have been taken into account as an assumption was made that the only appropriate approach to such an analysis would be to relate progress in systemic transition, which necessarily is the consequence of a number of decisions taken and reforms implemented during the transition period on the political and economic level, to total FDI stocks in these countries. In order to ensure comparability of results, total FDI stocks in EDCs in 2014 were related to their respective GDPs, which also shows their relative importance for each economy while, importantly, disregarding their size and economic potential. Then, to show progress achieved in implementing market reforms, the presence and stability of the democratic system and general conditions of doing business in EDCs, the results of research done into these areas by, respectively, the European Bank for Reconstruction and Development ("Transition Report"), Freedom House ("Nations in Transit") and World Bank ("Doing Business") were used.

2.1 Progress in implementing market reforms in Eastern Dimension countries as a determinant of their investment attractiveness for foreign capital

One of the key factors determining investment attractiveness of EDCs, and thus also the value of capital from EU countries which has been invested in them, is progress they made in implementing market reforms. In principle, the broader the market economy is, combined with transparent and effective institutions safeguarding market rules and ownership rights along with stable economic growth, the more attractive a given economy is in the eyes of potential foreign investors.

It should be stressed that the systemic transition of EDCs started at the moment of – and was prompted by – the collapse of the Union of Soviet Socialist Republics (USSR), which formally took place in December 1991. Right from the beginning, however, it varied greatly not only in the group of these countries but also among all other post-Soviet countries, in terms of transition strategies adopted and the time when they were formulated and implemented, but also the effectiveness of their execution.

Firstly, as for progress in market reforms in EDCs to date, and with reference to data published by the European Bank for Reconstruction and Development (EBRD), which annually evaluates advancement in transition achieved by EDCs, putting particular stress on the scope and effectiveness of implemented reforms in the areas of changes in the ownership structure (small- and large-scale privatization), governance and enterprise restructuring, price liberalization, trade & Forex system and competition policy, it should be highlighted that among EDCs the leaders in that regard were Georgia and Armenia. In 2014, their total score for progress achieved in economic transition, according to the EBRD, was 3.46 points and 3.44 points, respectively (out of the maximum of 4.33 points). As especially high (maximum score possible for these areas) the EBRD evaluated changes in the areas of price liberalization and trade and foreign exchange system in these two countries, which clearly means that in these areas market rules applied there were fully unhindered. Sadly, the weak points of

Georgia and Armenia, as attested by the EBRD, were visible in too slow changes in the areas of governance and enterprise restructuring, as well as – what is noteworthy – in the area of competition policy. However, the objection that too few pro-market actions were taken in the area of competition policy is in fact raised against all six EDCs (EBRD, 2014).

Secondly, progress made in implementing market reforms in years 2004-2014 in Ukraine and Moldova is deemed by the EBRD to be roughly the same. In 2014, total average scores of these countries were 3.25 points each. Thirdly, Azerbaijan scored 2.92 points, which puts it on the 5th place. EBRD experts saw virtual lack of large-scale privatization, lack of changes in the areas of governance and enterprise restructuring as well as competition policy as this country's biggest weaknesses.

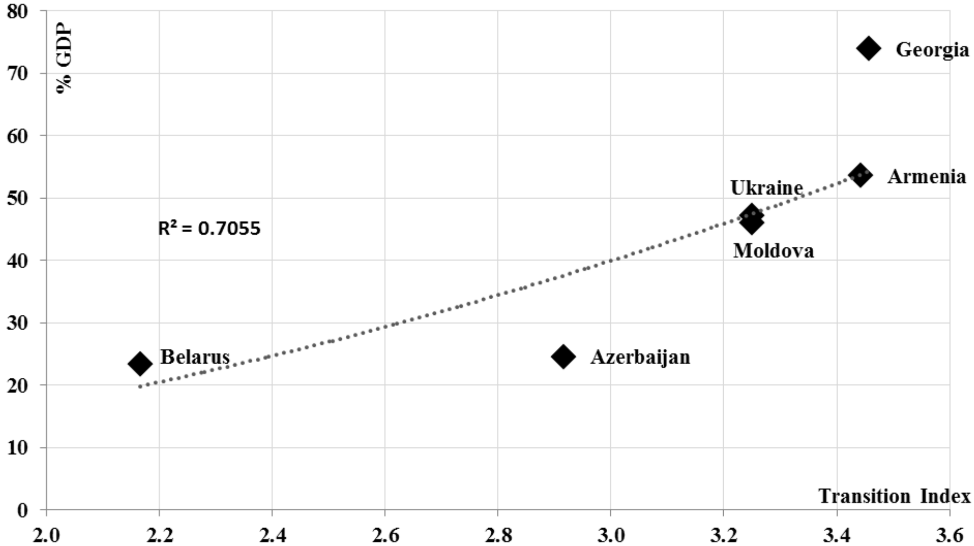
And finally, a definite outsider of all EDCs in terms of introducing market reforms is Belarus (although, up to the mid-1990s, i.e., when A. Lukashenko came to power, there was no indication for that). In 2014, the average score for progress in implementing market reforms in this country, according to the EBRD, was only 2.17 points (out of the maximum of 4.33 points). Suffice to say that out of all post-Soviet countries, only one – Turkmenistan – scored worse (1.77 points), as Turkmenistan's economy is even more centrally planned than that of Belarus. In Belarus, no changes whatsoever towards implementing free market regulations have been observed in the areas of governance and enterprise restructuring, large-scale privatization and competition policy.

Next, when looking at progress in market reforms in individual EDCs, it can be observed that it tends to be generally the bigger, the more these countries are involved in cooperation with the EU under the ENP.

So, if progress in introducing market reforms in individual EDCs is related to total FDI stocks (as a percentage of their GDP), a very strong correlation between these two indicators comes to light (Figure 6). As a result, one can assume that differences in progress made in EDCs are identical with their investment attractiveness for foreign investors, as measured by total FDI stocks.

As data presented in Figure 6 show, by far the most important role (as measured by their relation to GDP) was played by FDIs in these countries where progress in introducing market reforms was the biggest, that is in Georgia (73.93%) and Armenia (53.61%). On the other end of the spectrum was Belarus, where due to the economic policy pursued by A. Lukashenko being far from free market rules, as well as due to a number of other factors of geopolitical nature, total FDI stocks in 2014 did not exceed 23.29% of that country's GDP. However, a much greater progress in economic transition in Azerbaijan than in Belarus (albeit far from the one achieved by Ukraine or Moldova, to say nothing of Armenia or Georgia) was not reflected in a relatively higher share of total FDI stocks in Azerbaijan's GDP as at the end of 2014, which – at just 24.54% – was only fractionally higher than in Belarus. All the same, it also should be noted here that over the recent years a gradual increase in foreign investors' interest in Azerbaijani economy has been observed, in particular in its part connected with extraction and transmission of energy resources, which is testified by the steady increase in FDI flows (as a percentage of GDP) into that country recorded since 2009 (Figure 4).

Figure 6. Progress in introducing market reforms* vs. total FDI stocks in Eastern Dimension countries (as a percentage of their GDP) in 2014



* The higher the Transition Index, the higher the level of democratic progress in a given country.
Source: Author's analysis based on data from EBRD (2014) and UNCTAD data, http://unctadstat.unctad.org (accessed 2 April, 2016).

2.2. Progress in transition of political systems achieved in Eastern Dimension countries (including the scope of democratization of their political and social life) as a determinant of their investment attractiveness for foreign capital

Undisputedly, an important determinant of investment attractiveness of any given country, whether for domestic or for foreign capital, is stability and democratization of its political system. In particular, this includes, amongst others, the scope of general political freedom, the strength of democracy and rule of law, the range of civil liberties, economic strategies developed by the ruling parties and the degree to which they have been and are being implemented. It is especially important for economies undergoing systemic transition and characterized by low endogenous capital accumulation, essential to, on the one hand, finance the reforms, and, on the other, to launch the necessary pro-growth investments, giving the chance to successfully reform the country and to generate economic growth in the long term. Obviously, any political instability, low observance of rule of law, lack of transparency about how the political machinery of the state operates, as well as unsuccessful fight against corruption destabilize the number and scope of investments, especially by foreign capital.

As far as political systems in EDCs are concerned, it should be noted from the outset that not only had these systems developed in the atmosphere of post-Soviet legacy and huge internal challenges to economic transition, but also that Russia's (most often destabilizing) interference with the current affairs in these countries was and still remains extremely important. There are countless examples of such a destabilizing influence, such as Russia's support for the separatist movements in Transnistria in Moldova as well as for the self-proclaimed republics in Donetsk and Luhansk in Ukraine, gaining a political and economic *de facto* control over Belarus, the military conflict with Georgia, or active incitement of the conflict over Nagorno Karabakh between Armenia and Azerbaijan, to mention just a few. Also, it should be added here that in fact all EDCs from the very moment of regaining their independence after the dissolution of the USSR did not really know whether to integrate with Western European structures (which would have required quick changes in their political systems in order to gradually adapt them to EU standards, that is towards a democracy based on political pluralism) or with Russia under the Commonwealth of Independent States and now the Eurasian Economic Union (EaEU).

One of the basic measures of progress achieved in transforming a country's political system, which is – as mentioned above – an important determinant of investment attractiveness of any country, is the actual scope of its democratization. Research into that scope in transition countries, so also in EDCs, is done by Freedom House, which publishes its annual special report on that topic titled "Nations in Transit". While assessing democratization of a given country, Freedom House takes into account the situation prevalent in that country regarding electoral process, civil society, independent media, national democratic governance, local democratic governance, judicial framework and independence, as well as corruption (Freedom House, 2014, p. 3).

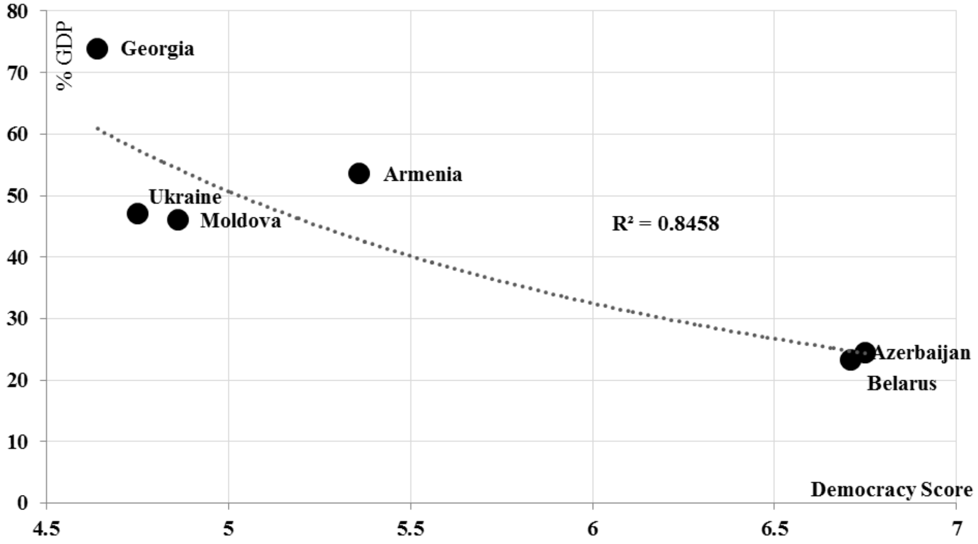
According to Freedom House data, there are significant differences between EDCs in democratization of their political systems. Relatively the best in this respect is the situation in Georgia, followed by Ukraine and Moldova. However, this does not mean that no reservations were raised against them; on the contrary, such reservations are made for Ukraine as to the high persistence of corruption and lack of freedom for independent media, and for Moldova – to the areas of judicial framework and independence.

As for transition of the political system and democratization, by far the worst assessment has been given to Belarus and Azerbaijan. These two countries are even considered by Freedom House to be authoritarian (ruled by dictators), where not even basic civil liberties are respected by the authorities (even if formally appearances are maintained to the contrary).

With reference to the above, it can be once again reiterated that the scope of political changes towards democratization of the political and social life in EDCs is the bigger, the more a given country is involved in cooperation with the EU under the ENP. Furthermore, if we relate advancement in democratization of individual EDCs, as a measure of their progress towards transforming their political systems, to total FDI stocks (as on 31 December 2014), an interesting correlation can be observed (Figure 7).

Data presented in Figure 7 clearly show that a very strong interdependence (correlation) exists between the democratic progress in a given EDC, being an expression of progress towards transforming its political system, and total FDI stocks (as a percentage of the country's GDP). As at the end of 2014, the highest total FDI stocks in relation to the respective country's GDP were recorded in Georgia, which also in that year was ranked by Freedom House as the EDC with the highest democratization progress and advancement towards transforming the country's political system in the group. At the other extreme were placed, for obvious reasons, Azerbaijan and Belarus. Thus, a general conclusion can be drawn that political changes towards establishing a democracy, rule of law and transparency of political life are indeed an important determinant of flow of FDIs to the EDCs.

Figure 7. Democratic progress* vs. total FDI stocks in Eastern Dimension countries (as a percentage of their GDP) in 2014



* The lower the Democracy score, the higher the level of democratic progress in a given country.

Source: Author's representation based on data from Freedom House (2014) and UNCTAD data, http://unctadstat.unctad.org (accessed 2 April 2016).

However, when analyzing the correlation between the progress achieved by the EDCs in the transition of their political systems towards the democratization of their political and social life, and their attractiveness for foreign capital (which is positive, as indicated above), another interesting aspect should be emphasized, namely Russian direct investments in these countries. While Russian direct investments do constitute part of total FDI stocks in the EDCs, what applies to FDIs from EU countries or from the USA, i.e. the fact that stability and democratization of their political systems plays an important part in taking investment decisions by investors from these countries, does not seem to apply to (and, more often than not, indeed does not apply to) investments from Russia. Many Russian investments are made for purely political or geostrategic gains, and their overriding goal is, on the one hand, to support and reward these post-Soviet countries which are submissive to and cooperate with Russia, and, on the other, to help accomplish the Kremlin's strategy aimed at making them economically more dependent on Russia. For obvious reasons, the progress in political transition achieved by the EDCs is, in fact, of no relevance for them. The best examples to illustrate that are Russian direct investments in Belarus (Annex 1), the volume of which significantly exceeded Russian direct investments in the remaining EDCs over the analyzed period; what is more, these were virtually the only FDIs in this country, as Belarus is widely considered to be far from being democratic. Similarly, it is also mostly for political and geostrategic reasons that Russian, mostly state-owned, companies have been investing for many years in other EDCs.

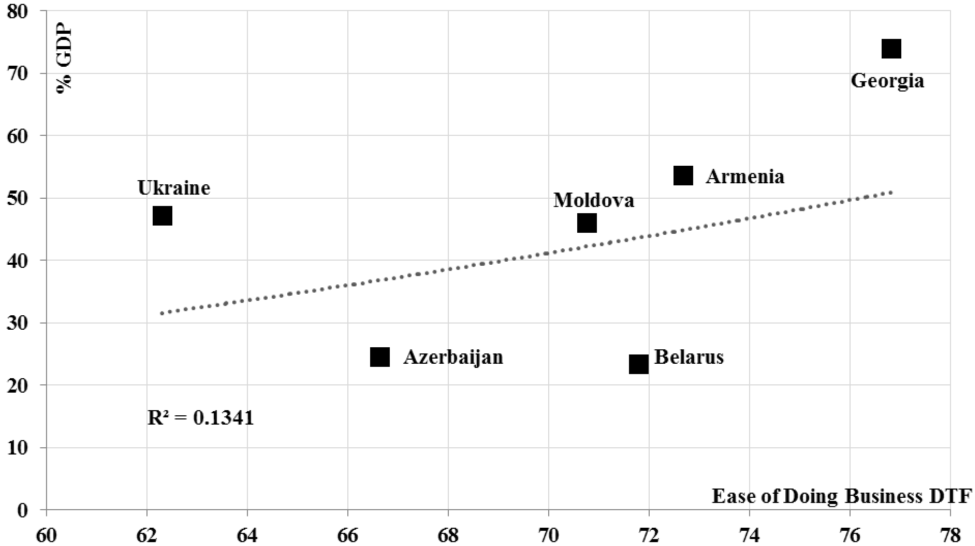
2.3. General conditions for doing business in Eastern Dimension countries as a determinant of their investment attractiveness for foreign capital

Another crucial factor determining investment attractiveness of individual EDCs for foreign capital is conditions for doing business prevailing in them. Naturally, these conditions are a product of political, economic and social changes which have taken place in EDCs over the last 25 years. Generally speaking, the cultural system present in these countries has traditionally been characterized by a lack of public trust, both towards other people and the state itself (not to mention foreign capital), as well as a lack of community feeling. Thus, creating lasting and well-performing ties in these countries, in form of social networks, based on mutual trust is considerably hampered, which, combined with quite wide-spread disrespect for rule of law and pervasive corruption, significantly raises transactional costs for both individual enterprises and for the economy as a whole, which not only further hinders transition processes but also lowers their international competitiveness with regard to FDI capital flows (Falkowski, 2013).

General conditions for doing business in individual countries around the world are evaluated, using consistent methodology, by the World Bank in its "Doing Business" reports. While compiling its Ease of Doing Business index for every country, the situation with regard to the following areas of a given economy is taken into account: Starting a business; Dealing with construction permits; Getting electricity; Registering property; Getting credit; Protecting investors; Paying taxes; Trading across borders; Enforcing contracts; and Resolving insolvency (World Bank, 2015).

When briefly describing conditions for doing business in EDCs in 2014 (which was the consequence of all previous changes and regulations as implemented to date, so also those from years 2004-2014, and the general socio-cultural conditions developing over the years) based on the "Doing Business 2015[2]" report, substantial differences among EDCs must be stressed.

Figure 8. Ease of doing business in Eastern Dimension countries (as measured by DTF – Distance to Frontier) * vs. total FDI stocks (as a percentage of their GDP) in 2014



* The lower the value of the Ease of Doing Business DTF, the worse the conditions for doing business in a given country.
Source: Author's analysis based on data from World Bank (2015) and UNCTAD data, http://unctadstat.unctad.org (accessed 2 April 2016).

[2] The "Doing Business 2015" report based on the respective data for 2014.

Firstly, a definite and uncontested leader in this respect is Georgia, which in 2014 was ranked 15th out of the total of 189 economies captured by the Ease of Doing Business index, well ahead of not only all other EDCs but also all CEE countries (including Estonia). Among the strongest competitive advantages of Georgia with regard to ease of doing business, as identified by the World Bank, were, first and foremost, the following assets: one of the easiest and cheapest worldwide procedures to be followed when starting a business, registering property, dealing with construction permits and getting credit. In the same ranking, the other EDCs were classified on the following positions: Armenia – 45th place, Belarus – 57th, Moldova – 63rd, and Azerbaijan – 80th, whereas, according to the World Bank, in 2014 the worst conditions for doing business out of all EDCs were in Ukraine (96th). Traditionally, complexity of procedures and their costs for getting electricity, paying taxes, trading across borders, and resolving insolvency were identified as the biggest frailties of Ukraine in this respect.

Now, if we relate the ease of doing business in EDCs to the share of total FDI stocks (as on 31 December 2014) in their GDPs, a strong interdependence between these two factors can be observed, suggesting that the easier it was to conduct business activities in a given country, the bigger was the importance of flow of foreign capital for the economy of that country (Figure 8). Two countries were exceptions to that rule, Belarus and Azerbaijan, for which total FDI stocks in relation to conditions for doing business present in these two countries (according to the World Bank) seemed to be underestimated. However, this does not challenge the thesis of high importance of formal regulations in the area of quality of the business climate, and in particular of ease of doing business, in EDCs for their investment attractiveness for FDIs.

Conclusions

The paper indicates that the EDCs neither accurately reflected the world's FDI trends nor were similar to each other as far as their FDI inflows over the period 2004-2014 were concerned. In terms of the value of inward FDI stocks (as on 31 December 2014), Ukraine was, of course, the undisputed leader. Nevertheless, concerning the ratio of inward FDI stocks to GDP, it was Georgia that achieved the best results (74%), followed by Armenia (54%), Ukraine (47%), Moldova (46%), Azerbaijan (24.5%) and Belarus (23%). The results of the best performing EDCs can be considered as very good in comparison to all the other transition economies, as both Georgia and Armenia belonged to the top 5 countries in this regard. Furthermore, the results achieved by most of the EDCs were also good in comparison to the neighbouring EU members (e.g., in 2014, the ratio of inward FDI stocks to GDP achieved the level of 83.5% in Bulgaria, 45% in Poland and 37% in Romania).

As regards FDI determinants, an important role is played by the factors related to the advancement of the EDCs' transition process. Firstly, FDI capital flows to EDCs are highly determined by progress made by them in introducing market reforms, the stability and democratization of their political systems and general conditions for doing business. This has been confirmed by the existence of correlation between these factors and the share of the total FDI stocks (as on 31 December 2014) in their GDP, which was shown in the paper.

Secondly, advancement in market reforms in EDCs, the scope of political changes towards democratization of their political and social life, and also regulation of their business environment is the higher, the more these countries are involved in cooperation with the European Union under the European Neighbourhood Policy. Therefore, it seems justified to assume that as the endogenous capital resources present in the EDCs alone, that is without continued access to external sources of capital, i.e. FDIs, are clearly insufficient to achieve the desired multiplier effect of pro-development investment for their economies, their further economic and social development seems to very much depend on ever closer cooperation between these countries and the European Union. Undoubtedly, this will not be a quick and easy process, due to the problems existing both on the side of the European Union (migration crisis, Brexit, a rise in nationalist tendencies in some EU member states), which may push the development of relations with EU neighbours covered under the ENP into the background, and on the side of the EDCs. Among the latter, as potential threats can be named possibly lower determination for strengthening the EDCs' cooperation with the EU as it may necessitate certain reforms to be implemented and adjustments to the EU standards of democracy and free market to be made, but also the policy consistently pursued by Russia towards the EDCs which is aimed at destabilizing their internal situation, thus undermining their role as stable EU partners. Just how effective Russian actions in this regard have been so far is best proven by the (negative) result of the Dutch referendum on ratification of the EU-Ukraine Association Agreement.

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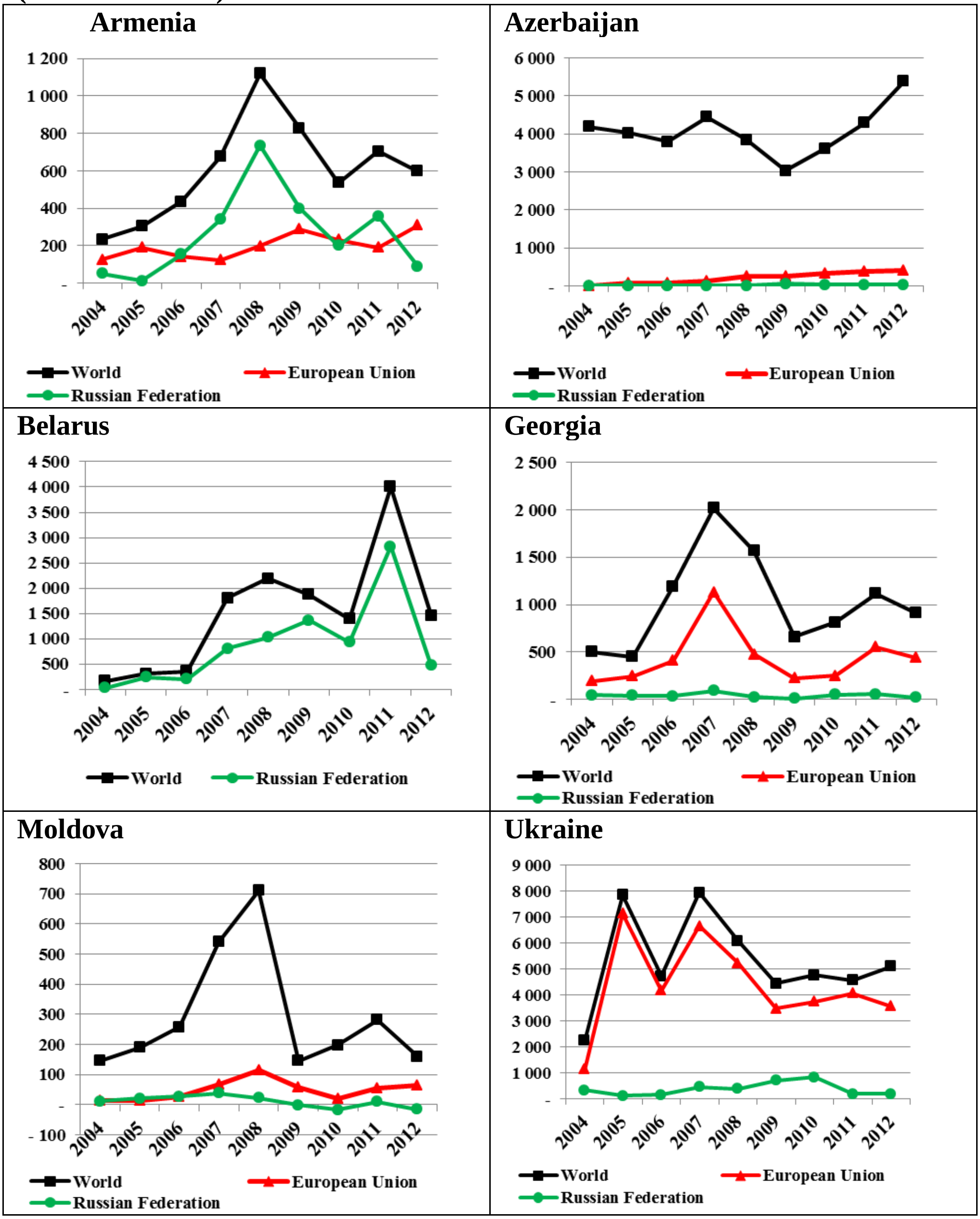
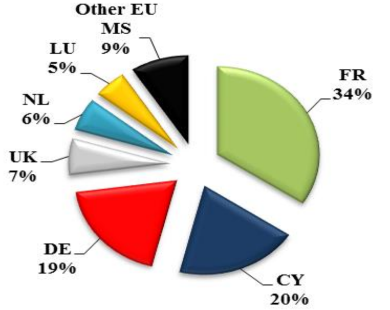
Annex 1. FDI flows in the ENP's EDCs host economies, by geographical origin (millions of USD)



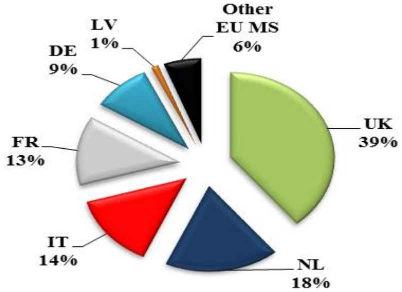
Source: Author's representation based on data from UNCTAD, http://unctadstat.unctad.org (accessed 2 April 2016).

Annex 2. EDCs' inward FDI stocks originated from the EU member states (% of the given host economy's total inward FDI stocks originated from the EU)*

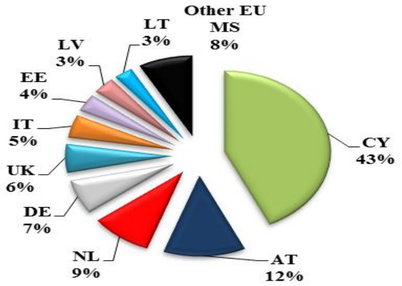
Armenia



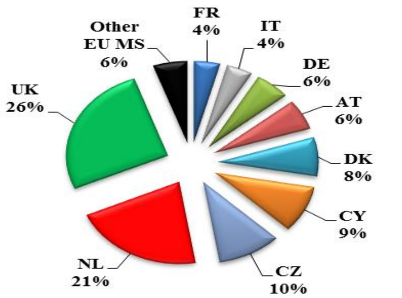
Azerbaijan



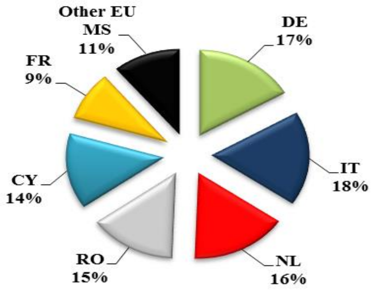
Belarus



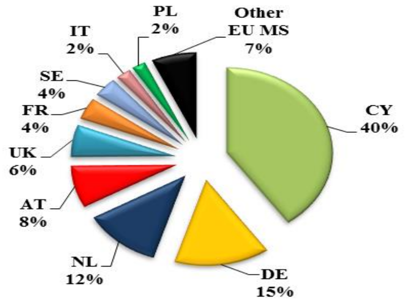
Georgia



Moldova



Ukraine



* The most recent year for which regional data are available: 2012 (Armenia, Azerbaijan, Belarus, Moldova, Ukraine), 2011 (Georgia).
Abbreviations: UK – United Kingdom, NL – Netherlands, IT – Italy, FR – France, DE – Germany, LV – Latvia, CY – Cyprus, LU – Luxembourg, AT – Austria, EE – Estonia, LT – Lithuania, DK – Denmark, CZ – Czech Republic, SE – Sweden, PL – Poland, RO – Romania, MS – member states.
Source: The Authors' calculations based on UNCTAD data, http://unctadstat.unctad.org (accessed 2 April 2016).