Addendum 12b

Seminar on the Promotion of Foreign Direct Investment to Southeastern Europe

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Importance and Elements of FDI
for Countries in Transition to a Market Economy

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1-0 Introduction

1-1 This is a presentation paper for the Seminar on Promoting FDI in Southeast European countries (SEE countries). The purpose of this paper is to investigate the importance and elements of FDI for countries in transition to a market economy, and to study paradigms related to FDI. This paper also aims to provide a common scale for evaluating the FDI environment of each SEE country. The author is ready to improve this paper with appropriate comments from outside parties.

1-2 SEE countries are currently in transition from socialism to market oriented economies. However, each country had a different type and level of socialism in the past from which to mark its starting point (conditions vary as some countries did not have distinctive socialist economic elements while others had very strict systems), different historical and ethnic backgrounds, different economic elements such as natural resources, capital formation, labor availability and different goals for their economic transition in future. In addition, some countries have already achieved a certain level of economic transition and others have not. Some countries are close to the EU economic zone and have virtually introduced the Euro currency. There are also countries that have seen war and/or domestic unrest. In view of the above-mentioned differences, this author focuses on the most general and common factors and elements of FDI in transitional economies.

2-0 The necessity and effects of FDI and related risks in transitional economies

2-1-1 There have been various studies on FDI that cover its necessity and effects. This year's OECD report, "Foreign Direct Investment for Development: Maximizing Benefits, Minimizing Costs" discusses key factors to encourage economic development, employment, technology transfer, human capital development, integration into international trade, promotion of competition, corporate development, and income increases, and points out that one of the effects of FDI is to bring out dormant capital in FDI host countries. At the same time, the report notes that those effects are made possible only when basic development proceeds and appropriate policies exist in the FDI host countries. In short, most of the issues to be resolved in promoting FDI lie on the recipient side. In that sense, improving the investment environment in the FDI host country is the most important factor.

2-1-2 While investment in developing countries and transitional economies is potentially highly profitable for foreign companies (especially with regard to natural resource development), there is a risk of capital loss as well.

2-1-3 Risk factors in transitional economies are generally categorized into the following:

1) Unstable macro-economy
2) Possibility of losing assets due to the weak binding effect of ownership and contract enforcement
3) Physical destruction due to war and/or domestic social unrest
4) Insufficient domestic economic policies (including reform policies)
5) Low-quality public services
6) Insufficient liberalization of the trade regime

2-4 Bearing the above-mentioned points in mind, the elements to be discussed in this paper are as follows:

1) Achievement and current status of transition to a market economy
2) Economic structural reform
3) Social and economic infrastructure
4) Goods market
5) Labor market
6) Industrial policy
7) Reform of trade and investment regime
8) Conflict resolution system
9) FDI host country's institutions promoting FDI

3-0 The first element: "the achievement and current status of transition to a market economy"

3-1 A stable macro-economy is very important for foreign companies to make investment decisions and judgments. For foreign companies, FDI means investing a huge amount of capital into a project and generating more gain than the initial investment after a certain period. Calculating the cost and profit is possible under ongoing inflation when the inflation rate is constant, but nonetheless depreciation of the initial investment and assets due to inflation is a serious threat. Therefore, a stable macro-economy and directly related policies, including finance and currency policies, are the biggest concerns of foreign investment firms. A number of countries are implementing macroeconomic measures under agreements with the IMF (such as stand-by arrangements). Although the relevance of IMF policies to transition economies remains controversial (reviewing the "Washington Consensus" was a topic at the SEE seminar last March), once IMF policies are launched, they should be pursued to some extent. Given this, it is then especially important to show both at home and abroad that governments and central banks in the FDI host countries are committed to working toward stable macro-economies in a systematic manner. A similar argument holds for other individual reforms. In that sense, the existence of short-, medium- and long-term economic programs in the FDI host country is a major concern of foreign firms. FDI host countries are required to plan a wide range of effective and highly transparent investment policies and arrange human and organizational capabilities to implement those policies.

3-2 It is hard to withdraw FDI once it is launched, and in the case of any uncertainty in laws and rules, there is a large possibility that the risk premium will increase. SEE countries are in transition from their former socialist economy models of contract and ownership to market economy models to greater or lesser degrees. It is a major, time-consuming change requiring comprehensive changes in the legislative system. At the beginning of the transition, some countries suspended laws that originated under their former socialist economies and applied a contract and ownership system under the market economy model as an interim measure for administration alone, but such interim systems should be formalized after discussion by parliamentary bodies and others at the earliest possible time. Also, when the transition from an old system to a new one takes a long time, the cost of collecting information to understand the situation increases, creating another disadvantage for foreign investors.

3-3 The ownership of land plots by foreigners is also very important, since land can serve as an asset or collateral for FDI.

3-4 There are two other points to be considered, although they are slightly different issues from the main theme of "the extent of the achievement of transition to a market economy."

3-4-1 The first one is demographics. Population usually decreases in a transition period or domestic conflict. This often reduces the working population. This is a long-term negative factor as it decreases domestic consumption and production, and increases the budget for social welfare and related programs.

3-4-2 Disorder and instability in federal systems is another major negative factor. Disorder in fiscal federalism (fiscal federalist relations: disorder of budgetary relations between the federal central government and regional or local administrations) in particular complicates the tax relationship and creates more costs for foreign companies. In addition, foreign companies face more difficulties when federal and local laws conflict with each other in the same field during increasing instability in the federal system. If such disorder and instability exist, they should be eliminated as soon as possible.

4-0 The second element: "economic structural reform"

4-1 The important factors are as follows:

- Promising industries that each country wants to bring to the attention of foreign investors
- Industries in which each country believes it possesses a comparative advantage
- Formation of supporting and subcontracting industries in establishing assembly industries

4-2 This author emphasizes the following points:

4-2-1 One of the common things seen in former socialist economies with regard to privatization-related investments is large-scale state enterprises that monopolize a market. However, a number of these enterprises are now inefficient and have accumulated debt. They should in principle be privatized in order to improve managerial efficiency. This author believes that, after corporate asset evaluation, the privatization of state enterprises should be accompanied not only by the conversion of the companies to joint stock ones, but also by their breakup. In the course of dividing up these companies, policies should be implemented so that the production sector is either divided vertically (mainly by area), or horizontally (mainly by field) or some combination of the two after separating the peripheral elements (such as apartments for employees, schools and hospitals) from the management entity. Each country should decide which measures to take for each industry in light of the social and economic conditions in that country. It is worth considering concentrating accumulated debt into a specific organization (e.g., the privatization process of the former Japanese National Railways). Next, promising areas within each division should be fostered (e.g., policy-based finance, tax incentives, incubators, etc). The role of the central and local governments is significant in this process. Here, surplus personnel in unprofitable sectors should be absorbed and, at the same time, unprofitable areas should be cleared (bankrupted). In that sense, solid bankruptcy legislation is necessary and social security (including unemployment benefits) should be planned so that this issue can be addressed over the long term. Entrepreneurs should be actively fostered along with privatizing state enterprises as well. Finally, competition among companies and entrepreneurs surviving the privatization and division should be promoted for greater efficiency and public welfare.

4-2-2 When a foreign company makes investments abroad, it quite often forms a capital alliance with a local partner (such as establishing a joint venture) or establishes a company with its own capital. Here, factors such as ownership, the acceptance of foreign capital and joint ventures, labor and employment systems, corporate governance, and land legislation should be considered. If a company was divided due to the above-mentioned privatization, it is easier for foreign companies to find a subcontractor-like partner when investing in fields such as machine manufacturing (in terms of size, direction and know-how).

4-2-3 The freedom to, for example, transfer capital abroad and banking services are minimum requirements for financial systems at the initial stage. Some countries may have policy-based finance for specific industries or small and medium-sized companies. This is, of course, advantageous to foreign investment but, at the same time, should be managed with transparency and equality to prevent it from providing a hotbed for graft and corruption. Although it is not necessary right after the initial investment, the existence of financial and securities markets will be important as the companies may wish to be financed by banks in the target investment countries or to issue bonds or increase capital.

4-2-4 FDI could create a negative impact on the environment through drilling for resources and the expansion of heavy industries. Although the impact on the environment is usually reduced as FDI introduces more efficient technologies to FDI host countries, sometimes investing companies bring in machine equipment that could not be used back in their countries due to tighter environmental standards. In that case, reducing the impact on the environment is not always possible. Therefore, FDI host countries should establish appropriate environmental standards as well.

4-2-5 Whether the manager has a market economy mindset for management and foreign language skills is unexpectedly important in the initial stages of a market economy.

5-0 The third element: “social and economic infrastructure”

5-1 The important factors are as follows:

- Roads, ports, airports, etc.
- Energy supply such as electric power
- Communication facilities and services
- Basic social services such as sewage and waste disposal

5-2 Social and economic infrastructure is naturally important. This author emphasizes the following in this regard.

5-2-1 Infrastructure development should not be required of foreign investing companies but primarily of FDI host countries. Securing energy and water supply is essential.

5-2-2 Basic social services such as sewage and waste disposal are also important.

5-2-3 There were some cases of countries in economic transition assigning infrastructure development to foreign investors (e.g., when a foreign investor wants to create a hotel facility in the city center, the city administration sets down the condition of building a sewage system in a remote area of the city), but many foreign companies may stop investing due to the lack of accountability.

6-0 The fourth element: “goods market”

6-1 The important factors are as follows;

- Proximity to a mass consumer market
- FTA
- Transportation and logistics

6-2 These are naturally important. This author emphasizes the following in this regard.

6-2-1 Most of the SEE countries have concluded bilateral or multilateral FTAs with neighboring countries. We also know that EU accession is a target of many SEE countries. Some countries have already introduced the Euro as their official currency even though their accession to the EU has not been finalized. Some countries have joined other regional blocs (e.g., the Black Sea Economic Cooperation Organization and CEFTA).

6-2-2 Careful consideration should be given to the facts that (i) the creation of an FTA area has positive aspects for the participants in the FTA, but negative aspects for non-participant countries engaging in business in the FTA areas, and (ii) the overlap of various FTAs in a single area complicate business. Decisions on the positioning and affiliation of each SEE country with certain FTA areas are issues for that country to address. However, these items should be discussed in-depth to avoid problems in the future.

7-0 The fifth element: "labor market"

7-1 The important factors are as follows:

- Labor standards
- Labor force structure
- Labor discipline, diligence, wage level, quality
- Industrial and union relations

7-2 These points are important in the investment environment. This author emphasizes the following two points.

7-2-1 Social security (labor legislation, education, technology, and medical insurance) generally needs to attain a certain level for the country to enjoy the benefits that FDI brings. Labor legislation is especially important among these. On the other hand, the author is aware that many countries maintain an extraordinarily generous labor law system as former socialist countries, including the requirement of union permission for lay-offs and strict restrictions on overtime work. These are good for workers but increase costs for companies. It is appropriate to introduce systems that are in accord with the transition to a market economy and labor policies meeting ILO standards.

7-2-2 A number of countries draw attention to their high educational standards and skilled workers. At the same time, technological flexibility is important.

8-0 The sixth element: “industrial policy”

8-1 The important factors are as follows:

- Privatization of state enterprises and antimonopoly policies
- Resource development policies (PSA)
- Investment incentive programs
- Support of scientific technology and research and development

8-2 The importance of privatization was already explained in discussing the second theme, “industrial structure reform.” Antimonopoly policy is especially important in relation to the privatization of state enterprises mentioned above. FDI affects competition in the FDI host country’s market significantly. Vitalized domestic competition prompts economic growth and could eventually lead to higher productivity, lower prices, and more efficient resource allocation. However, in cases where the FDI host countries are small or the investing companies play an important role in the international market, or if competition laws are weak in the FDI host countries or entry barriers are high, competition could be hampered. The privatization of certain companies is sometimes an exception to antitrust law in a transition economy (e.g., natural monopolies in Russia). However, minimizing exceptions at the initial stage has a positive effect in the long run if privatization is to increase company efficiency in the future. FDI in developing countries and transition economies is often investment in natural resources. The next most common example is privatization-related investment (mass privatization was carried out in a number of countries in transition in the 1990s) and some investments aim at gaining access to huge domestic or neighboring markets. The author would like to emphasize the following points in relation to the above.

8-2-1 With regard to investment in natural resources, the above-mentioned ownership issues and disordered federal systems are related to one another. This is because the ownership of the natural resources produced is disputed among nations, regions or companies. In that sense, it is desirable to resolve the two problems – ownership and federal systems – promptly. PSA (Product Sharing Agreement) resource development is one realistic solution.

8-2-2 One of the important benefits of FDI for FDI host countries is technology transfer. Technologies here are not just technologies for production, but include business skills as well. Moreover, FDI has the potential to improve environmental and social conditions in the FDI host country by transferring “cleaner” technologies and introducing more socially responsible corporate policies. However, the technological level of the FDI host country should be high enough to digest the transferred technology to maximize the effect of the technology transfer. Also, foreign companies often impose their corporate philosophy and corporate governance on the capital partner in the FDI host country. These factors are very likely to drastically improve the management efficiency of the company.

9-0 The seventh element: “reform of trade and investment regime”

9-1 The important factors are as follows:

- Compliance with WTO and EU standards and policies for hosting foreign investment in each country
- Regulations on foreign capital investment ratios
- Foreign investment incentive measures
- Systems related to establishing and managing foreign companies (land ownership, local hiring requirements)

9-2 Four SEE countries have already become members of the WTO and three have observer status.* Moreover, some countries have voluntarily introduced EU standards and the Euro. This author emphasizes the following points.

9-2-1 Special measures to integrate the economies of FDI host countries into the international trade framework using the benefits of FDI, especially by establishing export processing zones (EPZ)/special economic zones (SEZ)/free economy zones (FEZ), have gained considerable attention. China, for example, gives investment incentives to foreign companies. The author is not sure if there are similar EPZ/SEZ/FEZ in Southeast Europe. However, if there are, and if incentives are given only to foreign companies in the zones, the negative effects should also be considered. This includes the burden on the state and region to establish and maintain export processing and special economic zones, and the risk of creating unequal playing fields for domestic and foreign companies, though these measures could sometimes contribute to expanding the trade of the FDI host country. Establishing incentive measures for foreign companies in such EPZ/SEZ/FEZ is against WTO provisions and therefore problematic (e.g., China promised to abolish such measures). Countries that plan to join the WTO should be careful.

9-2-2 If a WTO member country is divided, the new smaller countries will develop socioeconomic legislation separately, but even in such cases they should remain in compliance with their WTO commitments.

*	Rumania	January 1995	Member
	Bulgaria	December 1996	Member
	Albania	September 2000	Member
	Croatia	November 2000	Member
	Bosnia-Herzegovina		Observer
	Macedonia		Observer
	Federal Republic of Yugoslavia		

9-2-3 Each SEE country should carefully consider the FTA-related policies mentioned in 6-2 of this paper.

10-0 The eighth element: "conflict resolution system"

10-1 The important factors are as follows:

- Legal systems
- Other dispute settlement agencies

10-2 Countries with economies in transition often have legal systems not suited for a market economy. The legal systems themselves are in a transition period, and various commercial disputes could occur. Developing settlement systems is important when that happens.

10-3 Some transition economies may have applied flexible systems to administrate laws as an interim measure at the initial stage of the reform. Some local governments may have introduced such flexible systems in some areas, which may cause discrepancies in central and local regulation, disruptions in fiscal federalism, and confusion among foreign investors on which regulations they should obey. It is necessary to review and formalize interim law systems as permanent systems in the process of putting into place the country's basic structure.

11-0 The ninth element: "FDI host country's institutions promoting FDI"

11-1 The important factors are as follows:

- agency's name
- functions of each agency
- problems that each agency tackles

- contact points, etc.

11-2 Foreign companies invest in countries of which they have little knowledge, so it is desirable to have agencies that give them guidance, a consultative body in case of disputes, and agencies that support foreign investors' rights regarding indirect investment. Such institutions should be created with one center in the capital and one in each region.