The role of foreign direct investment in the transition from planned to market economies*

Carl H. McMillan**

This article explores the links between foreign direct investment and economic systems in the experience of the countries of Central and Eastern Europe (including the former Soviet Union). The institutional characteristics of economic systems of the Soviet type dictated an industrialization with virtually no recourse to foreign direct investment. The initiation of processes to dismantle that system has provided the scope for a significant opening of that area's economies. The transition managers' interest in foreign direct investment has been motivated by perceptions of its important potential contributions to industrial restructuring and to the development of the institutions of a market-based economy. The article explores that rationale and assesses it in terms of the initial response of foreign investors. It argues that foreign direct investment is unlikely to play the significant role in the transition originally anticipated.

As the drama in the East continues to unfold, the situation calls for continuing assessment and reassessment. The dust has not settled from the major upheavals of the turn of the decade, but some of the contours of the new landscape are beginning to be discernable. In any assessment of the emerging role for foreign direct investment (FDI) in the Eastern economies, it is important to distinguish the potential from the actual. This article will first set forth the *ex ante,* the desired, role for FDI, which provides the rationale for it as an important element in the transition. It will then use this as a framework for analyzing—in a necessarily preliminary way (through 1992)—the *ex post* actual role of FDI.

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** Professor at the Department of Economics Carleton University, Ottawa, Canada.

Improvement in the operational efficiency of enterprises has, however, been one of the major aims of Eastern privatizations. If financing is through portfolio rather than direct investment, potentially beneficial effects on the management of the assets are more likely to be diluted. Ways in which FDI can act as a channel for the introduction of new managerial functions and techniques were already discussed. Direct investment can also raise the efficiency of operations by introducing new productive technology, providing links to new markets and, perhaps most importantly, subjecting Eastern managers to the discipline of commercial rather than administrative criteria.[13] Hence, the influence of TNCs on the management of privatized state enterprises can accelerate their restructuring.

Whether FDI can exercise these potential effects on the efficiency of enterprise operations depends much upon the nature of privatization. Privatization programmes have varied considerably among the Eastern countries.[14] The politically more popular mass distribution of state-owned assets to the citizenry, by means of various voucher schemes and often through the intermediation of newly created investment funds, tends to restrict the participation of foreign investors and hence the potential effects of FDI on enterprise behaviour.[15] It is in those cases (most notably the former German Democratic Republic and Hungary) where state assets have been sold off that FDI is accorded greater scope.[16] So-called "spontaneous privatizations" have also provided the opportunity for TNCs to undertake major acquisitions even in countries (e.g. the former Czechoslovakia) that have otherwise favoured mass privatization schemes.

The development of a significant private sector hinges not only on the denationalization of state-owned assets but also on the creation of new assets through the growth of private enterprise. The initial, joint-venture phase of FDI in the Eastern economies created entities that were legally independent but operated for the most part within the administrative and operational framework of the local partner, state enterprises. They served, however, to initiate the process of evolution of the hitherto solely state-owned sector towards a more mixed ownership structure. More recently, a second phase, where the acquisition of state-owned assets became

[13] Through, for example, "hard" rather than "soft" budget constraints in the conceptualization of Janos Kornai (1980).

[14] Reference is here is to "large" privatizations. David Stark (1992) provided an interesting framework for comparative analysis.

[15] Foreign direct investment may, however, play a part in the distribution scheme itself. For example, an Austrian bank, Creditanstalt, has set up one of the larger investment funds in the Czech Republic.

[16] Kalman Mizsei (1992) discussed the relationship between privatization and FDI in the context of Poland and Hungary.

possible, has enlisted FDI in privatization of a more direct nature and on a larger scale. A third phase, already legally open, will engage foreign firms increasingly in the task of establishing entirely new ("greenfield") investments.

Economic restructuring

If FDI can thus help to move the ownership structure of the economy from preponderant state ownership towards a more desirable mix, it can also assist in another form of transitional restructuring. This is the restructuring of production, away from a pattern similarly dictated by past, political-ideological priorities towards a structure more firmly based on economic realities. While industrial restructuring is the primary objective, other sectors also come into play. Moreover, restructuring should not be regarded as a task limited to the transition, but an on-going one.

The enormity of the task and the difficult and costly political and social adjustments that accompany economic restructuring were stressed earlier. Foreign direct investment can potentially facilitate restructuring by easing some of the domestic constraints that slow its progress. The most obvious of these is the capital constraint. Capital requirements are enormous and domestic resources are inadequate; they have been reduced by recession and stretched by the multiple tasks of the transition.[17] In such circumstances, the impact of external capital is enhanced, especially if it can be directed to areas where expected, immediate returns from additional investment are high, such as incomplete investment projects inherited from the previous period (if they are economically sound). Takeovers of existing plant and distribution networks will not increase the net capital stock of the host country unless accompanied by additional, capital-creating investments.

Much has been made in the Western literature of the role of FDI as a channel for the international transfer of technology. This hinges on the notion that proprietary rights can be better safeguarded and more profitably exploited if technology is kept within the firm rather than leased or sold.[18] The acquisition of Western technology has been the primary objective of Eastern policy favouring FDI. It is arguably even more important now, in the transition, given the scale of the currently envisaged restructuring and the notable failure of earlier efforts to close the technology gap.

[17] See Zoethout, 1993, for a discussion of the capital requirements of the transition.

[18] For example, John Dunning's well known analysis of TNCs is significantly based on this idea; see Dunning, 1981.

Trends are mixed, as table 2 shows. The further growth of FDI flows to the area in 1992 suffered major shocks with the disintegration in 1991 of economies demonstrated to be of particular interest to foreign investors: the former Soviet Union and the former Yugoslavia (and in the case of the latter, the outbreak of civil war). On the other hand, there was a notable increase in flows to the Central European countries, and there is reason to believe that the pace of FDI in Poland will quicken in 1993.[23] The negative impact of the break up of the former Czechoslovakia at the end of 1992 is, however, still to be fully revealed.

Table 2. Estimated flows of foreign direct investment in Central and Eastern Europe, 1990-1992[a] (Million dollars)

Country	1990	1991	1992
Bulgaria	70	250	220
Czechoslovakia (former)	300	690	1500
Hungary	420	1900	2300
Poland	270	400	680
Romania	112	156	331
Soviet Union (former)	480/953	240/n.a.	..
Russia	n.a.	120	200
Yugoslavia[b] (former)	1381	235	..
Slovenia	333	290	300

Sources: Same as table 1.

[a] As in table 1.

[b] 1991 data for the former Yugoslavia represent the first four months of that year.

Why these disappointing results? Certainly, inadequacies and other negative features of the regulatory framework (including regulations and procedures governing not only the initial investment but also subsequent operations, taxation of revenues and transfer of funds abroad) are a factor—but not the principal one. The institutional legacies of the past, such as the lack of developed input markets and infrastructural deficiencies in areas such as banking and communications have also been important deterrents. Surveys show, however, that investors have been most concerned about the high degrees of political and economic instability, policy uncertainty and consequent risk that they face in most countries of the region.[24]

The uncertainty and risk are augmented by the evident absence of a broadly based public opinion in the host countries in favour of FDI. On the contrary, much of the public looks upon such investment with resentment and suspicion. These attitudes provide support for those who are philosophically opposed to FDI or whose interests are threatened by it.

These deterrent factors are well illustrated by the case of the Russian oil industry, a case that is all the more important because it is so widely regarded as offering enormous investment potential. Still possessing major, underdeveloped reserves and long closed to FDI, it presents to Western oil companies a kind of last frontier. Moreover, the sharp fall-off in Russian oil output since 1988 has created a strong need for inputs of Western capital, technology and know-how. Despite this potential and despite high expected returns from oilfield operations, actual FDI in Russian oil has been negligible and most has been in service contracts for the workover of existing fields in partnership with Russian enterprises. This seems likely to remain the case, so long as political instability continues to generate great policy uncertainty about the future development of the industry and hence high risks to investors.[25]

Investor response to such uncertainties has been to postpone investment projects, to withdraw from negotiations, or to leave negotiated commitments unrealized. Those investors that have proceeded have typically sought to reduce their exposure by minimizing their "upfront" capital investment and by making their contributions in kind rather than in cash, or indirectly in the form of loans. Governments in turn have sought to offset the risks that investors face by putting into place official insurance programmes (especially against political risk), but to little effect.

[24] Survey data indicate the importance of these factors. For investor attitudes towards the area's economies in 1992, see Business International, 1992. See Sherr et al. (1991) and McMillan (1991) for surveys of investor approaches to the Soviet economy. For a general discussion of the obstacles to FDI in the former Soviet Union, see IMF et al. (1991), especially vol. 2, p. 75ff and, for Central and Eastern Europe, Artsien et al., (1993).

[25] Optimistic articles occasionally appear in the business press. These are based on investor interest, not action. They sum up all of the potential investment projects to impressive foreign investment figures but ignore current realities. See, for example, "Investors see a new star rising slowly in the East", *Financial Times,* 5 January 1993, based on a report in *The East European Investment Monthly* (New York), or "Oil boom in CIS may attract $85 bln", *Financial Times,* 5 May 1993, quoting *East-West Investment* (Geneva).

The case of Hungary is the exception that also helps to prove the point. Hungary, one of the smallest of the regional economies, has attracted by far the largest amount of FDI. This is generally explained in terms of Hungary's advantages of national unity and political stability in comparison with its neighbours. Moreover, its relatively progressive history of reform in the communist period left Hungary with the positive legacy of a more investor-friendly business environment than found elsewhere in the region.

Conclusions

The transition in Central and Eastern Europe has created significant opportunities and requirements for FDI. However, at least in its initial phase, the political, economic and social instability that has accompanied the transition has motivated many investors to take a cautious approach and even to abandon or postpone investment projects.

There is therefore an incongruity between the expectations of transition managers regarding the role that FDI would play in restoring growth and restructuring their economies, and the perceptions of many potential investors of the associated risks and returns. Investment flows to the area, in the crucial first years of the transition, have as a result generally not been of the magnitudes required for FDI to ease domestic resource constraints sufficiently to have an appreciable impact on progress towards a market-based economy. In most cases, the FDI stock is a negligible share of GDP. The sectoral distribution of FDI has been uneven, however. It has been concentrated in a few industries (e.g. automobiles, food processing, hotels and restaurants, business services) where its impact is therefore far greater than the average.

Only in Hungary, and perhaps also in the Czech Republic, had FDI by end-1992 attained magnitudes where it might be said to be playing a significant role in economic recovery and transformation. In Hungary, the ratio of FDI stock to GDP in 1992 is estimated to have attained 8.6 percent.[26] It is not at all clear, however, that future flows to Hungary will continue at past levels. To date, foreign acquisitions of major shares in leading Hungarian enterprises have accounted for the bulk of FDI inflows. That phase of privatisation now appears to be ending in Hungary, and with it Hungary's favourable treatment by foreign investors.[27] Greenfield

[26] Calculation based on PlanEcon GDP projection for 1992.

[27] This was affirmed by Lajos Csepi, head of the Hungarian State Property Agency, who was quoted as adding that many of the best companies have now been privatized. See "Privatisation before restructuring says Bank", *Financial Times*, 26 April 1993, and "Hongrie: privatisation populaire", Les Echos, 24 April 1993.

investments will now have to take up the slack, and few such investments on a major scale have been made in Hungary or elsewhere in the region.

In the communist period, FDI was fundamentally limited by the institutional characteristics of the system, even when official policies favourable to it had been adopted. In the post-communist period, the remnants of that system, combined with the political, economic and social problems associated with its replacement, continue to create conditions that hold the actual level of FDI well below the desired. It now seems increasingly unlikely that FDI will play the important role in the Eastern transition that was originally envisaged for it. ■

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