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Eastern Europe

Foreign investment and capitalist enterprise

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How has foreign direct investment affected eastern Europe? Is stable capitalist enterprise being established?

ANY balance sheet of foreign investment in the countries of Eastern Europe, to be meaningful, must be prefaced by some comments and clarifications. Firstly, on the social implications of such investment in the historically unprecedented transformations now occurring in Eastern Europe, which most assessments, with their strong ideological bias, completely overlook; secondly, on the very concepts that are used in the statistical analyses, which are anything but transparent. Only then can we discuss the major features of the foreign investments that have been carried out over the last ten years in Eastern Europe.

An historical turning point

Openness to foreign capital (in some dual-ownership joint-venture undertakings), the creation of small private companies with few employees, and trading in commodities were nothing new in the former so-called socialist systems - they go back to the Soviet New Economic Plan in the 1920s. In themselves, such activities did not constitute any change in the system or its economic logic; to avoid a quibble over terminology, let us say that on the whole these societies, while conflictual and oppressive, were not subject to the logic of capitalist profit. Wasteful bureaucratic practices had little to do with capital's drive to minimize costs.

What constitutes a turning point since the fall of the Berlin Wall and Yeltsin's shock therapy in the early 1990s is, however, a transformation of system and logic in which generalized privatisations and the systematic opening to the market and to foreign capital are designed to subordinate the economy (social relations) to market profitability criteria and thus to suppress anything that might evoke and perpetuate any so-called socialist (and more generally non-capitalist) dynamic.

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Nevertheless, the dominant discourse and statistical analyses refer to a "transition to the market economy" as if this were a "natural" mechanism, a return to some universal laws. The events of the last ten years in the former Soviet Union and Eastern Europe are viewed through the prism of an "alignment" with the criteria of the "liberal globalisation" (a.k.a. neo-conservative globalisation) that has been operating since 1980. The external vectors of this program, those that provide the needed "experts", have been the creditors (especially the major international financial institutions) and the European Union. It was the wealth of Western Europe, and not just the positive image it derived from its democratic traditions and the memory of past social policy achievements, that served as the principal argument in favour of "swallowing the pill" (albeit with increasing reluctance) of the reforms in those countries in the periphery and the orbit of the European Union. The privatisations even of public services and the elimination of social welfare, subsidies and protection from foreign trade have become "rules" and surreptitiously transformed into "community conquests" without any consultation with the people of Europe.

The "right of competition", prevailing over all other rights, has been the basis for attracting private financing. It is a neo-conservative article of faith that privatisation and the unfettered mobility of capital internationally must bring growth and satisfaction of needs at the lowest cost. But this meant wiping the slate clean, doing away with not only the bureaucracy or its single-party system (which would be met with near-universal joy) but the old system as a whole.

Although these precepts and hypotheses are more controversial than ever among Western economists, Eastern Europe is much less receptive to criticism of them: one must "prove" that one has broken with the "socialist" past. "Economic science" (liberal doctrine, in fact) supposedly replaces the political arbitrariness of the old single-party regime. And privatisations are often presented as the only way to get rid of the bureaucratism of the past. Any criticism of the liberal policies and unprotected openness to foreign capital is quickly denounced as "old-fashioned" or "populist". People simply want to live better and more freely, not be worse off.

The politicians of every stripe are therefore confronted with a dual source of power and legitimacy. Political pluralism imposes a popular verdict on the prevailing policies, which is fortunate since capitalist transformation implies the freedom to sack workers and the undermining of social rights. But the creditors' money and participation in the European Union are external, conditional sources for the reforms that are undertaken, the logic of which in Eastern Europe implies the "flexibility" and completely unfettered mobility that is sought within the EU by globalised capital.

The dominant discourse of the economists who believe in this "orthodoxy" associates the successes of the "transition" with these structural transformations measured in figures on privatisation. Theoretically, the more open one is to privatisation, the more one is supposed to attract foreign investments (the source of efficiency), and the better off one ought to be.

The balance sheet bears little relationship to this dogma.

Defining foreign investment

"Foreign investments", in the IMF's standardized balance of payments terminology, refers not to an increase in (physical) productive capacity but to any entry of capital irrespective of its purpose. It may take three major forms:

Foreign Direct Investment (FDI): this presupposes greater stability (as opposed to speculative capital). FDI is "defined" according to the capacity to "control" ownership. An entire business is directly purchased or created, or at least 10% of the shares in an existing company are held by foreign investors. This 10% figure is obviously arbitrary: it does not produce any certainty of stable "ownership" conduct, still less the efficiency of that conduct apart from the simple logic of maximizing the profits of shareholders, especially foreigners. But it reflects a strong trend in contemporary capitalism, exemplified by pension funds: the desire to draw a large number of "small stakeholders" ("households") into the financial markets, dispersing ownership while depriving these shareholders of any real power, the effective control over decisions resting in the hands of a "strategic investor" holding a minority of the shares. This is the dominant form of the privatisations in Eastern Europe: millions of powerless shareholders allowing a concentration of assets in hands that are often almost invisible - the State, with its periodic alterations in dominant parties and its turf wars, alternately combining with and confronting the oligarchs and former managers of enterprises, banks and government ministries and of course foreign capital.

"Portfolio" investment: this is the bulk of the more volatile and speculative capital - debt securities (bonds), or shares in the capital of a business, provided, as noted above, that they comprise less than 10% of the shares. This "floating" capital is attracted in particular by the privatisations at fire-sale prices under a debt repayment program, or by the high interest rates on public debt issues. One of the IMF's basic precepts, apart from budget austerity, was to push for financing government deficits through the issue of securities available to non-residents.

The giddy rise in interest rates on Russian GKO's (treasury bills) after the Asian crisis, to try to retain in Russia the capital that was financing the debt, was a catalyser of the Russian crisis of the summer of 1998. The sudden swings in such unstable financing were a common feature of the financial crises of the 1990s, from Mexico to Asia to Russia.

Some investments in shares can be just as unstable thanks to the development of the "secondary markets" in which these securities can be "liquidated".

Finally, the "other foreign investments" may be credits. They are often hinged on the preceding forms of investment, although the debtor countries prefer FDI because it does not increase their debt burden. But the banks made credits for the purchase of some securities freely available in the period when stock markets were booming. In the Russian crisis, the new private banks themselves promoted speculation in GKO's in lieu of financing the economy. Who controls the banks controls the underlying logic of the economy. That is why opening up this sector to foreign capital was consistently considered "strategic" and thus protected. The logic of the WTO's negotiations over "services" was to drop those protections as well.

Limited opening

In practice, the scenario in Eastern Europe involved a limited opening to FDI in the 1970s, but indebtedness for the purpose of importing Western technology, in the hope of later repaying the debt through improved exports. Profits from the oil industry were generally recycled by the private banks to the countries of the South and the East, which became heavily indebted. But the downturn in the advanced capitalist countries and the neo-conservative offensive of the 1980s shuffled the cards - and triggered IMF intervention.

The debt then became an essential lever for imposing privatisations and an opening to FDI, which was supposedly to reduce the debt and, in the countries of the so-called Soviet bloc, to dismantle the old system. According to the neo-conservative dogma, foreign direct investment would be completely beneficial to the host countries. The actual effect requires a concrete analysis.

The host countries generally expect that non-debt financing will bring in advanced technology and know-how, create jobs and increase export capacity, which can then more than cover external deficits. But the investors' expectations may be quite different: equity participation in an existing company aimed at controlling a competitor; low-paying jobs with little or no union protection, hence fragile; an opportunity to unload polluting technologies that are outmoded or prohibited elsewhere; a forced expansion of imports of their own products (notwithstanding existing substitutes), etc. Finally, far from a sharing of technological and scientific knowledge, the general dynamic is to exclude the host country, creating an ongoing dependency accompanied by an accelerating and dramatic "brain drain". The use of parts factories, relocated far from the parent company, prevents the host country from controlling the production process as a whole.

The balance sheets are still incomplete. But already there is every reason to question the logic of the MAI (Multilateral Agreement on Investment) and WTO negotiations, in which a central issue is precisely a state's right to control investment, and hence to be able to determine its own development priorities and objectives and to subordinate FDI to them.

What was being privatised?

Who could purchase the public firms which, in these generally industrialized countries, accounted for the bulk of production? Under the old regime, financial accumulation was impossible. Existing savings were roughly estimated at no more than 10% to 30% of the value of the firms put up for privatisation.

Hungary is the only case (other than Estonia, on a lesser scale) in which the principal form of privatisation from the beginning of the 1990s was the direct sale of the best firms. But in a context in which the accumulation of national capital is very low, it is foreign capital that took the lion's share (and that is why, until the mid-1990s, Hungary received half of all FDI going into Eastern Europe). However, selling off the best companies to foreign capital was not popular either in the nomenklatura or in the population as a whole. The principal form of privatisation in the early 1990s in the Czech Republic, Slovenia, Russia and Poland was what was referred to (in a number of variants) as "mass privatisation" of public companies: the distribution to citizens or employees of "coupons" with which they could purchase shares in the enterprises, now transformed into limited liability companies.

The workers took over these companies in an attempt to stabilize their jobs, opting for "privatisations" that left the majority of the shares in enterprise collectives (including managers). The governments, however, viewed these processes as a means of compensating for the lack of national capital; giving some popular "legitimacy" to the privatisation of the bulk of the firms; "demonstrating" to the international institutions that the reforms "were going ahead" and therefore making some headway in their negotiations over their debts and membership in the EU; and enabling the former managers of the firms and the party/State to allocate to themselves substantial shares in these "privatisations" and open up a process of undermining social protection measures.

But none of this brought new money into the State treasury, nor did it bring about a relationship of forces that would make it possible to impose on the workers restructuring projects entailing high unemployment - although it did make way for some opaque financial transactions.

The privatisations and opening to foreign capital have been characterized systematically - from Albania to Russia, Romania and the Czech Republic - by recurring corruption scandals, rigged financial deals and privatisations of state functions. Veritable wars have broken out over natural resources and tourist resorts (sources of foreign exchange): who will control the oil and natural gas of the former Soviet republics, the mines of Kosovo, access to the Adriatic coast? Far from putting an end to the rule of the old nomenklatura, the privatisations have enabled a great many of its cadres to convert their old privileges of position into privileges of property. "Nationalism" has replaced the rights of the workers in Yugoslavia, legitimising the new powers - and the appropriation of the territories on pseudo-ethnic foundations.

Under international pressure, the second half of the 1990s witnessed an acceleration of the opening to foreign capital. But where did it go?

Distribution of FDI over the decade

Where it went depended, on the one hand, on the choices made by the ruling groups (themselves under pressure from social and political dissidents) and, on the other, on the decisions of the foreign investors.

The relative weakness of the privatisations and of FDI in Slovenia is an illustration of the impact of local decisions. Domestic resistance to "outside advisors" was particularly effective in that Slovenia's standard of living and capacity to export to Western European markets were relatively high in the former Yugoslavia. So Slovenia's past accomplishments and resistance to neo-conservative precepts were major factors in its success in terms of living standards.

In Hungary, the converse occurred - the sell-off of the best firms to foreign capital. Everywhere else, and given the growing openness to foreign capital after the mid-1990s, the differing results are a product of the criteria adopted by the foreign investors themselves. Overall, they reflect an extreme concentration of investments.

The distribution of FDI in Eastern Europe was dictated by some universal criteria. Private money, in its quest for purchasing power, goes first to the wealthy regions. The bulk of global FDI is conducted between developed countries - in 1998, the source of 90% of FDI and the recipients of 60% of FDI (see UN reports, UNCTAD 2000). In the "rest of the world", FDI is strongly focused on a few countries in the South and the East, the best off in terms of resources and growth, and especially those where the government is the most firmly established and property rights are protected.

The former Soviet Union and the countries of Eastern Europe potentially offered substantial natural resources and/or a cheap and skilled labour force, as well as market segments (wherever there is some purchasing power, although the widening poverty reduces its scope) and, quite simply, quick profits (speculation on "emerging markets"). But political and social instability, the lack of infrastructures (including telecommunications) and thus the high cost of the necessary restructuring, as well as the bureaucratic mazes and jurisdictional conflicts (if not local wars) served as disincentives.

The major part of FDI outside the developed countries went to China, with its strong state. China took in a total of \$300 billion during the 1990s, against a mere \$15 billion for Yeltsin's chaotic Russia. The latter, notwithstanding the attractiveness of its natural resources, had accumulated FDI of only \$345 per capita by 1997, on the eve of the summer 1998 crisis. Over the same period Hungary, by way of comparison, had attracted more than \$1,600 in FDI per capita.

As a percentage of GDP, the statistics sometimes vary considerably, depending on the source. In the Commonwealth of Independent States, GDP evaluations are often quite problematic owing to the new monetary criteria and the extent of barter relationships. Furthermore, the effective FDI figures may also vary depending on whether contracts are accounted for at the time they are registered as a project or when they are actually completed. According to Wladimir Andreff, Azerbaijan held the record, with foreign direct investment accounting for 70% of its GDP in 1998 [1] (a reflection of the "contracts of the century" in the oil and natural gas industry signed in 1994 and 1998 with the United States and Turkey, but also with Japan, Russia, Great Britain and Saudi Arabia). Apart from this case (and based on the same sources), FDI as a percentage of GDP ranges between 12 and 45 percent in Kazakhstan, Armenia and the Central European countries (the lowest levels being in Slovenia). The other countries of the CIS and the Balkans received less than 10% of their GDP in FDI during the same period. And no matter which source is consulted, Russia was at the bottom of the scale with FDI accounting for less than 3% of its GDP in 1998.

This distribution of FDI in 1998 reflects the larger reality when the FDI figures are viewed from the perspective of the stock of FDI [2] in all the countries in transition in this region. Central Europe (Hungary, Poland, the Czech Republic, Slovakia and Slovenia) accounted for 58% of all FDI inputs. More generally, the ten countries of Central and Eastern Europe that are candidates for membership in the European Union account for 69% of all FDI in the region. In contrast, the CIS as a whole, including Russia, has attracted only 29%, and the Balkans 2%.

Finally, looking at FDI per capita - a more meaningful measure than the absolute figures, and less problematic in interpretation than GDP - it is Central Europe, in the orbit of the EU and the wealthiest part of the group, which was clearly on top in 1998, with more than \$1,000 in FDI per capita. Azerbaijan and Kazakhstan came next with about \$400 per capita and the vast majority of all the others had between 30 and 100 dollars per capita (only \$91 in the case of Russia).

Russian uncertainties

Uncertainty as to the legislation governing ownership and government authority, and the assessment of the social

and political risks, weighed heavily in this generally low performance of FDI in a region with substantial natural resources. Between 1991 and 1998, the region's GDP fell by 50%.

The flight of capital from Russia over the decade exceeded inflows to a large extent and expressed the Mafioso-like, speculative nature of this unfettered capitalism so wary of productive investments in a country where, in 1998, more than 50% of transactions took the form of barter. The "systemic" resistance to the market was combined with a reorientation of the major firms to turning a profit without having to restructure. New networks and new dynamics of extremely primitive and unfettered capital accumulation were combined with the maintenance of old networks of planned economic relations in new forms that foiled restructuring and bankruptcies.

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Paradoxically, the 1998 crisis prompted the first resumption in growth since Yeltsin's 1991 shock therapy. The devaluation of the ruble favoured national production and reduced barter to less than 30% of GDP while at the same time some control over capital flows was (provisionally) established. The "order" imposed by Putin on the provincial governors and oligarchs - and on the Chechens - marks the restoration of a strong state with an ultra-liberal Labour Code. It just goes to show how, contrary to the claims of dogma, a strong state is in reality the precondition for a unified market economy.

Consequently, Russia will likely attract more foreign capital in future, even though the political and economic arm-twisting in the shadows, behind the military-industrial complex and Gazprom, and beyond that for control of the region, are strategic issues for a government that likes to think of itself as a major international power. Putin has managed to use the "anti-terrorist" war in Afghanistan for his own interests, which are both rival to and in part convergent with those of the United States in particular, in the control of energy resources in the newly independent republics of Central Asia and the Caucasus.

Concentration of FDI

There are very big differences among the 10 Central and East European Countries (CEECs) [3] that are candidates for EU membership. Although instability in the Balkans and NATO's war in March-June 1999 prompted the EU to treat all of these countries as future candidates, the function of the South-East Europe Stability Pact, established in 1999, is to open doors without really opening them while driving for prior cooperation agreements.

But, as we have seen, it is the Central European countries that have received by far the bulk of the FDI going to that region. Luckily for them, their financial markets are relatively underdeveloped and they were not affected too much by the fluctuations in the "emerging markets" (Asia, Russia, Latin America) in 1998. Their insertion in the EU orbit tended to serve as a positive factor in the eyes of investors. However, there are major differences developing among the CEECs.

Together, the CEECs had taken in a total of about \$100 billion over ten years by the year 2000 - almost ten times more than Russia. Close to 80% of this FDI was concentrated in the three wealthiest countries of the 10-member CEEC: Poland, the Czech Republic and Hungary. Poland, by its size, had the largest share. In 2000, the CEECs took in about 1.7% of FDI flows, amounting to about \$20 billion in an area with a hundred million inhabitants - half the flow into China that year. [4])

Within each country (Russia as well as the CEECs) most FDI has gone to the capital cities; in 1977, 77% of FDI going to Russia was concentrated in Moscow. As a rule, FDI heads for the most prosperous regions and especially urban concentrations (those with the best infrastructure, the highest standard of living and the most skills). This

deepens the inequality between countries and between regions.

The CEECs are directly subject to the Anglo-Saxon "model", which is tending to become generalized within the EU itself. But the restructuring of the major enterprises will be consistently difficult because it is socially explosive. The vast majority of FDI is in major retailing (particularly the food industry), telecommunications including mobile phones (France Télécom purchased the Polish exchange TPSA for \$3 billion in 2000), and, beginning in the late 1990s, the financial sector: more than 70% of the Polish banks and most of the Central European banks overall are now controlled by foreign capital. This process, which is relatively recent, means that the constraints weighing on the major companies may well harden.

Everywhere, however, the growth is primarily the result of the increase in the number of small businesses, while often entire sectors of the economy, grouped around the huge enterprises of the past, remain stricken. These were primary locations of socialization of the workers under the old regimes. But it is much more costly, both economically and socially, to restructure them.

In the Central and East European countries, the United States is less of a factor. Germany is the primary source of FDI and the leading trading partner of most of the CEECs, the Deutsche mark (now replaced by the Euro) playing an essential role in "nest eggs" when it is not the official currency (as it is in Montenegro and Kosovo). The Netherlands, Austria and Italy are also major investors. Proximity counts for a lot: Sweden and Finland, for example, invest to a greater degree in the Baltic states.

Fragile economies

Behind the "successes", as registered in the numbers and quantities of FDI or privatisations, social relations are being transformed. Bulgaria's real unemployment rate is higher than 30%. Similar levels exist in a number of regions of Poland and Hungary. And far from having reached the "end of the tunnel", the "most advanced" economies such as Poland, entered a recession in recent months, as did the Czech Republic in 1998. The others are still in the early stages of the restructuring necessitated by the new economic logic.

The deepening of social and regional disparities, the unemployment and external deficits illustrate how these countries are experiencing "competition". And it is certain that foreign-owned firms will display greater readiness to submit to those rules, relatively unfettered as they are by "compromises" between various domestic social forces subject to pressures from the electorate.

Most of the foreign-owned firms are also the ones that export to EU markets, and they often import their own products. All of the CEECs that are candidates for EU membership are running current account deficits with the Union. The radical restructuring of trade flows in the wake of the 1991 dissolution of the COMECON (the Soviet bloc's counterpart to the Common Market) has resulted in a new dependency that can be a serious drag on the East European economies.

The slowdown in EU growth, particularly in Germany, will mean a significant drop in exports to the West. And domestic purchasing power is limited; the queues have disappeared but most citizens cannot afford to buy the products. Fiscal austerity and the contraction in banking credit will not help to sustain growth. Furthermore, in a country like Poland the desire to attract foreign capital in order to finance the public debt has been expressed in a rise in interest rates that is now adding to the difficulties faced by private businesses.

Conditional "assistance"

The funding originating from the European Union for "assisting membership" has much the effect of a vicious circle: far from compensating for these problems, it aggravates them. For the most part, this funding is not donations but credits (in the case of two thirds of such "assistance"), and conditional credits at that. The criteria for allocation, or for the rescheduling of debts, are in fact political and economic.

For example, in terms of donations, Poland is the only one of these countries to have had its debt cancelled, in the early 1990s - something that is never mentioned as having anything to do with the fact that it is also the first economy to register growth again. The cancellation of Poland's debt was one of the "other foreign investments" noted in the balance of payments.

Concealed in this entry were some geo-strategic considerations: Poland was the only such country in which a mass trade union movement, Solidarnosc, had challenged the old regime, in 1980. The privatisations, allegedly associated with democracy and pluralism, were never demanded by a congress of Solidarnosc. The corruption of the Polish trade unionists - like that of the independent union of the Ukrainian miners in the early 1990s - was also part of the "invisibles" in the balance of payments.

Geo-strategic criteria must also be considered in any assessment of trends in "assistance" credits. The future boundaries of the European Union are a basic issue. But in the context of austere fiscal policy, another concern is to minimize the costs of enlargement. The major recipients are therefore those countries that are the closest and wealthiest (and most likely to repay), the same criteria that orient FDI. About half of this Western "assistance" comes from the EU and the European Investment Bank (EIB).

Within the EU, the largest official bilateral assistance credits are granted by Germany, France and Italy. The primary vehicle for the EU's multilateral assistance to the CEECs is a specific multilateral agreement called PHARE (Program of Community Aid for Central and East European Countries). Over ten years (from 1990 to 1999), the Commission in Brussels has committed a total of 10.89 billion Euros in favour of the CEECs under this program - compared with the 100 billion DMs that Germany's eastern Landers (provinces) have received from that country's federal government, and the \$112 billion surplus on current account rung up by the EU during the same period.

What this means is that, on the one hand, the EU is not prepared to pay, in order to absorb all the CEECs, what it cost to unify Germany, and on the other, that the CEECs bring in far more than they cost. The interrelationship between "assistance", credits, privatisations and FDI is therefore "organic", and associated with the overall economic logic of the governing institutions (governments, international financial institutions and the EU). And it is at that level, as well, that the challenge is developing.

[1] Wladimir Andreff, "L'investissement direct étranger dans le développement inégal des pays en transition", Nouveaux Cahiers de l'IUED, Du socialisme à l'économie de marché: errances de la transition (October 2001).

[2] A country's stock of FDI is the sum total of all the FDI it has received up to a particular date. FDI "flows" are the variations between two dates (usually measured in years).

[3] In order of credibility of EU membership, under the European Commission criteria, they are Hungary, Poland, the Czech Republic, Slovenia, Estonia, Slovakia, Latvia, Lithuania, Bulgaria and Romania.

[4] See <http://europa.eu.int/comm/enlargement/index.htm>.