POLICY IMPLICATIONS REGARDING FDI DURING THE CRISIS (CASE STUDY: EMERGING MARKETS) *

IMPLICAŢIILE POLITICILOR CE PRIVESC ISD, ÎN TIMPUL CRIZEI (STUDIU DE CAZ: ŢĂRILE EMERGENTE)*

MAGDALENA RADULESCU[1]

[1]***University of Pitesti, Romania; magdalenaradulescu@yahoo.com***

Abstract: *The emerging market countries have responded to the macroeconomic challenges of the recent wave of capital inflows in a variety of ways, depending on the monetary policy framework and the specific policy objectives of the authorities. Deepening economic and financial integration between emerging and advanced economies manifested itself, among other ways, in the recent surge in private capital flows from advanced economies to emerging markets, but also in the reverse flows of capital from emerging market countries running large external surpluses to some advanced economies and developing countries. Along with many economic and financial benefits, increased capital flows have brought with them considerable policy challenges.*

Key words: *FDI flows, emerging countries, new EU's member states, policy implications.*

1. INTRODUCTION

No region in the world has been left unharmed by the present setback in TNCs' FDI plans (Fig. 1). This trend in favor of emerging countries will be especially marked for East, South and South-East Asia (set to become the top priority region over the next three years), Latin America and West Asia. Despite a slight increase, North Africa and sub-Saharan Africa are likely to remain at the bottom of the list. The CIS and CEE region accounts for a limited share in world inward FDI stocks, despite sustained increase in the recent years. It benefited from a new boost in FDI flows in 2008. Two countries (the Russian Federation and Ukraine) rank among the top 30 locations for FDI, with the Russian Federation in fifth position, one

* Lucrarea este finanțată din proiectul POSDRU/89/1.5/S/62988 din 2010.

rank down from last year. Two countries (Poland and the Czech Republic) rank among the 30 most favored locations.

The UNCTAD survey revealed few changes in TNCs' perceptions of the top 15 locations for FDI since last year (Fig. 2). The only new country to be added to the list is Thailand, replacing Turkey and South Africa. The members of the top five remain unchanged, with only some change in rankings: the United States takes second place, overtaking India, and Brazil moves to fourth place, overtaking the Russian Federation.

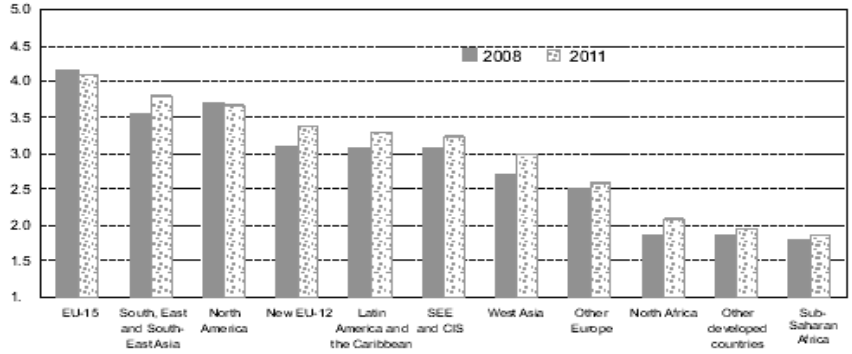


Figure 1. FDI growth prospects, by host region, 2008–2011

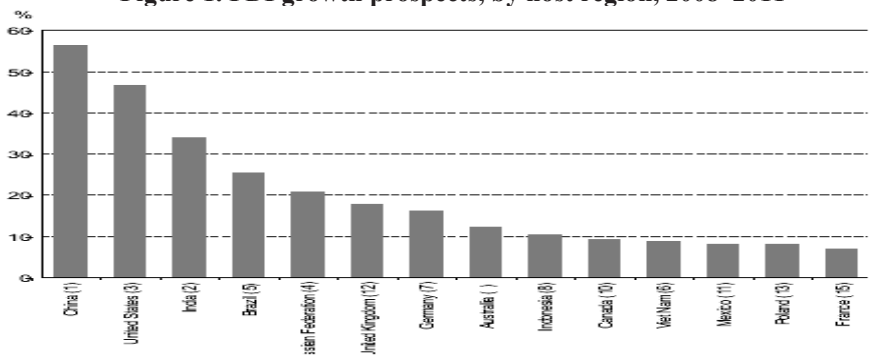


Figure 2. The 15 most attractive economies for FDI, 2009–2011

Source: UNCTAD WIS survey 2009-2011.

Among other countries, the United Kingdom, and to a lesser extent Australia, have improved their rankings at the expense of Viet Nam and Indonesia. These rankings show only a few differences depending on the home region of the companies: Asian TNCs seem more prone to favor Asian countries over European ones, with the opposite being true for European TNCs.

The top 15 countries in the list account for 74 % of the total number of responses. There is an even greater concentration in developing and transition economies: the 10 most mentioned countries accounted for 76% of responses of TNCs from these countries. In other words, companies' interests in developing and transition economies, albeit growing, remain focused on a relatively limited number of countries.

Deepening economic and financial integration between emerging and advanced economies manifested itself, among other ways, in the recent surge in private capital flows from advanced economies to emerging markets, but also in the reverse flows of capital from emerging market countries running large external surpluses to some advanced economies and developing countries. Along with many economic and financial benefits, increased capital flows have brought with them considerable policy challenges. Over the past decade, private capital flows have clearly come to dominate official flows in all emerging markets.

In CEE, opportunities created by accession to the European Union have boosted gross private capital inflows to over 20% of GDP on average in recent years (bottom right-hand panel), an unprecedented level for EMEs in recent history. As a result, this region now receives around 26% of gross private capital inflows to emerging markets (compared with around 11% in the mid-1990s); Latin America receives around 12% (against 29%); emerging Asia 47% (against 51%); and other emerging markets around 19% (against 9%).

The development of financial systems and the growing presence of foreign financial institutions in EMEs have greatly expanded the scope of financial intermediation and lowered the cost of financial services in emerging markets, particularly in Latin America and central and eastern Europe (Chopra, 2007; Mihaljek, 2006). At the same time, they have altered the nature of risks to financial stability by generally lowering the solvency risk but increasing the credit risk and the potential for capital flow volatility and cross-border contagion.

One supporting piece of evidence is the absence of any significant bank failure in CEE following privatizations to foreign strategic partners in the late 1990s and early 2000s. These foreign-owned banks have so far shown resilience in the face of, at times, considerable volatility in local financial markets, and despite numerous "early warnings" from various

macro-prudential indicators devised for detecting banking system vulnerabilities. Swedish, Austrian and Italian banks with a large presence in the region tend to take a long-term view of the growth opportunities in CEE, and have consistently sought to protect their franchises.

Another incentive problem specific to foreign-owned institutions that might lead to an underestimation of the build-up in credit risk is the structure of managerial compensation. Top managers of foreign-owned subsidiaries or branches are often expatriate professionals working on fixed-term contracts. During their limited term in a given EME, they have an incentive to boost the volume of lending, which is typically used as a criterion for assessing the size of their bonus payments.

A third set of financial stability risks associated with the large presence of foreign banks is the risk of financial contagion. Once the recognition or materialization of credit risk in one country triggers a broader reassessment of risk in the whole region, close financial linkages between home and host country institutions can serve as channels for contagion.

2. INWARD AND OUTWARD OF FDI IN THE EMERGING MARKETS. POLICY CHALLENGES

The emerging market countries have responded to the macroeconomic challenges of the recent wave of capital inflows in a variety of ways, depending on the monetary policy framework and the specific policy objectives of the authorities. Given that most countries maintained some form of exchange rate and/or monetary target, the policy response to the inflows aimed in general at addressing the impossible trinity dilemma. As the countries liberalized the capital account while integrating with global capital markets, attempts to achieve simultaneously inflation and exchange rate targets put a strain on the existing mix of monetary and exchange rate policies.

Most emerging market countries relaxed controls on capital inflows as well as outflows. For example, China, India and Russia further liberalized their rules on residents' investment in foreign securities in 2006 and 2007. The recent surge in China's private sector investments in foreign debt securities appears to be partly related to this move. CEE countries have relaxed capital controls the most, with larger Asian emerging economies remaining relatively restrictive, and Latin America maintaining capital controls at more or less unchanged levels since the mid-1990s (IMF, 2008).

Countries in Latin America and CEE have retained the possibility of imposing new capital controls under their foreign exchange laws, although they have not done so in practice. The countries in general fear that such measures would be considered a significant step back in their economic development and liberalization process, and would be largely circumvented.
One major challenge for developing countries is to remain attractive for FDI in the crisis, especially for such investment that serves their long-term development goals and enhances competitiveness (investment in areas such as infrastructure, agriculture, sustainable energy and technology). Public investment programs adopted by several developing countries, as noted above, can have a positive effect on inward foreign investment.

However, huge economic stimulus packages may not be an option for many developing countries, in particular LDCs. Bilateral and regional investment agreements, including those that aim for broader economic partnership between the contracting parties, can help encourage foreign investment (UNCTAD, 2009). FDI and development enhancing effects are more likely to result from such agreements when they contain effective and operational provisions on investment promotion and when they take into account the need of developing countries for policy space. Investment insurance and other home country measures encouraging outward FDI are cases in point.

Retaining existing investment is also important, especially since TNCs in financial difficulty may consider closing foreign affiliates or transferring them to cheaper locations. To avoid such divestment, developing countries need to consider to what extent they can accommodate TNCs' cost-saving strategies. As indicated above, a number of developing countries have included tax relief in their economic stimulus packages. However, national efforts to maintain and attract foreign investment must not result in "race to the bottom" policies, under which developing countries lower social and environmental standards or offer unsustainable financial or fiscal advantages. International coordination, in particular in a regional context, can help to prevent such an outcome.

In times of crisis and increased strains on public funds, governments will closely review the usefulness of public programs and institutions, including IPAs. In developing countries, especially the most vulnerable, agencies may face more difficulties in securing public funding, including for

measures aimed at dealing with the new challenges. These measures could include new priorities in investment promotion with a stronger focus on investor aftercare and policy advocacy, accelerating a trend that could already be observed in IPAs before the crisis.

Since most developing countries are recipients rather than sources of foreign investment, they must be primarily concerned by the effects of the financial crisis on investment inflows. However, some developing countries, in particular the more rapidly emerging economies, also need to consider the impact of the crisis and the evolving policy environment on their outward investment flows, which have become an increasingly important part of their development strategies.

While more state intervention may – as said above – reduce investment opportunities to some extent, rising global demand for fresh capital also offers new investment prospects for enterprises in developing countries that have enough financial resources to invest abroad. In particular, divestment strategies of companies in financial difficulties could offer an opportunity for companies from developing countries to purchase these foreign subsidiaries at an attractive price and to acquire technology, brands and other assets. In a few cases, state support has directly benefited TNCs from developing countries.

3. SPECIFIC CHALLENGES FOR THE ACCESSION COUNTRIES

Many of the new and accession member states have yet to confront the difficulty in embedding inward FDI into domestic economic and innovation systems. One of the challenges in creating embeddedness is associated with matching the industrial structure and comparative advantage of the region with the kinds of FDI that are being attracted. As highlighted in the previous sections, benefits from FDI are maximized when the kinds of investment projects being attracted are matched with the potential clusters of domestic competitiveness that the TNCs may be able to tap into.

In the case of the accession countries, many have well-developed components of science and technology systems. Some are even endowed with considerable capacity in high value-adding activities such as R&D, software development and design. This has been used as a basis to attract and embed highly specialized high-competence TNC facilities. Nonetheless, one of the considerable disadvantages these countries face is the challenge of dismantling centrally planned innovation systems that are driven

primarily by planners and bureaucrats rather than by demand conditions and the specific needs of firms (Narula and Lall, 2006).

Foreign affiliates interact with knowledge organizations such as local universities and public research institutes, which undertake basic or applied research, produce R&D manpower and provide technical services to firms (UNCTAD, 2009). Foreign affiliates may cooperate with these institutions, by providing financial support and conducting joint research projects. Such collaboration can also help R&D by other enterprises, by raising the research capabilities of knowledge institutions, bringing them into contact with industrial work and promoting spin-offs. At the same time, however, TNCs may also be locked into existing supplier relationships, partnerships and R&D networks in other locations, and may be reluctant to seek to establish new associations with as yet unproven local suppliers and universities.

Thus, governments need to create incentives for the TNC to consider local partners, and not expect these to happen "naturally". In circumstances where domestic firms are not present, linkages between foreign affiliates may represent the sole available mode of industrial upgrading and capability development in the CEE countries. As long as industrial and technological upgrading happens and spills over to other firms, it does not matter who the beneficiary is, as long as it serves to further embed the TNC affiliate in the host country.

It is important that the focus of these incubators be on the collaboration with TNC affiliates, and the provision of the infrastructure and environment to foster competitive R&D. At another level, it may also be necessary to create (and encourage the creation of) new, more nimble and entrepreneurial smaller firms, and not attempt to force a "fit" between the older, large and formerly state-owned enterprises whose competences do not properly match the needs of the TNC affiliates. In the case of the accession countries, there has been a historical trend to focus on large firms, and the absence of special treatment for start-up firms and SMEs means that bureaucratic red tape prevents the establishment of such a policy.

The challenges that the accession countries face vis-à-vis developing countries are plainly easier in many ways, because membership does provide them with important location advantages. They have access to a much larger and more affluent market; valuable resources are made

available by the EU to improve their basic infrastructure; they are obliged to converge their institutional arrangements with EU standards; they are protected by EU regulation and laws; and they have the political and economic clout of the EU in the areas of competition policy, trade policy, and so forth. However, they are also in the "home region" of some of the world's largest TNCs, and thus face greater and immediate competition, and cannot afford to be passive.

4. CONCLUSIONS

Various voices advocate the necessity of going beyond the mere short-term management of the ongoing crisis and of setting up the bases of sounder economic regulations, especially in banking, with more control and restriction on the activities of commercial banks, hedge funds and other financial institutions.

The current institutional reform of the global financial system suggests that governments should pay more attention to the interaction and coherence between the global financial system and international investment agreements, since the latter cover both long-term and short-term capital movements.

Apart from the much needed international regulation of the financial markets, economic stimulus packages should be built around common principles that embrace open markets and avoid "beggar thy neighbor" policies. It is important that developing countries are actively engaged in ongoing discussions on these issues.

REFERENCES

1. **IMF** (2008) *"World Economic Outlook",* New York, December, pp. 110-125.
2. **MIHALJEK, DUBRAVKO** (2006) "*Privatisation, consolidation and the increased role of foreign banks*", in "The banking system in emerging economies: how much progress has been made?", BIS Papers, no 28, pp.42.
3. **NARULA, RAJNEESH AND SANJAYA LALL** (2006) "*Understanding FDI-assisted development"*, Routledge: London, pp.23-54.
4. **UNCTAD** (2009) "*World Investment Report 2009"*, United Nations: New York and Geneva, pp.156-163.