# Attracting foreign direct investment under high risk and volatility of international financial markets

## *Atragerea investiţiilor străine în condiţii de incertitudine şi riscuri sporite ale pieţelor financiare*

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**Abstract**

*International financial crisis caused significant reduction of investment flows, especially to emerging markets, vulnerable to external shocks and foreign exchange rate fluctuations. Under these conditions, decision factors are pushed to adopt changes in investment strategies in order to maintain competitiveness in attracting foreign investments needed to stabilize economy and continue development programs. Under the conditions of incertitude and high risks emerging economies adopted different investment strategies. We propose to analyze in this article the following aspects: Which are the most efficient economic policies under the new circumstances of international financial markets? How to diminish the effects of the global economic crisis and ensure attracting of needed foreign investment? Which is the role of international financial institutions to support investment process in Central and Eastern Europe?*

**Keywords:** *economic recession, foreign direct investment, government policy, risk analysis, foreign exchange market*

**Rezumat**

*Criza financiară internaţională a redus drastic fluxurile investiţionale, mai ales pe pieţele emergente, vulnerabile la şocurile externe şi fluctuaţiile ratelor de schimb valutar. În aceste condiţii factorii de decizie urmează a adopta schimbări în strategiile investiţionale pentru a fi competitivi în atragerea investiţiilor străine necesare pentru asigurarea stabilităţii economice şi continuării programelor de dezvoltare. În condiţiile de incertitudine şi riscuri sporite economiile emergente au adoptat diferite strategii investiţionale. În articol ne propunem să abordăm următoarele chestiuni: Care pârghii de politici economice sunt mai eficiente în noile condiţii ale pieţei financiare internaţionale?*

*Cum să atenuăm efectele crizei economice globale şi să asigurăm atragerea investiţiilor străine necesare? Ce rol urmează să joace instituţiile financiare internaţionale în susţinerea proceselor investiţionale în ţările din Europa Centrală şi de Est?*

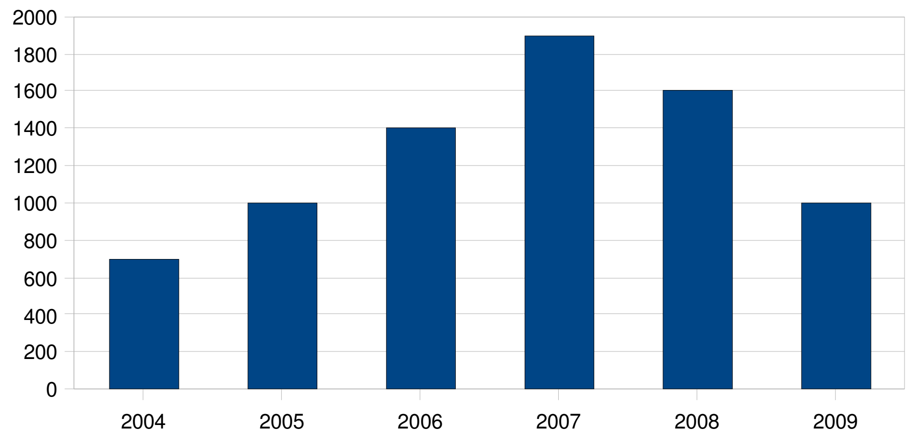
**Cuvinte-cheie:** *recesiune economica, investitii straine directe, politica guvernamentala, analiza riscului*

**JEL Classification:** E60, F21

The international financial crisis caused significant reduction of investment flows, especially to emerging markets, sensitive to external shocks and exchange rate fluctuations. Till 2007 foreign direct investment flows (FDI) have grown constantly to achieve 1,9 trillion USD globally. In recent years the trends of FDI flows changed, so that in 2008 global FDI valued only 1,6 trillion USD, and 1 trillion USD is forecasted for 2009 by Economist Intelligence Unit.

The global FDI growth during 2004-2007 was stimulated by positive evolution of OECD economies, international trade boom, emerging economies development, positive trends of market prices for natural resources and relative stability of financial markets. (see Graph 1)

**Graph 1. Inward global FDI flows (billion USD)**




*Source. UNCTAD, Economist Intelligence Unit* www.eiu.com

FDI attraction by emerging economies from Central and Eastern Europe was determined by the following factors:

- domestic market size and access to EU export markets
- reducing production costs, especially for labor force
- access to large natural resources

- privatisation and methods used
- political and business environment stability
- geographic location.

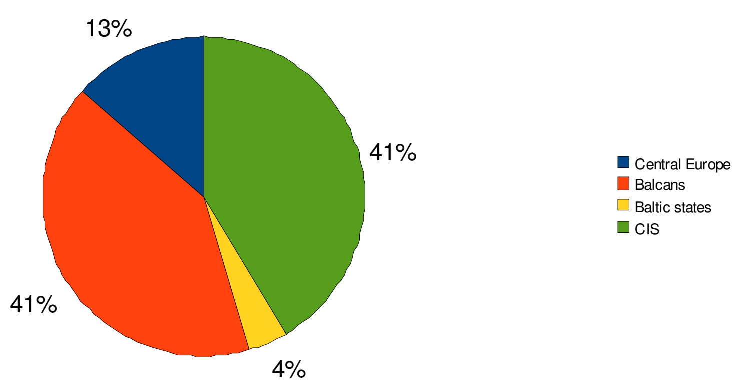
These propitious conditions of global economy allowed Central and Eastern European countries, including FSU to attract more than 1 trillion USD FDI stock till the end of 2007. This represents 2590 USD of FDI per capita or 35% of regional GDP, so that FDI had a significant impact to local economies.

FDI attraction allowed emerging economies from Central and Eastern Europe to:
- increase productivity and qualification of labor force
- increase export performance, especially to EU countries
- make modernisation traditional industrial capacities
- develop services sector, especially financial and commercial ones
- improve infrastructure and energy distribution networks
- increase living standards and contribute to national budgets

More than 80 per cent of FDI stocks to Central and Eastern Europe origin from EU-15 countries, and more than half of it was oriented to services sector. Industrial investment mainly focused to traditional industries and assembly so that FDI impact to new industries development was diffused.

Analysing the regional structure of FDI stocks shows a high discrepancy between Central European and Baltic countries with FDI stock per capita of about 6500 USD and 5900 USD, and Balkans and FSU with FDI stocks per capita amounting to only 2700 USD and 1600 USD correspondingly. In Balkans the following countries performed well: Bulgaria, Croatia, Montenegro and Romania with FDI stock per capita more than 2800 USD, especially increasing last years. In former Soviet Union only Kazakhstan and Russia have registered FDI stocks higher than 2000 USD per capita, due to there natural resources, especially fuel. (see Graph 2)

**Graph 2. Structure of FDI stocks to Central and Eastern Europe, end of 2007**

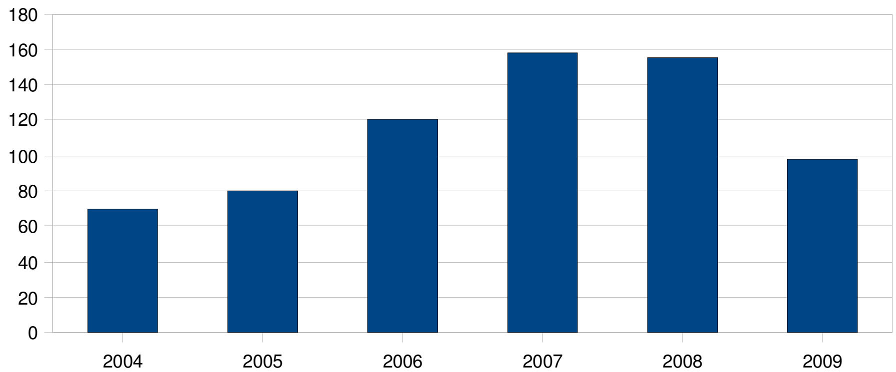



*Source. Economist Intelligence Unit* www.eiu.com

The performances registered by Central and Eastern European countries, including CIS in attracting FDI resulted from increasing interest of Multinational companies to expand their sales markets, and delocalise production for cost reasons, privatisation programs launched in the region and investment in extraction of raw materials and infrastructure development.

In 2008 the volume of FDI flows to emerging economies tend to reduce by 4 billion USD compared to precedent year. Central Europe, Balkans and Baltic states registered FDI flows down by 11 billion USD, compared to CIS countries which performed well to increase FDI flows by 8 billion USD. (see Graph 3)

**Graph 3. FDI flows to Central and Eastern Europe (billion USD)**




*Source. Economist Intelligence Unit* www.eiu.com

For 2009 the forecasts for FDI in Central and Eastern Europe are pessimistic to achieve only 98 billion USD according to Economist Intelligence Unit.

The following factors explain this break down:

– global economic recession which caused 40 per cent drop in global FDI flows
– lower cost competitiveness compared to Asia, even if positive compared to EU-15
– negative price trends for natural resources, real estate, equipment as growth drivers in past years
– instability of local currencies, bank systems, increasing cost of financing, liquidity problems
– profits relocation from emerging economies to origin countries of multinationals.

Under these circumstances, decision makers from emerging economies have to adopt significant changes in investment strategies to ensure competitiveness in FDI attraction, needed to stabilise the economies and continue modernisation programs.

In order to keep FDI levels the following factors are determinant for next 3 years in Central and Eastern Europe:

– macroeconomic risk levels – GDP growth rates, exchange rates, current account deficits, budget deficits

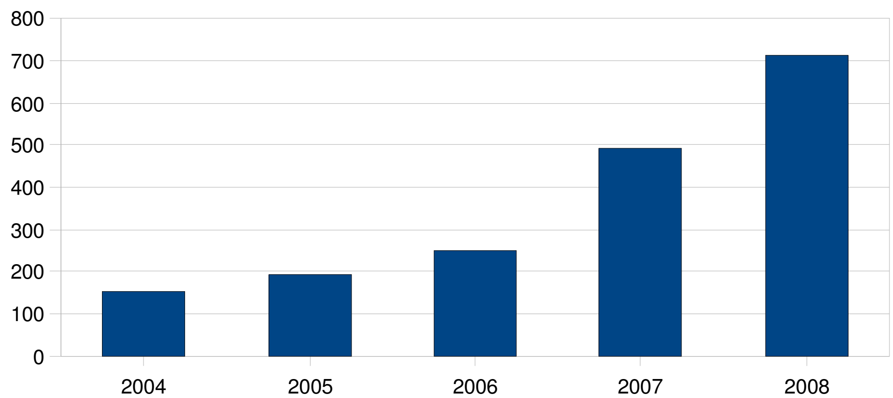
– Investment climate – regulatory framework, stimulus to investors, decision making transparency, predictability of legal changes
– Cost levels for raw materials, labor force, taxation
– EU membership, level of integration in European structures
– Investment in infrastructure with private-public partnership programs
– External financing from IMF, World Bank, EBRD, EBI
– Political risk level, especially for Balkans and CIS countries.

Economist Intelligence Unit made a survey asking 300 executives acting in Central and Eastern Europe and identified the following barriers to investment in the region, which have to be managed accurately:

– political instability
– economic instability
– bureaucracy
– counting norms
– corruption
– high taxation
– low infrastructure.

During last 5 years, Republic of Moldova, like other countries in the region performed well in terms of FDI attraction. The total FDI stock to Moldovan economy amounted to 1,9 billion USD at the end of 2007, with a significant impact to domestic economy (43 per cent of GDP). Anyway, FDI stock per capita in Moldova is much lower compared to Central and Eastern Europe, and CIS with only 510 USD. In 2008 FDI continued to grow to achieve a record figure of 713 million USD, or 11 per cent of GDP. (see Graph 4)

**Graph 4. FDI flows to Republic of Moldova (million USD)**




*Source. National Bank of Moldova* www.bnm.org

These performances resulted from positive trends of local economy (more than 5% annual growth rate), local currency stability and even appreciation, positive evolution of consumption, real estate and financial markets, privatisation programs implemented last years, as well as from private sector development, foreign trade growth, budget stability, fiscal stimulation of investors, and low cost of labor force.

Low level of FDI per capita in Moldova compared to other countries can be explained by weak knowledge of Moldova abroad, low capacity and purchasing power of local market, lack of natural resources, energetic dependence from one source, unclearly foreign policy vector (EU/CIS) and domestic policy problems (democracy, corruption, bureaucracy), Trannistrian conflict unsolved and low infrastructure.

Even if positive trends have been registered till 2008, the 2009 agenda of Moldovan decision maker factors includes many hot topics:

- Government capacity to continue implementation of Action plan signed with EU, to implement EU acquis in local legislation and regulations, ensure stimulatory business environment and infrastructure modernisation...
- Political capacity to manage in a democratic way parliamentary and presidential elections, crucial for further evolution of Republic of Moldova at international level
- National Bank efforts to maintain price stability, local currency, banking system in order to diminish the impact of external shocks
- National budget stability and government spending control under the condition of reduced tax incomes from consumption and imports.

The capacity of decision making factors to manage the above stated topics will determine not only foreign investment flows, but all economic evolution of Republic of Moldova under global and regional economic crisis.

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