OECD – CUTS Roundtable
Foreign direct investment in transition economies: Challenges, Policies and Good practices

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Foreign direct investment in transition economies

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Representatives from the Turkish government and FDI Organizations,
Representatives of UNCTAD

Distinguished guests, ladies and gentleman

On behalf of UNDP, it is a great pleasure for me to participate in this Regional Roundtable on FDI in Transition Economies. UNDP has been an ardent supporter of developments in the promotion of FDIs in the region and in Turkey. We believe that FDIs can play an important role in economic growth and social development in the Eastern European and Balkan region countries and in Turkey, in particular.

Few subjects have been of greater interest to business people, economists, and historians than FDI. Beginning with the activities of the East India Trading Company during the 19th century, historians have often depicted FDI as a mechanism for the imperialistic exploitation of the developing world's riches. When direct investments by American corporations in Europe after the Second World War caused some observers to fear "the American challenge"; FDI was seen as a mechanism for promoting the expansion of American economic and political power. The activities of multinational corporations in developing countries galvanized the new left in the 1960s, and more recently have come under attack from the anti-globalization movement.

Despite this, the conventional development wisdom during the past 25 years has taken an increasingly benign view of FDI. This view—which is shared by governments in most of the world's developing countries—emphasizes FDI's advantages for recipient countries. It is now broadly understood that inward equity FDI represents not only the import of non-debt creating capital, while at the same time it is also a mechanism for transferring technology from developed to developing countries and generating employment. Generally, it is now accepted that FDI is key to realizing the goal of sustainable human development—for any country, developed or otherwise. However, the global financial infrastructure at present faces a number of daunting problems. Many of these became apparent during the East Asian and Russian financial crises during 1997-1998, and have been apparent in Argentina's recent financial collapse. Among others, these questions pertain to the role of the Bretton Woods institutions, "optimal" exchange rate regimes and mechanisms for moving from one regime to the other, the

introduction of global standards for financial transparency and prohibitions against money laundering, and whether "Tobin taxes" or other instruments should be thrown into the wheels of international commerce in order to slow down the movement of hot money around the global market place. It is noteworthy, however, that discussions on redesigning the global financial architecture only rarely question the desirability of FDI.

The transition economies of Central and Eastern Europe show why FDI is now viewed with such near-universal approbation. Perhaps in no other part of the world during the last ten years has FDI had such profound, beneficial effects on prospects for sustainable human development. The sharp growth in per-capita GDP and labor productivity seen in such countries as Poland, Hungary, and Estonia since the mid-1990s has been driven by the large amounts of FDI that these countries have attracted. Without their FDI successes, these countries would now not be front-runners for EU accession.

Analyzing FDI in transition economies shows that they typically occur in one of five different ways:

1) Privatization-related acquisitions in food processing, retail, and other light-industrial consumer-oriented sectors. FDI here is driven by the desire for market access, especially to buyers in households with incomes and tastes broadly similar to those found in OECD countries. Governments often prefer such FDI to the alternative of imports of these same goods produced in other countries, often financed by foreign credits. Such purchases were a major part of the "first wave" of FDI that occurred in Central Europe during the early 1990s.

2) Privatization-related acquisitions in the energy and metallurgical sectors. This type of FDI is driven by deposits of energy resources or precious metals, and is driven by the inability of national governments to raise the capital needed to exploit or refine these deposits by themselves. This FDI is quite common in such energy exporters as Kazakhstan or in countries with important non-ferrous metallurgical sectors.

3) Privatization-related acquisitions of banks and telecoms. Acquisitions in these sectors are typically the largest privatizations in transition economies, due to the relatively large size and quasi-monopolistic positions of the national companies involved. Such sales at present account for large shares of FDI and privatization receipts in Poland, the Czech Republic, and Slovakia.

4) Privatization-related acquisitions of engineering companies. A handful of Central Europe's leading engineering companies—such as Tungsram in Hungary and Skoda in the Czech Republic—have been able to attract foreign buyers. Such examples are relatively rare, due to the small number of potentially viable companies and governments' unwillingness to part with them. These sales are typically accompanied by major pre- and post-privatization restructuring.

5) Greenfield investments. This form of FDI where new facilities are designed and built for the investments is still relatively rare in transition economies, but has become quite important in Central Europe. Electronics equipment and automobile components are sectors that have particularly benefited from greenfield FDI in Central Europe and the Baltic States. This FDI generally reflects locational decisions by multinational corporations oriented towards producing for the EU market.

The large amounts of FDI that have gone into Central Europe and the Baltics can be easily explained by conventional economic theory. They reflect the combination of Central Europe's relatively low unit labor costs and its close proximity to one of the global economy's core regions.

This does not mean, however, that these FDI flows result solely from market forces. National and sub-national governments typically compete actively for major international investment projects by offering tax holidays, special tariff regimes, and other benefits. Likewise, countries with the most liberal foreign exchange regimes have not always had the most success in attracting FDI.

For most of the Central and East European region, FDI has been closely tied with privatization, with the sales of state assets to multinational companies. While prospects for this shift towards greenfield FDI seem rather promising in the Czech Republic, Poland, and Estonia, it remains to be seen whether a broader group of transition economies, especially in the CIS, will be able to attract significant amounts of greenfield FDI.

The reason much of the attention is focused on the Central European countries is that there seem to be important lessons to be learned from their experiences. Interviews with senior MNC executives suggest that Turkey's key competitors in attracting FDI are Hungary, Poland and the Czech Republic. However, Turkey has been less successful in attracting FDI when compared to all of its Central European neighbours. In fact, Hungary, which is generally considered the leader in attracting FDI, has attracted about 15 times the amount of FDI per capita drawn by Turkey. This is significant, especially considering the fact that the Eastern European countries are all candidates to join the EU. The government of Turkey is currently taking important steps towards making Turkey more attractive to FDI by forging ahead with such policies as new foreign investment law, simplification of procedures, the implementation of inflation accounting and coordinating efforts by different ministries. We would like to stress that the UNDP can also help Turkey by supporting dialogues on FDI between countries and businesses in the region and facilitate the sharing of best practices and positive experiences.

The FDI statistics show that annual FDI flows in Turkey grew rapidly from the mid-1980s, reaching $1 billion in 1990. However, FDI flows per annum have not increased for the decade since then. In other words, during the 1990s when global FDI flows accelerated – exceeding the growth in world trade since 1989 – FDI in Turkey remained rather static.

However, according to a recent survey of multi national companies, Turkey is seen as having a favourable investment climate when compared to many of its Central and Eastern European neighbours. Therefore, Turkey's realization of the importance of foreign direct investment for its economic and social development and the proactive approach it has taken to increasing FDI are important steps. Just recently, Deputy Prime Minister and Foreign Minister Abdullah Gul pointed out that Turkey has the capacity to increase significantly its FDI from the current US$1 billion per annum. In order to accomplish this, Mr.Gul said that the government will need to improve the investment environment in Turkey through first enacting the Foreign Capital Law. Mr.Ali Babacan, State Minister for Economy said recently that through this law he expects that principles such as application to a single authority; establishment of foreign capital information agency; setting up a coordinating committee with membership of civil society organisations such as YASED, TOBB and TUSIAD to address the multifaceted issues surrounding FDIs; and designing an FDI promotion and investment plan within the frame of a national development plan. These are applaudable efforts – and without doubt – they will contribute towards a fast improvement of the FDI investment environment in Turkey.

Let me mention briefly the role that the UNDP can play in FDI development: First, the UNDP's current development cooperation capacity at the country level and its wide international network can be tapped further to support the development of FDI. This support can be in the forms of (i) transfer of technical know-how, (ii) legislative initiatives and, (iii) human resources and institutional capacity building.

Second; the UNDP, by working closely with the key actors at the national, regional and global levels, can support the FDI dialogue between the countries and facilitate the exchanging of relevant experiences and best practices. Finally; Through these two broad areas of activities, -

the UNDP can support the development of related national processes that facilitate an increased level of foreign direct investments.

As UNDP, we were pleased to have supported the first YASED Conference held in Turkey in December 2001 on “FDI Prospects in Turkey”. UNDP was also a partner to YASED and to the Turkish government partners in the organization of a second FDI Conference in February 2002. In both conferences, two UNCTAD experts who specialized in FDI promotion issues in the region joined UNDP. UNDP will continue to support FDI promotion in the RBEC region in close cooperation with Turkish and regional partners in the organization of a Regional Conference on FDI Promotion, which is scheduled to be held in Bucharest, Romania in October 2003. The Turkish private sector organizations and media corporations have shown great interest in sponsoring in part and participating in this event which will provide the opportunity to review key and critical factors of FDI that impact upon the development of the countries in the RBEC region.

Thank you for your kind attention.