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The International Investment Market and its Role in Social Stability and Sustainable Development during Financial Crises (evidence for the Republic of Moldova)

by
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Abbreviations

FDI – Foreign Direct Investments
NBS – National Bureau of Statistics of the Republic of Moldova
MDL – Moldovan Lei (currency of Moldova)
USD – dollar of the United States of America
PI – Portfolio Investments
UN – United Nations
IMF – International Monetary Fund
OSCE – Organization for Security and Co-operation in Europe
NFII – new forms of international investments
ECB – European Central Bank
WP – working paper
DP – discussion paper
RP – research paper
Mil. - millions

Key words

Foreign direct investments, globalization, capital flows, economic and financial crisis, Republic of Moldova

Abstract

Foreign investments, primarily foreign direct investments (FDI) are viewed as a major stimulus to economic growth and development. A current positive attitude to FDI is indeed striking. More than that, at the end of the twentieth century developing countries faced a series of serious financial crises differed markedly from those which had occurred previously. Many problems were compounded by the direct influence of transnational corporations – the main players on the global investment market and the main promoters of FDI. It will be analyzed in this paper how these problems affected or may affect social life and sustainable development of the countries.

Unfortunately, we have an idea of market fundamentalism, which is now the dominant ideology, holding that markets are self-correcting, and this is false... There are now, for example, complex forms of investments... The large potential risks of such investments are not being acknowledged.

George Soros, 1998¹

Globalization issues became of top interest during the last decade. There is no generally accepted definition of this phenomenon; however it generally refers to the elimination of barriers in different spheres: economy, communication, culture etc. The world is getting smaller and closer, as there are no borders for almost anything. Globalization offers substantial opportunities for participating countries, but it also requires rapid adjustments in order to benefit from most of these opportunities.

Economic globalization is primarily based on liberalization of capital movements, as well as integration of markets. In this context, international investments are considered the main instrument of economic globalization and the most powerful one. So, their impact on social stability and sustainable development can be also very significant.

Investment scientific approach recommends distinguishing *foreign direct investments (FDI)* and *portfolio investments (PI)*². Foreign direct investment is that investment, which is made to serve the business interests of the investor in a company, which is in a different nation distinct from the investor's country of origin³.

IMF, UN and OECD decided to consider the arbitrary value of 10% ownership of a company as the threshold percentage for the investing company to define its investment and FDI. However, this value is actually rejected by more and more countries and it doesn't seem so logical in the

¹ Interview with G. Soros "The Financial Crisis", Bloomberg TV, April 2008;

² Mody A., Razin A., Sadka E. The Role of Information in driving FDI, IMF WP 03/148, 2003;

³ <http://www.economywatch.com/foreign-direct-investment/definition.html>

context of control and influence, as even 5 or 7 percentage shareholding may lead to a high decision making potential and a significant power.

PI represents the acquisition of financial assets (which includes stock, bonds, deposits, and currencies) from one country in another country. In contrast to foreign direct investment, which is the acquisition of controlling interest in foreign firms and businesses, portfolio investment is foreign investment into the stock markets⁴.

Nevertheless, we would consider true and important to include in this classification one more group of investments, which may take place at the international level, but can't be categorized as FDI or PI. These are *other forms of international investments*, or new forms of international investments (NFII)⁵. They do not suppose the investor to have control (more than 10% shareholding), but are not usual portfolio investments in stocks or other securities either. For example, "turnkey" contracts or "production sharing" contracts.

The multiplicity of forms of international investments can be explained by the absolute diversity of countries' conditions for foreign capital and normal business purpose to maximize its profits in these conditions.

So, it's seems easy to understand that companies want to invest overseas to maximize their profits. At the same time, the determinants of investing decision may vary depending on case and period. In this context the eclectic paradigm or OLI-model is a good economic theory that explains why, when, how and which advantage must be chosen for a certain firm as a form of international activity. Ownership advantages, locational advantages and internalization advantages are the basic categories of advantages – factors that can be applied on foreign markets⁶.

Dunning has identified also four primary types of corporate foreign investments according to the reasons of investments:

⁴ <http://glossary.econguru.com/economic-term/portfolio+investment>;

⁵ Oman Charles, *New forms of international investments in developing countries*, OECD, Paris, 1984;

⁶ Dunning J.H. *The Eclectic Paradigm of International Production: a Restatement and some Possible Extensions*, *Journal of International Business Studies*, vol. 19/1, 1988

Market seeking, i.e. firms may go overseas to find new buyers for goods and services. Thus, market seeking may happen when producers have saturated sales in their home market, or when they believe investments overseas will bring higher returns than additional investments at home.

Resource seeking when a company finds it cheaper to organize production process in a foreign subsidiary—for the purpose of selling it at home or in foreign markets.

Strategic asset seeking: Firms want to invest in other companies abroad to help build strategic assets, such as distribution networks or new technology.

Efficiency seeking: Companies seek to reorganize their overseas holdings in response to developing economic changes.

International investments increased dramatically in the last 20 years. There are many reasons that may explain this phenomenal growth, the main of them are the following:

1. Globalization effects, technology development. The 21st century brought great changes if telecommunications and transport services. New methods of communication (Skype for ex.) unquestionable promoted economic integration and capital movements.
2. Enormous economic growth rates. Access to East Asian markets and their partners promised high profit returns to the investors.
3. Financial liberalization and massive privatization. Shift from social models of economic planning to toward markets economies in former Soviet Union.

So, international investment market as well as the entire global economy is moving to a closer communication level and integration in all spheres. International investment is important to most economies, and can be particularly vital for developing countries. In many instances, developing countries have both the demand for a good or service, and the labor and natural resources to supply it, but they lack the access to capital necessary to begin producing.

There are many scientific publications about the role of international investments, mostly FDI in the social and economic development of the country. It is, anyway, absolutely clear, that effects of

foreign capital can be positive or negative (Carkovic, Levine 2002⁷; Dutt, 1997⁸; Alfaro 2003⁹). And besides those visible, there is a large range of spillovers.

So, the main purpose of the paper is to allocate these effects and their possible mutations during the financial crises.

International Investments and Their Positive sides

1. General effect of capital flows

International investments are vital for the development of many countries. They represent fuel for further economic development. A simplest positive side effect of investments is demonstrated in figure 1.

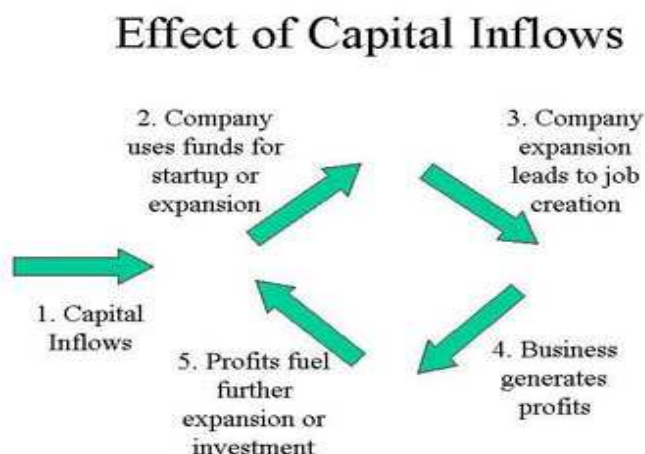


Figure 1. Effects of Capital Inflows¹⁰

Incoming capital flows determine expansion of business. At the same stage of development this business creates new jobs. As a result of the expansion, company's profits will increase also. Theoretically, reinvested profits will generate new expansions and so on. So, capital inflows may

⁷ Carkovic M., Levine R. How Does FDI Accelerate Economic Growth, University of Minnesota Department of Finance WP, June 2002;

⁸ Dutt A.K. The Pattern of Foreign Direct Investments and Economic Growth, World Development vol. 25 nr. 11, 1997;

⁹ Alfaro L. FDI and Growth: Does the Sector Matter? Harvard Business School, April 2003;

¹⁰ www.globalization101.org

contribute not only to the general capital formation, but also lead to job creation, which is an essential issue when speaking about social stability and development.

2. FDI and domestic investments

Mody and Murshid¹¹ and Mileva¹² analyzed the impact of FDI on domestic investments. Econometric study demonstrated that FDI influence positively and stimulate internal savings and investments.

For the Republic of Moldova this correlation can be indirectly demonstrated by the dynamics of foreign fixed capital investments and public fixed capital investments (figure 2).

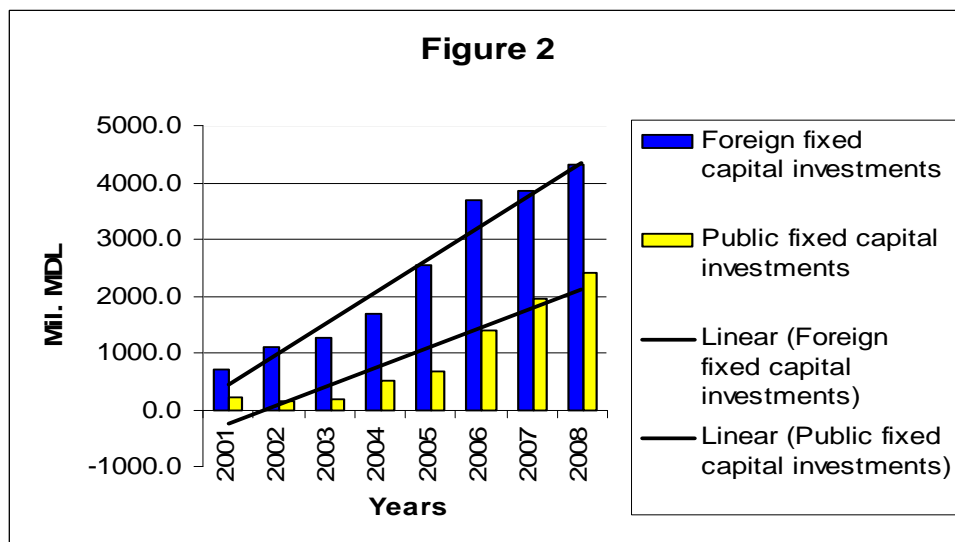


Figure 2. Foreign and public fixed capital investments in Moldova and their dynamic trend lines, 2001-2008, Mil. MDL

Data source: NBS¹³

We may observe that the growth of foreign fixed capital investments is accompanied by the growth of public fixed capital investments. However, foreign fixed capital investments demonstrate more dynamical rate of growth. Although, it is still a question in this context, which of these two sides of the coin represents cause and consequence.

¹¹ Mody A., Murshid A. Growing up with Capital Flows, *Journal of International Economics*, vo. 65(1), 2005;

¹² Mileva E., *The Impact of Capital Flows on Domestic Investment in Transition Economies*, ECB, WP871, 2008;

¹³ www.statistica.md

3. FDI and wages

It is obvious that globalization is strongly correlated with all investment issues. Economic theory (the model of international commerce) argues that global liberalization should equalize priced for production factors, including price for work, or wages. Extrapolating the theory, the growth of FDI should increase salaries level in developing countries.

In this sense we propose to analyze the structure of FDI in Moldova by economic activities (figure 3) in a connection with salaries levels in different economic activities (table 1).

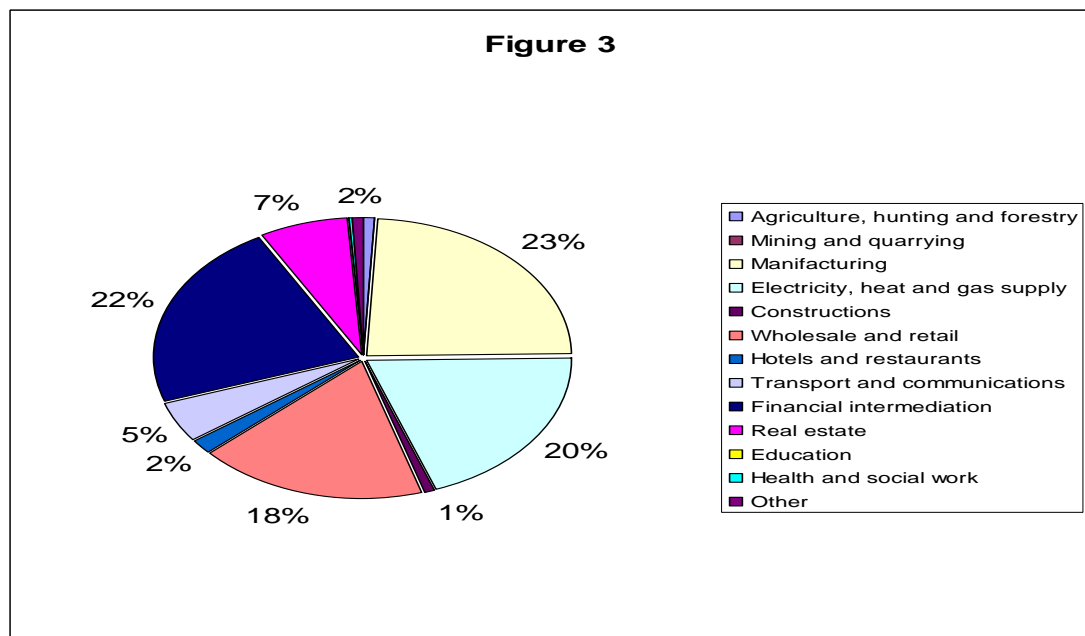


Figure 3. Foreign investments in the statutory capital of enterprises of the Republic of Moldova from the moment of registration by economic activities for the end of 2008, Mil. MDL

Data source: NBS

As we may observe, manufacturing (23%), financial intermediation services (22%) and electricity, heat and gas supply activities attracted together more than a half of total investments as statutory capital.

Below is the salary evolution in 2000-2008 by economic activities (table 1).

Table 1*Average salary by economic activities in Moldova in 2000-June 2009*

	2000	2001	2002	2003	2004	2005	2006	2007	2008	June 2009
Total	407,9	544	692	891	1103	1319	1697	2065	2530	2845
Including:										
<i>Financial intermediation</i>	<i>2353</i>	<i>2278</i>	<i>2564</i>	<i>2926</i>	<i>3255</i>	<i>3451</i>	<i>3863</i>	<i>4648</i>	<i>5446</i>	<i>5878</i>
<i>Electricity, heat and gas supply</i>	<i>720</i>	<i>889</i>	<i>1135</i>	<i>1535</i>	<i>1947</i>	<i>2324</i>	<i>2872</i>	<i>3596</i>	<i>4316</i>	<i>4574</i>
Industry	683,4	827	1002	1271	1502	1765	2085	2541	3042	3171
Manufacturing	677,7	813	972	1216	1418	1652	1915	2314	2763	2824
Transport and communications	635	861	1055	1454	1786	2143	2549	3040	3533	3627
Mining and quarrying	577,5	767	1008	1190	1599	2037	2624	3098	3740	3682
Agriculture, hunting and forestry	251,7	315	394	499	642,6	744	915	1099	1484	1376
Piscicultura	338,5	388	455	586	860,2	1043	1191	1281	1368	1371
Constructions	539,8	683	838	1194	1639	1973	2429	2968	3469	3271
Real estate	554	728	890	1133	1382	1671	2052	2584	3216	3617
Public administration	517,7	742	989	1050	1205	1364	2164	2389	2802	3256
Wholesale and retail	394,6	531	642	795	1051	1228	1555	2089	2531	2471
Hotels and restaurants	357,8	485	571	827	975	1151	1385	1760	2112	2196
Education	247,7	337	463	610	710,7	882	1209	1351	1671	2414
Health and social works	230,1	315	439	579	844,7	1017	1334	1703	2266	2940
Other activities	295,8	391	505	671	801,9	1011	1302	1600	2014	2462

Data source: NBS

It is absolutely clear that economic activities, which attracted more FDI in Moldova, like financial intermediation and electricity, heat and gas supply provided almost twice higher level of salaries than the rest of economic spheres. Less evident, but still significantly higher level of salaries are paid manufacturing industry.

M. Rama¹⁴ although suggested that positive effects of FDI on salaries doesn't have a long-term impact (figure 4).

¹⁴ Rama M. Openness and labor market vulnerability, <http://siteresources.worldbank.org/INTRANETTRADE/Resources/MartinRama.pdf>

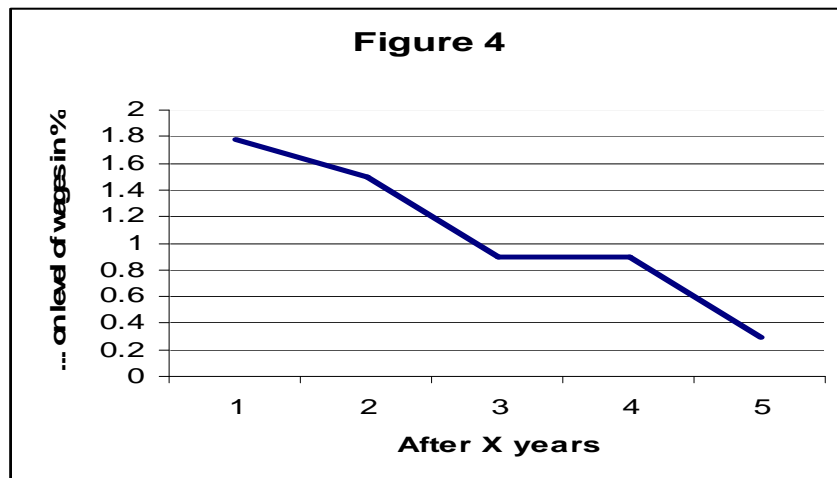


Figure 4. Salaries and FDI. Effects on an extra 1% of GDP in FDI...
Source: M. Rama, p. 6

The figure shows that in only 5 years the FDI impact on level of wages reduces twice.

Although the above mentioned positive effects of FDI are not undisputable, FDI flows can, nevertheless, stimulate technological transfer, create new jobs and contribute to legal development. It is clear in this context why host countries participate in this competition to attract investments. The broadly known steps in this direction are:

- Liberalization of markets and deregulation. This includes elimination of profit and capital repatriation restrictions, or foreign ownership restrictions.
- Deregulation of labour market or environmental regulations.
- Reduction of tax burden or subsidization.

All these policies have potentially significant value in development terms. The most evident costs are related to:

- ❶ Country's balance of payment (capital repatriation) and budget revenues (lower tax rates).
- ❷ Environmental standards. The so called "environmental dumping" may cause serious consequences for country's soils or water resources.
- ❸ Labour standards – reduction of workplace safety.

There is one strategically important cost attached to inward transfers. Any individual inward investment will ultimately require an outward net transfer much larger than the initial capital inflow¹⁵. In order to avoid the resource transfer the host country has to attract more and more investments each year, and than more investments to cover outflows from the previous. One may consider this chain a Ponzi finance scheme. As we all know, they can't last forever. There is no doubt that all economic or financial crises reduce investments, so the crisis may stimulate a breakdown of this Ponzi scheme.

The understanding of this fact requires a reference to the volatility of capital fluxes also. Robert Lipsey in 1999 has analyzed different capital sources depending on their ability to change in outward flows. The results are demonstrated in table 2.

Table 2
Frequency of changes of capital flows, 52 countries, 1980-1995

	Nr. of changes	Frequency of changes	Duration (years)
Net direct investments	130	2.5	6.4
Net portfolio investments	187	3.6	4.45
Other investments	217	4.17	3.83

Source: Lipsey Robert¹⁶

The results obtained by Lipsey are important in the context of arguing the priority of FDI in comparison to other types of investments. Direct investments seem to be less volatile and thus, more stable than other forms of international capital flows. At the same time, the general outward transfers during the crises can be extremely significant.

¹⁵ Woodward D. The Next Crisis? Direct and Equity Investment in Developing Countries, Zed Books, London and New York, 2001, p. 145;

¹⁶ Lipsey Robert, The Role of FDI in International capital flows, National Bureau of Economic Research, WP 7094, Cambridge, 1999

International Investments and their Crisis Reflections

The World Bank publication¹⁷ in 1994 stated that “Malaysia and Thailand are the FDI-led miracles in east Asia”. In 2001 David Woodward affirmed in his book that “Malaysia may also have experiences the first FDI-led financial crisis; and the Thailand had the second crisis, after that of Mexico, in which FDI was a significant contributory factor”¹⁸. It is essentially important in the context of crisis to analyze FDI and less PI, because as it was demonstrated, the volatility of PI is very high and they tend to reverse capital flows in the case of unfavorable conditions. The crisis “per se” strikes stock markets, as investors try to find more “safe variants” in developed countries.

At the same time, the fact that securities markets doesn't have a strong impact on financial markets in developing countries due to their low capitalization, automatically increases the importance of FDI for emerging economies, as a primary source of foreign capital.

It is, however, highly unlikely that FDI solely may cause financial crisis. But some concerns about FDI contributions to country's current situation still exist.

FDI impact on import and profit remittances can be greater than the impact of FDI inflow itself, and thus, the overall impact on balance of payments can be negative. Of course, foreign companies can't be solely responsible for the current account deficit, but it can be an important factor stimulating the crisis, and crisis effects.

We have analyzed certain data for the Republic of Moldova. Interesting findings can be deduced from the figure, presented below (figure 5), demonstrating very clear and evident correlation between the FDI inflows and other components of the balance of payments.

¹⁷ World Bank, East Asia's Trade and Investment: Regional and Global Gains from Liberalization, Washington DC, World Bank, Development in Practice Series, 1994, p. 47

¹⁸ Woodward D. The Next Crisis? Direct and Equity Investment in Developing Countries, Zed Books, London and New York, 2001, p. 186

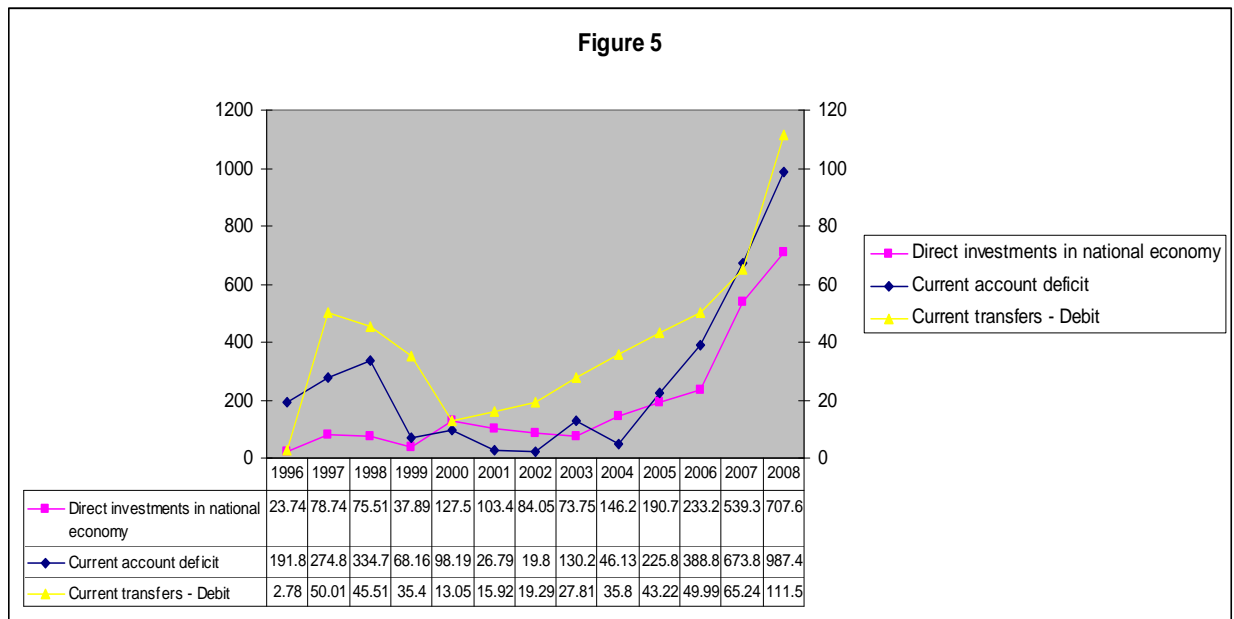


Figure 5. Direct investments in national economy, current account deficit and current transfers (outflows) in Moldova, 1996-2008

Data source: Balance of payments, National bank of Moldova¹⁹

It is clearly demonstrated that direct investments in national economy are strongly correlated with current transfers (outflows). Current transfers increase significantly with the investment growth and vice-versa. Unsurprisingly, taking into consideration previous statement (as current transfers influence balance of payment), direct investments have same evolution as the balance of payments or current account deficit.

FDI can be a powerful factor that affects balance of payments. As we know, current account weakness had a particular significance for Mexican, Latin American and Asian countries during the crises.

This impact of FDI on balance of payments can be explained by:

- growing FDI flow increases FDI-driven profits and thus, contribute to current transfers,
- foreign investors contribute to fixed assets import.

¹⁹ http://www.bnm.md/md/balance_of_payments

So, the obvious reduction of FDI during the economic crisis, which is happening because of the risky ambience for foreign investors, is not the only bad symptom associated with FDI during these crises. FDI impact on balance of payments before, but also after the crisis begins can play crucial role for country's situation and international position.

In this context it is necessary to mention the importance of IMF role. Each crisis means the necessity to sign a new agreement with IMF in order to cover current deficit for developing countries. In reality, IMF programs are "repeated games in which the government sets policy targets and the IMF withholds or disburses funding several times over the course of the program"²⁰. Although IMF programs have the potential to unlock different funds from other partners, for which collaboration with IMF is a sign of a country's creditworthiness, the conditions they ask from a country are almost always too rigid. Macroeconomic performance has an absolute priority and social development is viewed as a result of it. In order to obtain an international "good image", developing countries have to accept IMF rules, which may cause actually serious social constrains. This was in Moldova in 2009, when a new government had to sign a new agreement with IMF. Conditions of this agreement stipulated the reduction (or at least limitation of the increase) of budgetary salaries, pension reform with an increase of pension age, reduction of number of teaching staff in schools etc. It is clear in this context why "nobody likes IMF; if anyone did, it would be a bad sign"²¹.

The opportunity to be in the international financial and capital market is in reality a vital necessity for all countries today. At the same time, the actual mechanism is sometimes too "business oriented". Poor countries need to attract foreign capital as investments or loans. For this purpose they try to build good and stable relations with international organizations and structures. It is clear, although, that social stability and development is a matter of governments first of all.

There is, however, an argument, pronounced in the context of macroeconomic policies, which is considered an axiom, but in reality it is absolutely not. It is considered that for a country FDI are better than loans, because they bring technology, know-how and other positive effects. At the same

²⁰ Pop-Eleches G. *From Economic Crisis to Reform*, Princeton University Press, 2009, p. 45;

²¹ Krugman P. *The Return of depression economic and the crisis of 2008*, Norton and Co., New York, London, 2009, p. 115

time, loans are payable according to a certain scheme, but FDI volatility depends on investor's decisions. This is an unpredictable and complicate framework for governments, as they never know which the investor's "rescue" measures are.

This "rescue" measures can be of two types: silent and panic-driven. The investor's decision to stay silent during the crisis means no capital withdrawals, and a small slow-down of the development programs. The panic-driven type is explained by that what Nietzsche called "herd instinct"²² or herd behavior, as we may understand. If the market becomes dangerous and unstable, investors prefer to transfer their funds to other destinations. Other investors do the same and so on. In the situation of this "bad" scenario a country is dealing not only with FDI reduction, which is by itself is not good, but also with other negative facts, which may influence also social aspects of the country. These possible effects are extremely contagious for many sectors of country's development.

If the "bad" scenario is performed, it may cause first of all currency depreciation due to the excessive demand for foreign currency. This is accompanied by the significant reduction of remittances in developing countries during the crisis. What follows after that is clear: reduction of purchasing power and inflation, which will lead to the decrease of production of non-export goods. And the decrease of production will, probably, conduct to the reduction of jobs. So, in the conditions of crisis, FDI or the capital outflow connected with them is a powerful factor of keeping a stable economic and social situation. In this context, stimulation of reinvestment of profits is an essential tool.

Faced with some external influences, individual host countries have had to adjust their FDI policies in order to benefit from opportunities offered by a copious supply of investment applications and to confront threats to that supply at other times. For this reason, it is sometimes difficult to establish a direct link between changes in FDI policies and subsequent inflows of investment. To some extent because of the influence of external events, trends in FDI inflows have driven policy changes in host countries and not the other way round. Policies towards FDI have tended to react to events rather than shaping them.

²² <http://quotationsbook.com/quote/27319/>

An example, which may be relevant in this context for the Republic of Moldova is directly connected to the last economic crisis. It was discussed and proposed by the new government (which came to power at the end of 2009) to eliminate the zero income tax rate. This could definitely increase the budget possibilities for social and development programs, as it was demonstrated empirically that tax rates do not represent a very significant stimulus for foreign investors. More than that, countries with high tax rates may attract more FDI²³. There is more than taxation in successful international business. At the same time, traditional perception of situation and traditional approach to the fact that global FDI are declining imposed refusal of this measure and the zero income tax rate is still maintained in Moldova.

Raising standards of living is one of the most crucial challenges for the sustainable development of the humankind in the XXI century. FDI as a key ingredient of economic growth and the most reliable source of outside capital do not have to bring potentially damaging consequences to the host countries. Still, FDI, like other elements of globalization, impose substantial adjustment costs on particular members and particular communities in the society. The role of the government in these conditions is to reduce these costs by timely adopted decisions.

Crisis periods represent tests for the economies how they translated economic growth through FDI into something sustainable and durable. As for the Republic of Moldova, the high import dependence of the economy could not lead to the industrial upgrading. Major FDI are also not export-oriented. This means that FDI serve local consumption and do not improve linkages with the local economy in future.

So, the vision presented above confirms the multi faced nature of FDI. The next question refers to the eternal “What is to be done?”²⁴ During the last decades the “basic mantra”²⁵ – “Open your markets” was considered an axiom. Countries demonstrated their aspiration to liberal circulation of capital and goods in order to qualify for general modern stream. At the same time, for example, China, India or Vietnam had severe limits on the entry and exit of short-term FDI, and this

²³ Gorg H., Molana H., Montagna C. Foreign Direct Investment, Tax Competition and Social Expenditure, University of Nottingham, DP 07/03;

²⁴ Chernyshevsky N. What is to be done? – novel;

²⁵ Lewis M. Panic: the Story of Modern Financial Insanity, Norton and Co., New York, London, 2009, p. 115

countries weathered crisis comparatively well. They are moving to lighten the restrictions, but this tendency is very slow and gradual. Besides this, investors who plan to enter on ASEAN markets have to obtain a positive resolution from the Board of Investment – a screening specialized agency. Investors should demonstrate that their money will lead directly or indirectly to net income benefits.

This example, one may say, are not very common as ASEAN markets are very specific. That is quite true – they are. But other developing countries in this global pursuit for capital, do not have to observe only “who butters their bread”, but also “how do they do that” and “what is the quality of the butter”. In other words, taking into consideration possible negative effects of FDI during the economic crises, protection measures should be taken by the governments in order to reduce those unpleasant trends. In conclusion, we may argue that FDI represent an important source of economic and social transformations. The potentially positive impacts of foreign capital flows are:

- FDI generate a capital inflow for the host country and thus contribute to the domestic capital stock,
- FDI create jobs, but also increase salaries,
- FDI contribute to the public budget through taxes,
- FDI bring competition and managerial skills to the host country,

At the same time, FDI may have some problematic impacts, such as:

- negative impact on balance of payments because of the repatriation of profits and growing import,
- FDI may increase the level of inequality as foreign firms pay higher salaries,
- FDI may impose governments to reduce labor and environmental standards, which will cause social problems in future.

It is obvious that host countries’ capacity to benefit from the growing capital flows is a promising challenge. Policies aimed to attract “right kind of FDI”²⁶ become critical for the developing economies.

²⁶ Kubny J., Lundsgaarde E., Patel F. FDI – a means to foster sustainable development? DIE, Bonn, Germany, 12/2008