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on EU-10 and CIS



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The ICEG European Center issues its monthly publication, which includes 2-4 brief analyses on macroeconomic and microeconomic issues. The publication focuses on two groups of countries: **Commonwealth of Independent States - CIS** (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan) and the ten post-soviet New Member States of the European Union – **EU-10** (Bulgaria, Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Romania, Slovakia and Slovenia).

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Short review of major trends in FDI and OFDI developments in CIS countries

Olivér Kovács

Introduction

In October 2012, the Euroasian Development Bank (EDB) published its monitoring report on Foreign Direct Investment (FDI) trends in CIS countries. The report emphasised that Kazakhstan has become the greatest investor among CIS countries (EDB, 2012). This interesting fact gives us a hint that contemplating the major FDI and outward FDI trends among CIS countries may imply important messages to be discussed.

FDI has been deeply analysed in economic literature for a long time. FDI means investment with management control rather than purely securities related financial investments. The experience of the past shows that FDI predominantly flows from developed countries to less developed countries, but over the past two decades far more of them have gone to developing countries. Its volume has grown rapidly and became enormous not just in absolute numbers, but in proportion as well. These facts of economic life were well-known, therefore some would claim that there is nothing new process under the FDI scene.

However, as far as the developing countries are concerned, the emergence of substantial outward FDI from developing countries by multinational enterprises (MNEs) is observable. Over the past decade, firms from a number of emerging markets have become major investors abroad, complementing their home countries' traditional role as recipients of foreign direct investment (FDI) from the developed economies. These MNEs are investing both in developing and developed countries throughout the world. Outward FDI from emerging markets reached USD 457 billion in 2011, amounting to 27 percent of global outflows that year.

In this short review, we put the focus on CIS countries that are being embedded into the international investment flows by pinpointing some relevant FDI and OFDI trends and by comparing their performances to other groups of countries like transition economies and South-Eastern European countries. In the remaining part of the analysis, firstly we devote attention to the inward and outward FDI flows in the respected groups of countries and then presents the main trajectories with regard to the FDI and OFDI stocks.

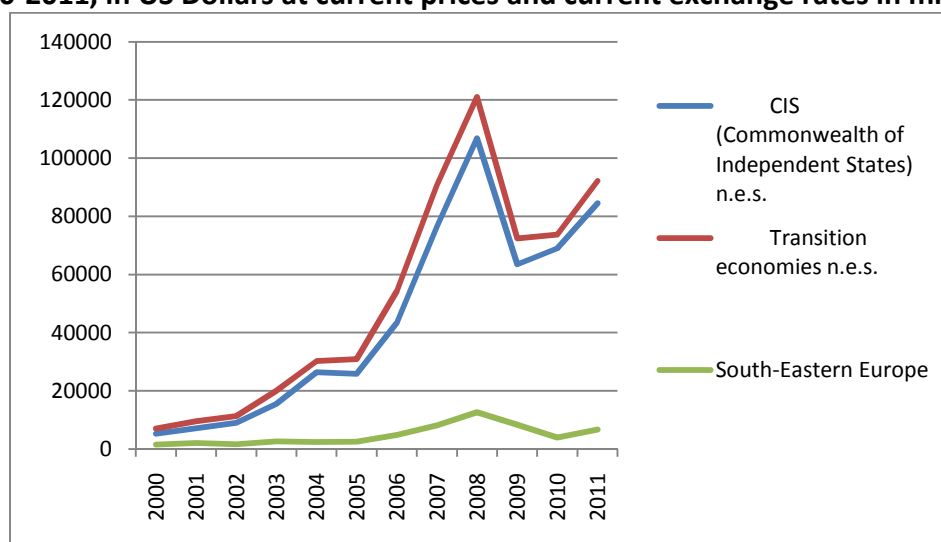
Methodology

The analysis is based on statistical data stemming either from national statistics or the consistent database of the UNCTADStat. The article covers the period 2000-2011, and embraces the following groups of countries: (i) CIS (Armenia, Azerbaijan, Belarus, Georgia, Kazakhstan, Kyrgyzstan, Moldova, Russia, Tajikistan, Turkmenistan, Ukraine and Uzbekistan); (ii) Transition economies (Albania, Armenia, Azerbaijan, Belarus, Bosnia and Herzegovina, Croatia, Georgia, Kazakhstan, Kyrgyzstan, Montenegro, Republic of Moldova, Russian Federation, Serbia, Serbia and Montenegro, Socialist Federative Republic of Yugoslavia, Tajikistan, The Former Yugoslav Republic of Macedonia, Turkmenistan, Ukraine, Union of Soviet Socialist Republics, Uzbekistan); and (iii) South-Eastern Europe (Albania, Bosnia and Herzegovina, Croatia, Montenegro, Serbia, The Former Yugoslav Republic of Macedonia).

Inward FDI flows

As far as the inward FDI flows in the period 2000-2011 are concerned, *Chart 1* shows that a more intensive increase can be observable after the midst of the 2000s which lasted more or less up until 2008 when the global financial and economic crisis erupted leading to greater uncertainties over the return of foreign direct investment and when investors became more cautious.

**Chart 1. Inward FDI flows
(2000-2011, in US Dollars at current prices and current exchange rates in millions)**

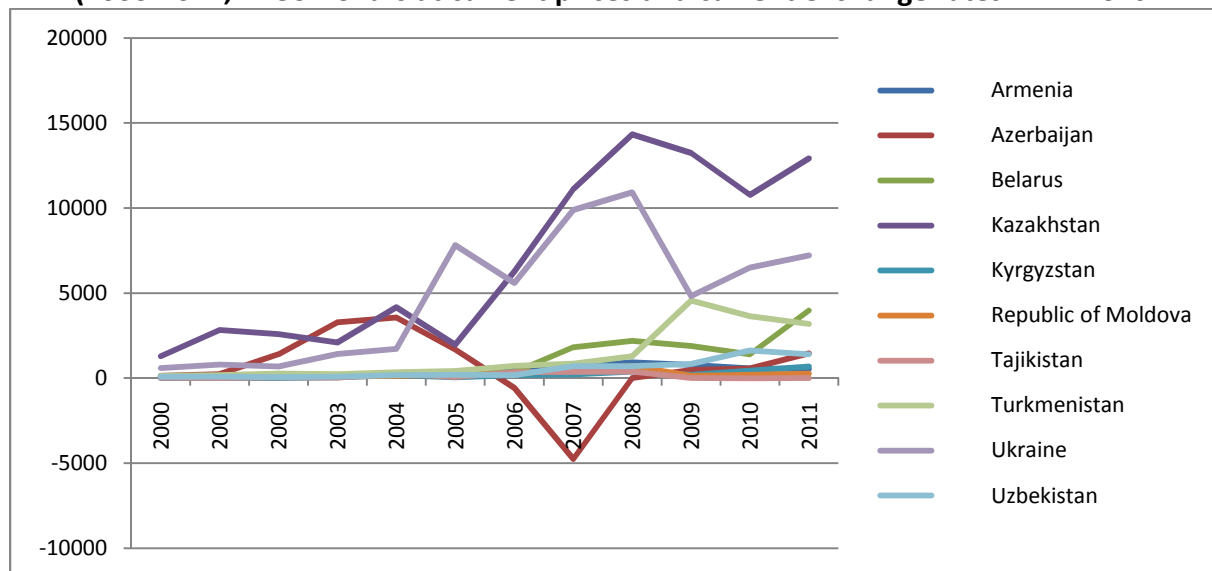


Note: Since data between 2000-2007 are missing for Serbia as well as for Montenegro, the trend of South-Eastern European countries should be handled cautiously.

Source: UNCTADStat

Apart from the fact that the Russian Federation represents an entirely another level of FDI inflows, it can be concluded that Ukraine and Kazakhstan (*Chart 2*) were those of achieving an increasing level of FDI inflows, and their attractive capacity did not evaporate once the financial and economic crisis arrived at the coast of this group of countries.

**Chart 2. Inward FDI flows in case of CIS countries
(2000-2011, in US Dollars at current prices and current exchange rates in millions)**



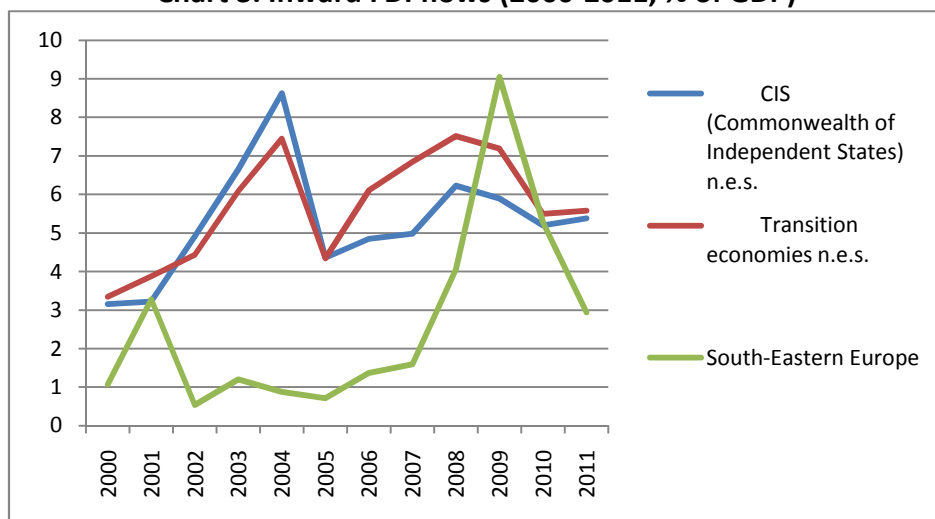
Note: Russian Federation has been selected out from the list of countries.

Source: UNCTADStat

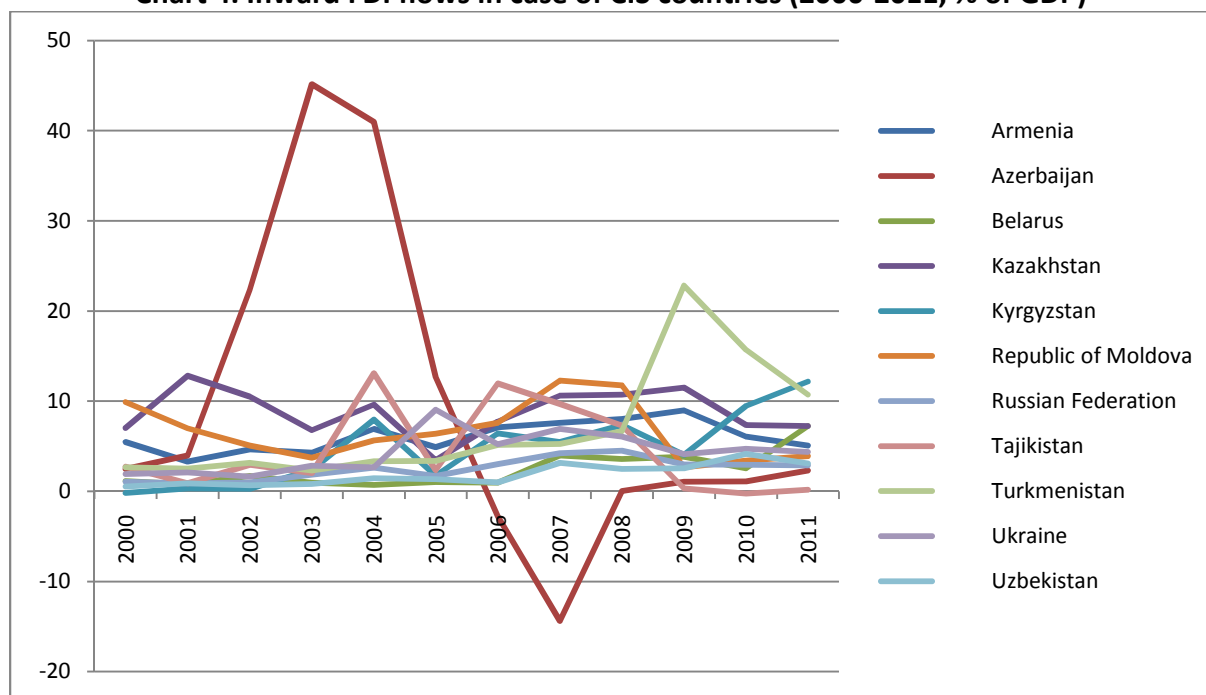
The only CIS country which suffered from huge FDI flight seems to be Azerbaijan due to the fact that FDI inflowing into Azerbaijan is primarily seeking energy sector related investment opportunities. It generates a relatively high degree of FDI exposure for the country on which its economic development depends a lot (See *Chart 4*). It calls our attention to the existence of a not so diversified economic structure which is clearly demonstrable with the example of Kyrgyzstan, where FDI has largely flowed into the financial sector of Kyrgyzstan reflecting the lack of necessarily diversified economic conditions and productivity disadvantages in other sectors.¹ Nevertheless, the chart also points out that some countries are more capable of attracting FDI than others.² Additionally, it seems that the investor companies' tolerance remained flexible after the advent of the 'Great Recession' in Europe. There were no huge declines in terms of FDI inflow in most of CIS countries. Unlike the South-Eastern European countries, FDI inflow in percentage of domestic GDP remained between 5 and 6% (*Chart 3*).

¹ See more on the Kyrgyz economy from Kovács (2010).

² Behind the curtain of this fact was, as Shiells (2003) rightly underlined, the substantial amount of investment in energy and other resource extraction or energy transportation infrastructure (e.g. Azerbaijan, Belarus, Georgia, and Kazakhstan).

Chart 3. Inward FDI flows (2000-2011, % of GDP)

Source: UNCTADStat

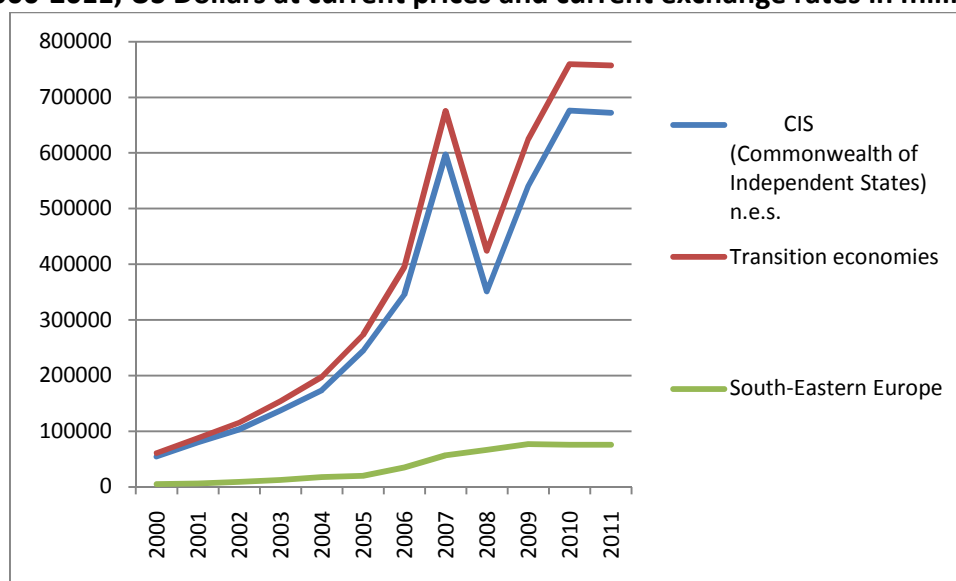
Chart 4. Inward FDI flows in case of CIS countries (2000-2011, % of GDP)

Source: UNCTADStat

Inward FDI stock

As far as the development of FDI stock in the respected groups of countries is concerned, one can lead to the conclusion that FDI stock has been evenly rising (in absolute terms) in case of South-Eastern European countries without showing any huge deterioration after the eruption of the recent financial and economic crisis (*Chart 5-6*).

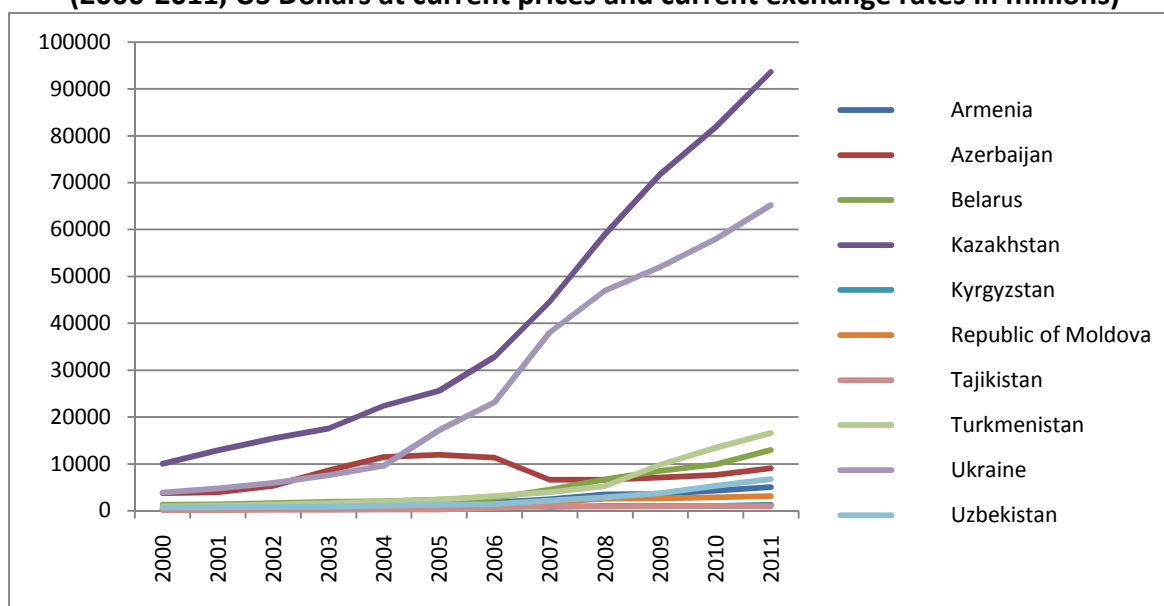
Chart 5. Inward FDI stock
(2000-2011, US Dollars at current prices and current exchange rates in millions)



Note: Since data between 2000-2007 are missing for Serbia as well as for Montenegro, the trend of South-Eastern European countries should be handled cautiously.

Source: UNCTADStat

Chart 6. Inward FDI stock in CIS countries
(2000-2011, US Dollars at current prices and current exchange rates in millions)



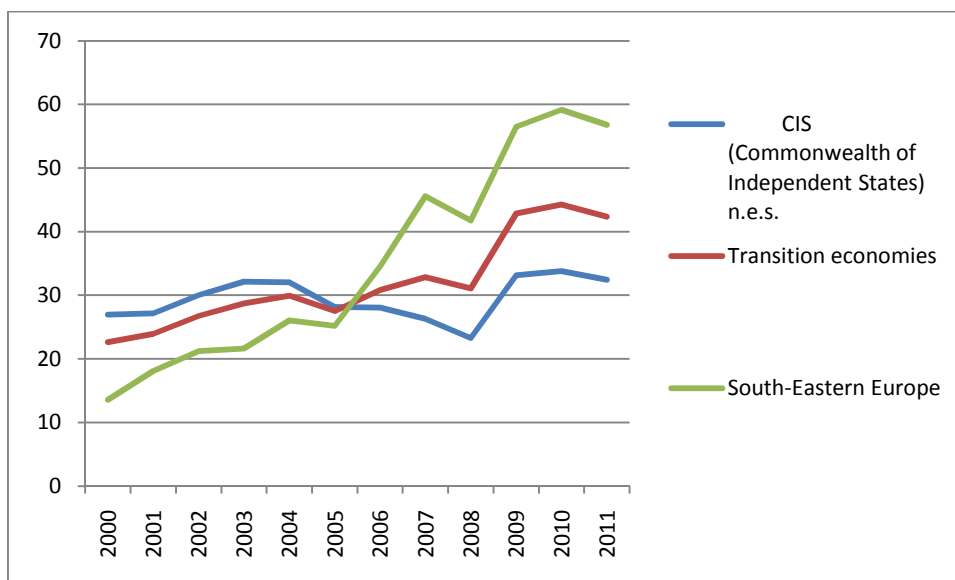
Note: Russian Federation has been selected out from the list of countries.

Source: UNCTADStat

In terms of GDP percentage, CIS countries are lagging behind transition economies as well as South-Eastern European countries (*Chart 7*) of which FDI-attractiveness have been increasing far above that of, for instance, Republic of Moldova or Tajikistan. One of the most fundamental reasons behind it is the fact that CIS countries are lacking the necessary and well-functioning financial sector that can bring impetus onto the development of FDI inflow

as well (Alfaro et al. 2008). It is partly the reason hiding behind the FDI-development of Azerbaijan (*Chart 8*) and the fact that investment outside the oil-sector remained untouched (Hübner, 2011).

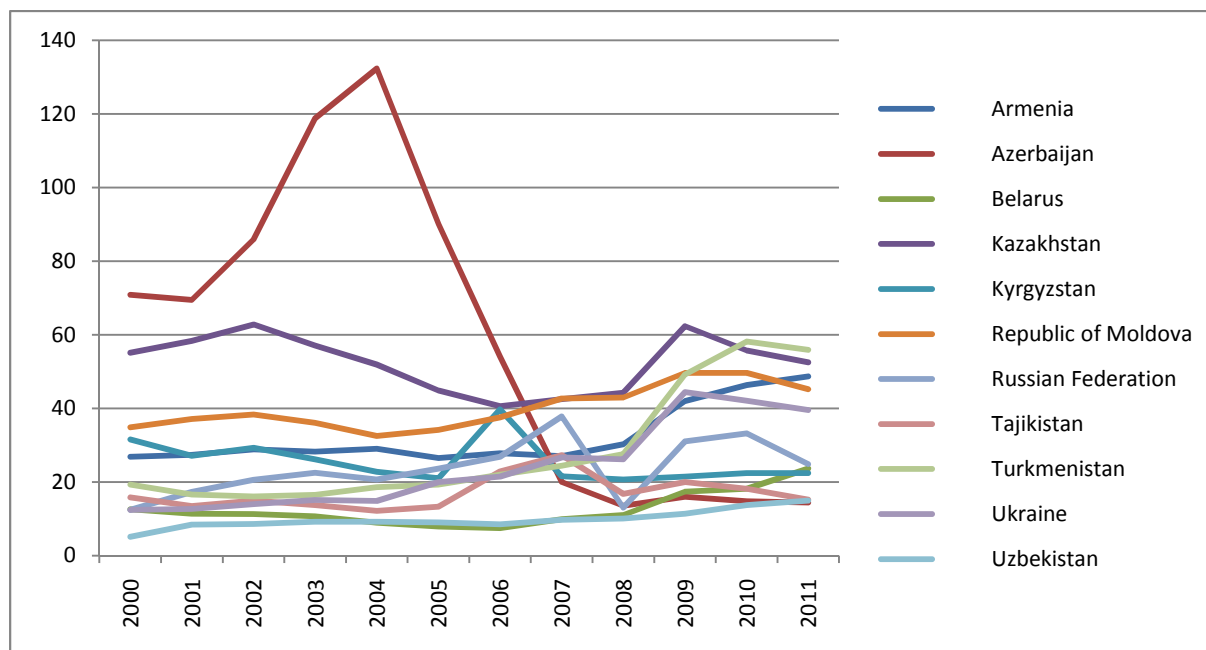
Chart 7. Inward FDI stock (2000-2011, % of GDP)



Note: Since data between 2000-2007 are missing for Serbia as well as for Montenegro, the trend of South-Eastern European countries should be handled cautiously.

Source: UNCTADStat

Chart 8. Inward FDI stock in CIS countries (2000-2011, % of GDP)



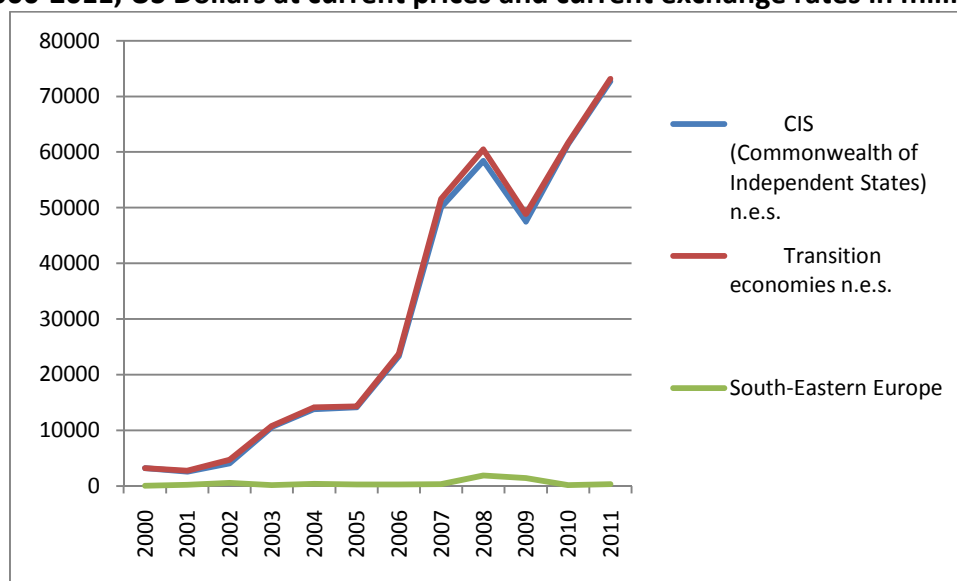
Source: UNCTADStat

Still, and by and large, the GDP growth rate of the CIS countries was 4.4% in real terms in the first half of 2012 compared with 4.3% in the same period in 2011. This development has been primarily fuelled by consumer sector (trade and services), as it was also accentuated by the recent report of the Eurasian Development Bank (EDB, 2012).

Outward FDI flows

In case of outward FDI flows, CIS and Transition economies have been performing quite similarly, due to the reason that these two groups of countries are heavily overlap (*Chart 9*).

Chart 9. Outward FDI flows
(2000-2011, US Dollars at current prices and current exchange rates in millions)



Note: Since data between 2000-2007 for Serbia as well as for Montenegro, and data between 2000-2003 for Albania and Bosnia and Herzegovina are missing, the trend of South-Eastern European countries should be handled cautiously.

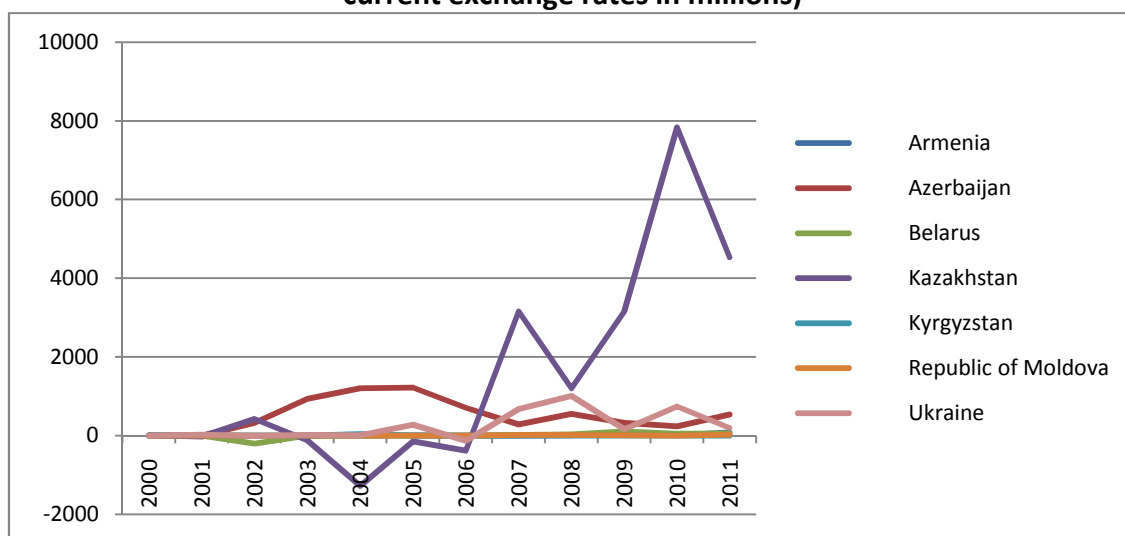
Source: UNCTADStat

As Chart 10 illustrates, one of the most hectic movements can be registered in case of Armenia in terms of FDI inflows in US dollar millions. We have to be aware of the fact that the spectacular increase (either in absolute terms or in % of GDP) was attributed to the decline in the Armenian GDP growth. During 2009 Armenia was undisputedly hit by the global financial meltdown and its spillover effects via the global demand shock. The economy was not able to fend off the recession owing to its poor economic diversification and its high external demand dependency (the economy contracted by 15 per cent in 2009). Instead of being comprehensive, we call the attention to the (i) falling oil and metal prices,

(ii) decreasing remittances and (iii) moderating FDI inflow as major circumstances whereby Armenia is particularly vulnerable to any external demand shock.

As for outward FDI flows, Armenia has been increasing its investments abroad since 2007 (by 2011, its nominal outward FDI flows became 7 times higher than it was in 2008). According to EDB (2012), Armenia outperformed not only Georgia (1.1%), but also Azerbaijan (2.7%) who served as one of the most robust investors for years.

Chart 10. Outward FDI flows in CIS countries (2000-2011, US Dollars at current prices and current exchange rates in millions)



Note: we simply select out the Russian Federation because its values are far above the values that of the other countries. Data for Tajikistan, Turkmenistan and Uzbekistan are not available.

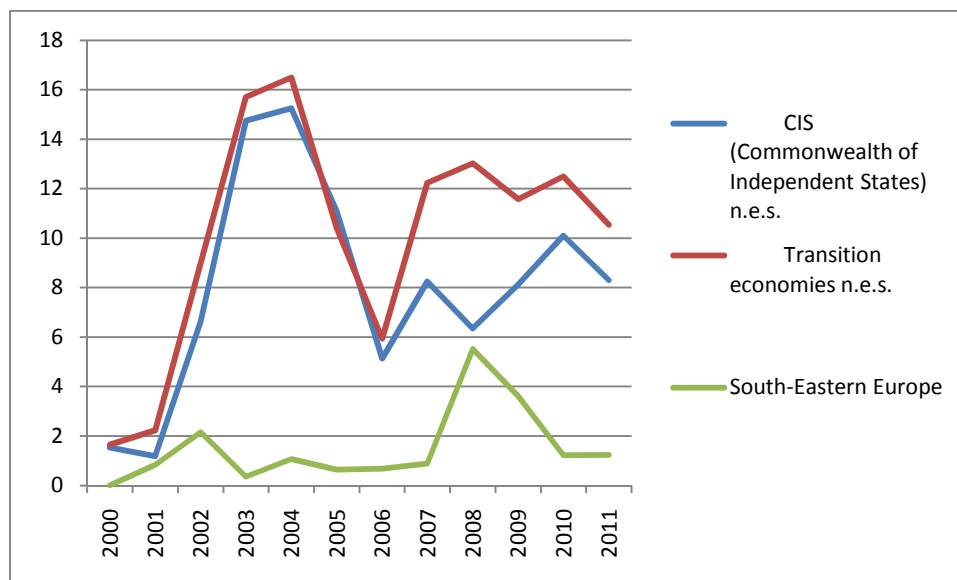
Source: UNCTADStat

Kazakhstan can be regarded as the largest investor among CIS countries. Along the 2000s, Kazakhstan has been transformed from a net recipient of FDI into a major foreign investor, especially in CIS countries. In this way, Kazakhstan has enmeshed lots of CIS countries with its pro-active presence by contributing to their economic growth as well due to the relatively good management of the Kazakh economy and the thankfully evolving oil prices in the past decade.³ In this way, Kazakhstan made big steps towards a deeper integration into the global economy by obtaining even more competitive economic structure (i.e. the ameliorating

³ Central Asia-Caucasus Institute Analyst (2012) pointed out that the Kazakh economy has been equipping for instance Kyrgyzstan and Tajikistan as well as Georgia through its foreign investment activity. For this reason, Kazakhstan's investments contribute significantly to the successful introduction of new technologies, managerial techniques, and to raise the scarce capital stocks of these countries. This per se is able to rehabilitate their economic growth and employment, and is also able to promote the economic diversification process of these developing states.

competitiveness contributed to the upgrading process of obsolete technologies and it also led to a more intensified knowledge transfer (Amagoh – Markus, 2010).

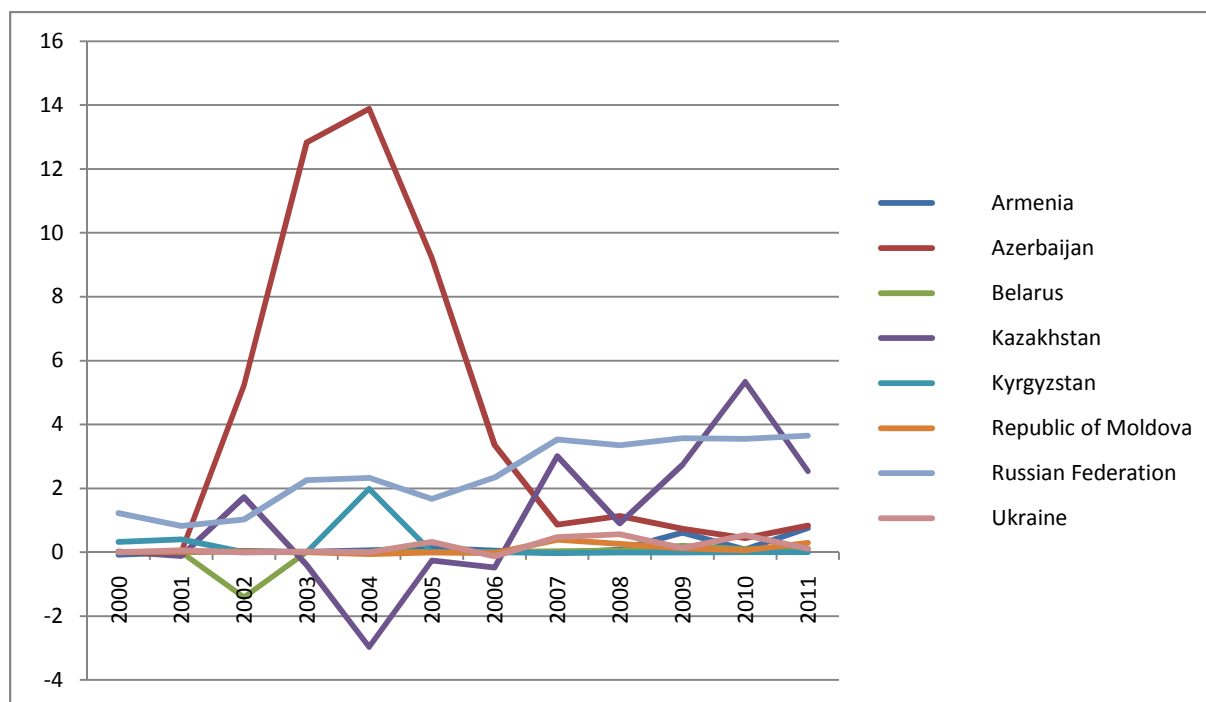
Chart 11. Outward FDI flows (2000-2011, % of GDP)



Note: Since data between 2000-2007 for Serbia as well as for Montenegro, and data between 2000-2003 for Albania and Bosnia and Herzegovina are missing, the trend of South-Eastern European countries should be handled cautiously.

Source: UNCTADStat

Chart 12. Outward FDI flows in CIS countries (2000-2011, % of GDP)



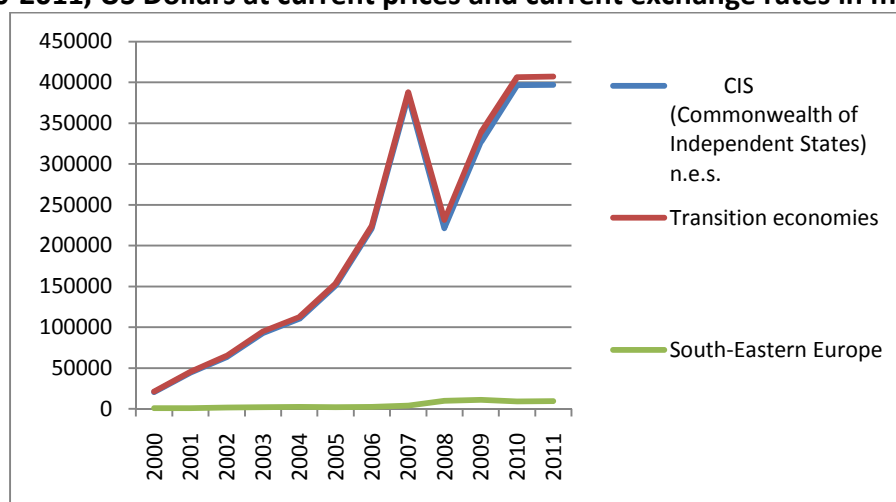
Note: data for Tajikistan, Turkmenistan and Uzbekistan are not available.

Source: UNCTADStat

Outward FDI stock

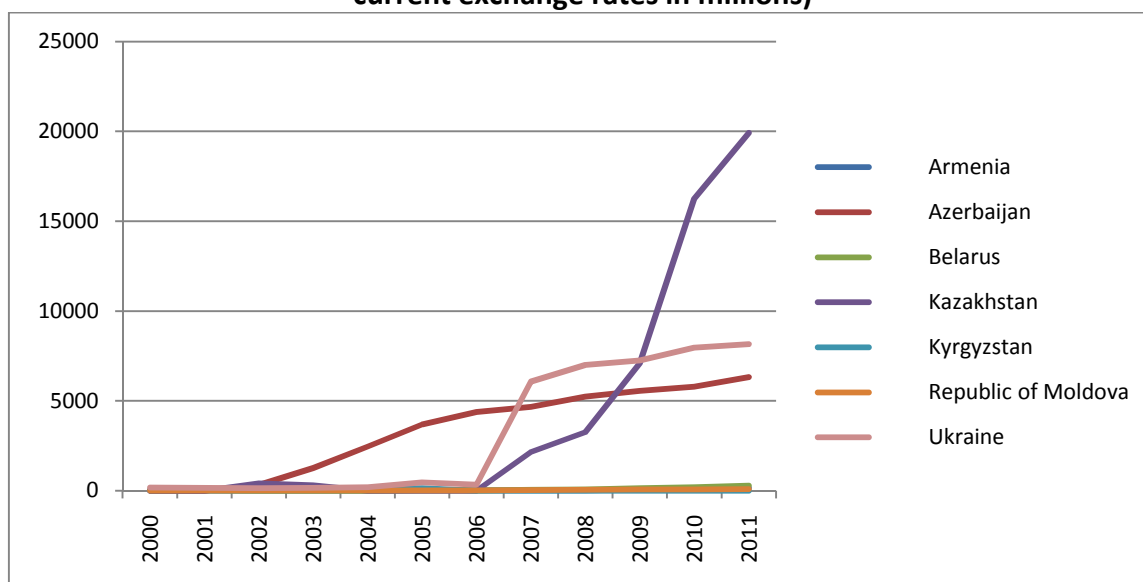
By concerning outward FDI stock, we can conclude that CIS countries have reached its pre-crisis level of outward FDI stock (*Chart 13*) by 2010, but in the aftermath, there are no sign of any further improvement. The recuperation was mainly driven by the FDI stock development of Armenia, Ukraine and Azerbaijan (*Chart 14*).

**Chart 13. Outward FDI stock
(2000-2011, US Dollars at current prices and current exchange rates in millions)**



Source: UNCTADStat

Chart 14. Outward FDI stock in CIS countries (2000-2011, US Dollars at current prices and current exchange rates in millions)



Note: we simply select out the Russian Federation because its values are far above the values that of the other countries. Data for Tajikistan, Turkmenistan and Uzbekistan are not available.

Source: UNCTADStat

One can recognise that OFDI stock of Kazakhstan has been increasing enormously since the midst of the 2000s. The intensification of OFDI activity was partly driven by the available savings realised in the course of surpassing inflowing FDI into Kazakhstan. This fact raises an even broader theoretical issue which has been addressed rather sporadically in the literature: why does FDI stream towards a country having poor institutional quality? This question alludes to the complexity of the real world and its often unfathomable nuances. By building on the existing empirical evidence on the main determinants of FDI flow collected by many (Lucas, 1990; Bénassy-Quéré et al 2007), we can claim with reasonable certainty that scholars often emphasis that low institutional quality (shortcomings property rights, political instability, corruption, red tape, regulatory barriers etc.) can be seen as one of the most pivotal detrimental elements against attracting FDI.

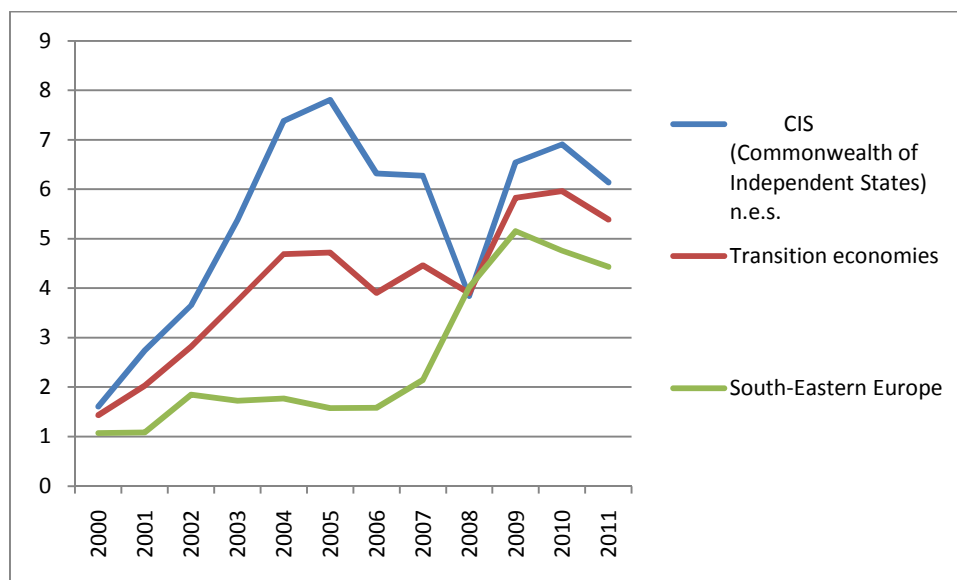
As a corollary, the differences across institutional qualities shed light on the major leitmotifs standing behind FDI flows. There are at least three types of these leitmotifs decipherable. *First*, a widely registered FDI trend is that it flows from a country having lower institutional quality to a country possessing a significantly higher level of institutional quality. This investor's behaviour is the manifestation of the 'asset-seeking' objective (i.e. to achieve new technologies, management practices, intellectual properties etc.). *Second*, FDI also flows from countries with low level of institutional quality (developing countries) into those of having similar level of institutional quality (e.g. when China invests in Brazil or Kazakh investors are in Turkmenistan or in the Kyrgyz republic via FDI). And *third*, there is also an FDI pattern conveying the message that flows of FDI can also be a real perspective when it comes to recipient countries with much worse institutional qualities compared to that of the host countries. This is the case when western countries invest in Kazakhstan. The answer to our question raised above rests upon the fact which was indicated earlier. Kazakhstan is a natural resource based economy⁴ and investing into a country with worse institutional quality may happen if the costs of being in a country with poorly functioning institutions are more likely to be overcompensated by returns on natural resources (e.g. energy sector).⁵

⁴ The Kazakh economy is heavily dependent on natural resource exports, which poses *inter alia* the so-called „Dutch disease“. See more: Kozeibayeva (2008)

⁵ Aleksynska and Havrylchuk (2011) found that countries having relatively surpassing volume of natural resources (e.g. Algeria, Azerbaijan, Kazakhstan, Russia, and Venezuela) that are worth more than \$4,675 per capita (in the top 10% of our sample) are more likely to attract FDI from investors from the South despite a large institutional distance and having worse institutions.

As it is discernible on *Chart 15*, CIS countries have been outperforming the other groups in terms of OFDI stock in percentage of GDP. Despite the economic crisis, this phenomenon seems to continue in the short and medium run.

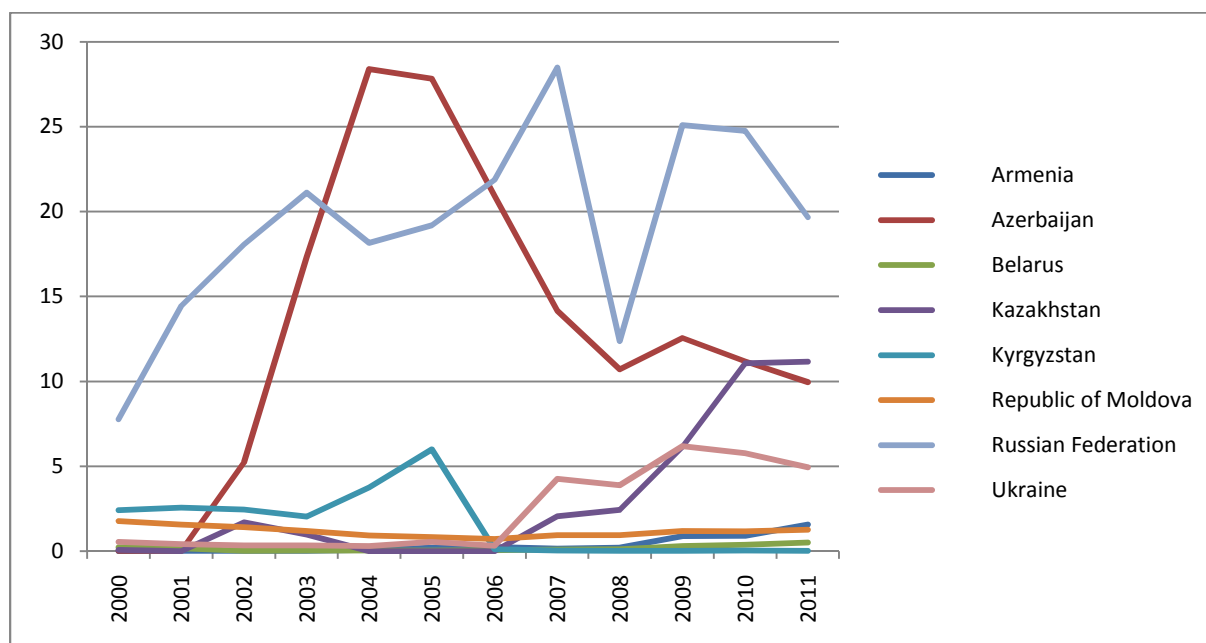
Chart 15. Outward FDI stock (2000-2011, % of GDP)



Note: Since data between 2000-2007 for Serbia as well as for Montenegro, and data between 2000-2003 for Albania and Bosnia and Herzegovina are missing, the trend of South-Eastern European countries should be handled cautiously. Data for Tajikistan, Turkmenistan and Uzbekistan are not available.

Source: UNCTADStat

Chart 16. Outward FDI stock in CIS countries (2000-2011, % of GDP)



Note: Data for Tajikistan, Turkmenistan and Uzbekistan are not available.

Source: UNCTADStat

Concluding remarks

One of the most pivotal insights of this short analysis is that CIS countries' FDI attractiveness has rebounded relatively faster after 2009, when the economic and financial crisis hit seriously the European continent.

Let us underscore that CIS countries cannot be treated as a group of homologous. In an interconnected world pervaded by various types of networks, CIS countries' development follows an unpredictable path where every question raises another set of questions.

As it was emphasised, OFDI developments of the Kazakh economy seems to be conducive both to the host and recipient countries, but not all OFDI data can be deemed as an unambiguously positive phenomenon in each recipient countries. For instance, FDI development in the Kyrgyz economy (i.e. concentration in the financial sector not in the manufacturing and services sector) conveys to a certain extent at least two messages (i) without perspective structural economic reforms in supporting the reduction of corruption and red tape and improving business framework conditions, capital flight may be in the cards, especially because of the structure of the economy being built exclusively on natural resources; (ii) in the absence of these, even an increasing level of FDI (concentrating continuously in the financial sector) would have merely a soupcon of positive impetus on economic development, simply because this kinds of FDI activity does not offer enough learning opportunities (know-how, skills, managerial practices) for small and medium sized firms operating in a monocultural country requiring significant diversification.

It suggests that looking merely at the algebraic sum of FDI and OFDI developments tends to create a misunderstanding over what is really happening and why in the given country and within a certain group of countries. Additionally, incorporating the analysis of institutional quality in a more vigorous way would be instructive because it largely determines the main leitmotifs behind the patterns observable in FDI and OFDI.

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Poland: Raising awareness on the importance of impulsive innovation activity

Olivér Kovács

It seems that this time is different, insofar as the duration of recent financial and economic crisis does not meet the experience of post-World War II economic history. It has been documented that economic crises tend to end on average in four and a half year (Reinhart – Rogoff, 2012).⁶ This crisis is still alive, however, it has become a rather multiple dimensional crisis having the weaving relations of interrelated and interacting crisis phenomena (financial crisis, sovereign debt crisis, modernisation crisis etc.)

There was even an emerged practice in one strand of recent studies that have been attributing the Polish economic performance (i.e. positive economic growth rate) to nothing, but a unique and ‘magical’ phenomena. If we take a mere glimpse at the Polish growth data, one can rightly point out that the Polish economy was the only one country which did not experience recession at all with the advent of financial and economic crisis erupted in 2008. According to Eurostat, Poland’s growth rates were as follows 5.1 percent, 1.6 percent, 3.9 percent and 4.3 percent growth in 2008, 2009, 2010 and 2011, respectively. Data for the EU were 0.3 percent, -4.3 percent, 2.1 percent and 1.5 percent growth in the same years.

Still room from improvement

Among the main driving forces behind this remarkable performance was primarily the relatively surpassing domestic market armed with its strong domestic demand. Nevertheless, Eurostat’s forecasts are now envisaging a decreasing growth rate for 2012 (e.g. 2.4% for 2012; 1.8% for 2013) due to the growing uncertainties over the future that is likely to reign companies’ willingness to invest and risk as much as they did in the previous years. This *per se* reduces innovation activities as well that can often be seen as economically and financially risky undertakings, especially when demand is getting on a wrong track. Dampening demand might be re-boosted to a certain degree *via* a more intensified and impulsive innovation activity within the Polish economy. It calls for demand-side policies to spark demand for innovation.

⁶ In terms of employment, regeneration of employment to the pre-crisis period often lasted a decade. See: Reinhart and Rogoff (2012), available: <http://www.bloomberg.com/news/2012-04-02/five-years-after-crisis-no-normal-recovery.html> Accessed on: 03.11.2012

This kind of policies often encapsulates the following policy types in support of demand for innovation: (i) fostering public procurement of innovation; (ii) pre-commercial public procurement; (iii) regulation as a tool for innovation policy; (iv) tax incentives to foster innovation demand; (v) awareness raising campaigns, labels; (vi) lead market type of initiatives; and (vii) building on a user-driven innovation approach.

With the view to demand-side policies, to date, Poland considers only policy tool for fostering public procurement of innovation.

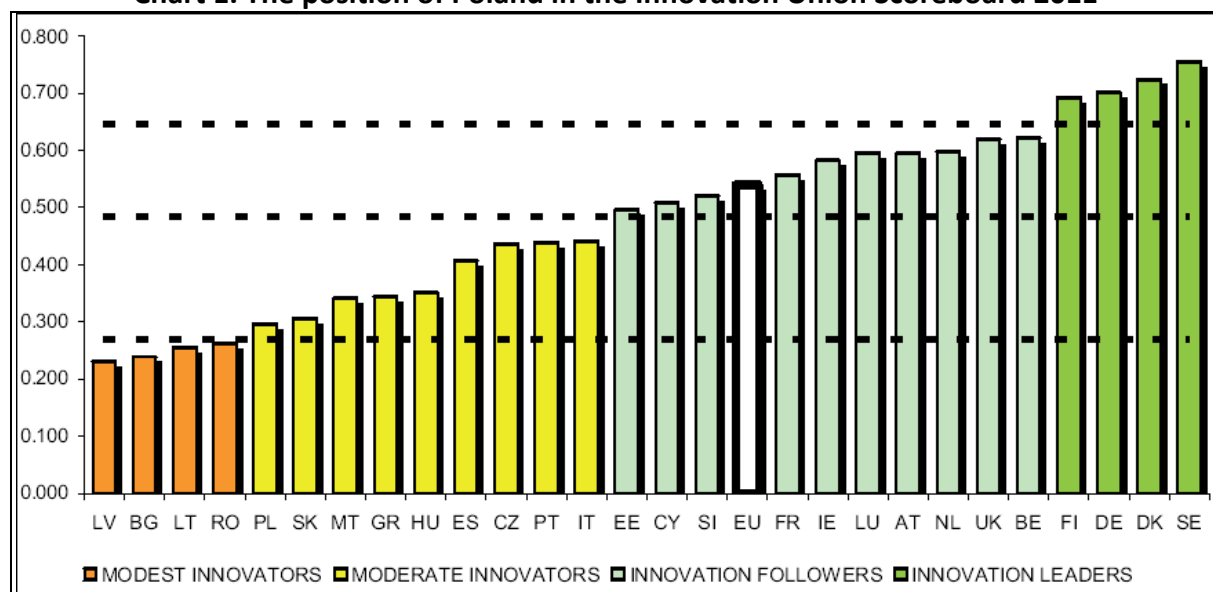
Table 1. Demand-side policies in the EU

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Source: Izsák – Edler (2012)

It is therefore not surprising that, in terms of innovation performance, Poland is far below the EU average; all the more it can be ranked with the group of countries that are moderate innovators in Europe (Chart 1).

Chart 1. The position of Poland in the Innovation Union Scoreboard 2011



Note: Average performance is measured using a composite indicator building on data for 24 indicators going from a lowest possible performance of 0 to a maximum possible performance of 1. Average performance in 2011 reflects performance in 2009/2010 due to a lag in data availability.

Source: DG Enterprise and Industry, available: http://ec.europa.eu/enterprise/policies/innovation/files/ius-2011_en.pdf

Raising awareness on impulsive innovation

The Ministry of Economy has been raising the awareness over the importance of impulsive innovation activity. In doing so it advocates meetings devoted to innovativeness by building on vivid discussions among policymakers and a wide range of experts, and, among others, it also patronizes young generation to propel creativity and interdisciplinary knowledge building.

On 10 May 2012, the Foundation in 2065 organised an international meeting called “New Technologies – Innovation – Business” in Warsaw, Poland. There was a common view stating that old problems even in a new form require new solutions of which inevitable ingredients are the creative people and the flexibility of finance (i.e. available financial resources that can be geared towards the development and implementation of innovative ideas).

It was also emphasised that strengthening and enhancing the relationship between science and policy as well as business is of particular importance. As Waldemar Pawlak, Deputy Prime Minister, Minister of Economy, noted: “You need a system that will effectively associate business partners, facilitate the flow of personnel and the formation of clusters and provide access to research infrastructures in the country and abroad”.

As far as the potential policy focus was concerned, the participants concluded that the Polish economy should focus on the two pillars of modern services and industries having the greatest potential for economic growth.

Regarding the issue of promoting the creation of creativity and a more innovative mindset building, in May 2012, Waldemar Pawlak, Deputy Prime Minister, Minister of Economy, opened the programming contest for students from around the world. It was the inauguration ceremony of the World Cup Academic Collegiate Programming Contest (ACM ICPC) which took place on May 15, 2012 in the Congress Hall of the Palace of Culture and Science in Warsaw.⁷

As the Deputy Minister emphasised, by now, students have to broaden their knowledge horizons by seizing every opportunity to obtain a more interdisciplinary knowledge thesaurus with permanent learning. In this way, creative and innovative thinking can be

⁷ More about the contest, see: <http://www.uw.edu.pl/aktualnosci/icpc.html>

nourished within the country. Deputy Prime Minister Waldemar Pawlak said that to win games you have to be good at programming, mathematician, computer scientist and programmer. The winners are interdisciplinarity and creativity.

Conclusion

Albeit Poland has been often viewed as an island within the European Union of economic growth during the recent financial and economic crisis accompanied with eurozone crisis and sovereign debt crisis, there is a caveat suggesting that there is no time for any torpor. In recognising this, the Polish government is to stimulate demand for innovation in a more dedicated way by using demand-side policy tools.

It is more than necessary especially if we consider the fact that long-term economic growth and development can only be sustainable if innovation is unleashed in favoring better products and services, and ultimately greater welfare and well-being. Without enhancing the Polish innovativeness, the sustainability of its growth performance may easily escape from the Poles' grasp.