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Assessment And Management Of Negative Impacts Of Foreign Direct Investment For Economies Of Central Asia

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ABSTRACT

Uzbekistan has only begun to make independent steps in global economic processes. Along with Central Asian countries, Kazakhstan, Kyrgyzstan, Turkmenistan and Tajikistan, Uzbekistan's economy and economic structure is pretty young, thus vulnerable to any unseen exogenous repercussions. We have already seen that how the Mexican Tequila crisis in 1994, the Asian crisis in 1997-98, the Russian crisis (even it was the leftover contagion from the Asian crisis) in 1998 and recent Kazakhstan real-estate crisis in summer of 2007 happened. It easy to see if we look behind capital flows. Capital flows have been heartache and headache for an economy for the last two decades. They are so mobile and volatile that can bear vicious ebbs and flow in no time at all. However, it is necessary to remember, that today it is difficult to speak of the economy of any country as about of separate island. Foreign Direct Investment is very necessary somehow, at least theoretically, to boost the economies of Central Asia. But there should be proper balance and policies to make the most of FDI inflows. An enchanted economy by enormous FDI inflows is exposed to very huge risk which might end up even with crisis!

KEYWORDS

FDI, capital inflow, emerging economy, crony capitalism, Tobin tax, financial stabilization of industrial production, economic growth, capital outflow, investment climate, tariff and nontariff barriers, corporate failures, exuberant growth, credit crisis, foreign exchange markets, OLI Paradigm.

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INTRODUCTION

We have seen in previous sections that foreign direct investment may sometimes cause a negative effect for vulnerable countries. Most of financial and economic crises, stemmed from unwise cross-border capital activities, were observed in emerging economies such as Argentina, Mexico, Thailand, Indonesia, Malaysia, Russia, recently Kazakhstan, to name but a few. These all mean there is still something remaining we have to consider or reconsider on which I try to shed the light on in this section.

What is the different about Central Asian case? The most prominent difference about Central Asia appears in institutional development. The region is still remaining to be the only "intact" place in terms of "foreign economic occupation". Region is full of natural, especially energetic resources. There is more than 50% annual leftover of energetic resources after the initial consumption in Central Asia. The region is located in geopolitically "convenient" place. After all, it is hard to believe that investors are reluctant to do business in here even they pretend to be so.

Actually, everybody's eyes are kept on what is going on the region. They ready for "hot money". Because they know it requires a whole process to build long-term perspective investment projects. Since "rent seeking" period was ended by the Asian Crisis, some remarks should also be applied to Central Asia.

The researches revealed that the share of FDI in total flows tends to be larger in countries that are riskier, more distant, resource rich, financially underdeveloped, institutionally weak and suffering from original sin. Hence, it is hard to argue that the rise in the share of FDI is an indication of good health.

The Asian Financial Crisis. The heavy capital inflow should not always be interpreted as virtuous factor for economic growth. The Asian Crisis has already made it clear that such activities not only impose negative trends in economies but also demolishes them. In 1997 to 1998, several Asian nations – including Thailand, Indonesia, Malaysia, South Korea and the Philippines – experienced a sudden reversal of international capital flows. During the preceding few years, these nations, as the favorites of international investors, had attracted large inflows of money, allowing them to import considerably more than they exported. But confidence in these economies collapsed in 1997. Foreign banks that had been lending heavily to Asian companies now demanded that the loans be repaid, stock market investors began selling off their holdings, and many domestic residents also began shifting funds overseas. Eventually, the Asian financial crisis was born.

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TABLE 1. **The Economies and Currencies of Asia, July–November 1997**

	2006 Current Account (bln. US$)	Liabilities to foreign banks (bln. US$)	Exchange rate		
			July (per US$)	November (per US$)	% change
Weaker Economies					
Indonesia (rupiah)	-9	29.7	2400	3600	-33.3%
Korea (won)	-23.1	36.5	900	1100	-18.2%
Malaysia (ringgit)	-8	27	2.5	3.5	-28.6%
Philippines (peso)	-3	2.8	27	34	-20.6
Thailand (baht)	-14.7	48	25	40	-37.5%
Stronger Economies					
China (yuan)	47.2	56.6	8.4	8.4	0%
Hong Kong (dollar)	0.0	28.8	7.75	7.73	+0.0%
Singapore (dollar)	14.3	55.3	1.43	1.6	-10.6%
Taiwan (dollar)	11	17.6	27.8	32.7	-15%

Source: International Monetary Fund, International Financial Statistics, October–November 1997.

The Thai government and central bank intervened in the foreign exchange markets directly (using up precious hard currency reserves) and indirectly (by raising interest rates to attempt to stop the continual outflow). The Thai investment markets ground to a halt, which caused massive currency losses and bank failures. On July 2, 1997, the Thai central bank finally allowed the baht to float (or sink in this case). The baht fell 17% against the U.S. dollar and more than 12% against the Japanese yen in a matter of hours. By November, the baht had fallen about 38%.

The slowed economies of the region quickly caused major reductions in world demands for many products, especially commodities. World oil, metal, and agricultural products markets all saw severe price falls as demand fell. These price drops were immediately noticeable in declining earnings and growth prospects for other emerging economies. The problems of

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Russia in 1998 were reflections of those declines.

The Russian Crisis of 1998. The crisis of August 1998 was the culmination of continuing deterioration in general economic conditions in Russia. During the period from 1995 to 1998, Russian borrowers – both governmental and nongovernmental – had gone to the international capital markets for large quantities of capital. Servicing this debt soon became an increasing problem, as dollar debt requires earning dollars to service that debt. The Russian current account, a surprisingly healthy surplus ranging between $15 billion and $20 billion per year, was not, however, finding its way into internal investment and external debt service. Capital flight accelerated, as hard-currency earnings flowed out as fast as they found their way in. Finally, in the spring of 1998, even Russian export earnings began to decline. Russian exports were predominantly commodity-based, and global commodity prices had been on the decline since the onset of the Asian economic crisis in the summer and fall of 1997.

Kazakhstan's real estate crisis. Kazakhstan's GDP grew by 10.6% in 2006 but slowed to 8.7% in 2007, and according to the forecasts of local analysts, will slow even further to 6% in 2008. Inflation, at the same time, grew from 8.6% in 2006 to 18.8% in 2007. The main factor that led to worsened economic conditions was the local credit crisis triggered by this summer's subprime woes in the United States and the subsequent global liquidity crunch. This crisis has hit hard Kazakhstan's praised banking sector and exposed its reliance on cheap foreign credit and overexposure to the speculative construction and real estate sectors.

A shake-up of such magnitude was a first for Kazakhstan. Until this summer, the market has been increasing steadily, and Kazakh real estate was among the most attractive investment plays in Central Asia. The growth came after nearly a decade of stunted development following the collapse of the Soviet Union in 1992 and the Asian financial crisis in 1998.

As the market boomed on and reached its peak in the summer of 2007, the presence of the bubble was obvious and widely discussed. But only the global credit crisis triggered by the uncertainties about the U.S. mortgage sector has finally brought the exuberant growth to a stop. The crisis and the lack of global liquidity have forced banks to make credit standards more stringent and raise interest rates. This has virtually overnight turned Kazakhstan's speculative demand-driven real estate market into a state of near-panic, and the years of double- and triple-digit growth in real estate prices in metropolitan have come to an end. So far, the price of one square meter on Almaty's real estate market has fallen almost a quarter from a June peak of nearly $4,000.

There are several causes for the abrupt fall in prices. One is that the remaining middle-class homebuyers and amateur speculators playing the market have suddenly been cut off from a source of funds. Mortgage rates have doubled, even tripled, virtually overnight, and many banks simply stopped issuing loans after the severity of the banking crisis in Kazakhstan was exposed. This resulted not only in a dramatic fall in demand for new construction but also a supply glut as many speculators (who came to dominate the market) were forced to sell their properties to meet mortgage payments.

This has been further exacerbated by the construction sector's dependence on bank credit for its operations. The sudden lack of financing for the construction sector has left the companies without resources to finish projects in early stages of construction or start new ones. That has left a significant number of hopeful home-owners and would-be investors – who have frequently bought their properties before foundations were laid – without a home and often with little hope to receive what they paid for.

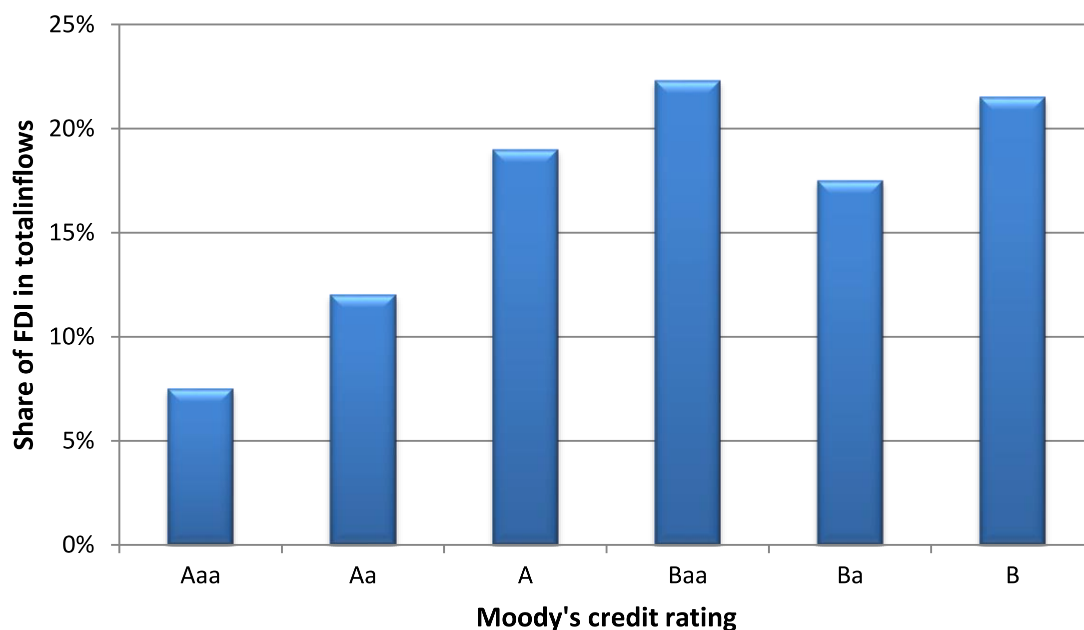
There are several lessons that should be drawn from this experience: Kazakhstan needs to further develop its financial system to offer its domestic investors alternatives to investing in real estate. While there is a small but growing mutual fund industry in Kazakhstan today, it is virtually inaccessible to the average Kazakh.

As we saw above, most of crises caused not by internal repercussions but by abrupt changes in external system. Sudden claim by investors to pay their share back or liquidate an investment project due to some unreasonable panics or so, brings about huge turmoil for a host country leaving vicious waves for long time.

One striking feature of FDI flows is that their share in total inflows is higher in riskier countries, with risk measured either by countries' credit ratings for sovereign (government) debt or by other indicators of country risk (Figure 6). There is also some evidence that its share is higher in countries where the quality of institutions is lower. What can explain these seemingly paradoxical findings? One explanation is that FDI is more likely than other forms of capital flows to take place in countries with missing or inefficient markets. In such settings, foreign investors will prefer to operate directly instead of relying on local financial markets, suppliers, or legal arrangements. The policy implications of this view, according to Albuquerque (2000), are "that countries trying to expand their access to international capital markets should concentrate on developing credible enforcement mechanisms instead of trying to get more FDI."

In a similar vein, Hausmann and Fernandez-Arias (2000) suggest that "Countries should concentrate on improving the environment for investment and the functioning of markets. They are likely to be rewarded with increasingly efficient overall investment as well as with more capital inflows". Although it is very likely that FDI is higher, as a share of capital inflows, where domestic policies and institutions are weak, this cannot be regarded as a criticism of FDI per se. Indeed, without it, the host countries could well be much poorer.

FIGURE 1: FDI's share in total inflows is higher in countries with weaker credit ratings



Source: Rui Albuquerque "The Composition of International Capital Flows: Risk Sharing through Foreign Direct Investment," 2000

FDI is not only a transfer of ownership from domestic to foreign residents but also a mechanism that makes it possible for foreign investors to exercise management and control over host country firms—that is, it is a corporate governance mechanism. The transfer of control may not always benefit the host country because of the circumstances under which it occurs, problems of adverse selection, or excessive leverage. Paul Krugman notes that sometimes the transfer of control occurs in the midst of a crisis and asks:

Is the transfer of control that is associated with foreign ownership appropriate under these circumstances? That is, loosely speaking, are foreign corporations taking over control of domestic enterprises because they have special competence, and can run them better, or simply because they have cash and the locals do not? … Does the firesale of domestic firms and their assets represent a burden to the afflicted countries, over and above the cost of the crisis itself?

Even outside of such fire-sale situations, FDI may not necessarily benefit the host country, as demonstrated by Razin, Sadka, and Yuen (1999) and Razin and Sadka (forthcoming). Through FDI, foreign investors gain crucial inside information about the productivity of the firms under their control. This gives them an informational advantage over "uninformed" domestic savers, whose buying of shares in domestic firms does not entail control. Taking advantage of this superior information, foreign direct investors will tend to retain high-productivity firms under their ownership and control and sell low-productivity firms to the uninformed savers. As with other adverse-selection problems of this kind, this process may lead to overinvestment by foreign direct investors.

Excessive leverage can also limit the benefits of FDI. Typically, the domestic investment undertaken by FDI establishments is heavily leveraged owing to borrowing in the domestic credit market. As a result, the fraction of domestic investment actually financed by foreign savings through FDI flows may not be as large as it seems (because foreign investors can repatriate funds borrowed in the domestic market), and the size of the gains from FDI may be reduced by the domestic borrowing done by foreign-owned firms.

Recent work has also cast the evidence on the stability of FDI in a new light. Though it is true that the machines are "bolted down" and, hence, difficult to move out of the host country on short notice, financial transactions can sometimes accomplish a reversal of FDI. For instance, the foreign subsidiary can borrow against its collateral domestically and then lend the money back to the parent company. Likewise, because a significant portion of FDI is intercompany debt, the parent company can quickly recall it.

There are some other cases in which FDI might not be beneficial to the recipient country – for instance, when such investment is geared toward serving domestic markets protected by high tariff or nontariff barriers. Under these circumstances, FDI may strengthen lobbying efforts to perpetuate the existing misallocation of resources. There could also be a loss of domestic competition arising from foreign acquisitions leading to a consolidation of domestic producers, through either takeovers or corporate failures.

Both economic theory and recent empirical evidence suggest that FDI has a beneficial impact on developing host countries. But recent work also points to some potential risks: it can be reversed through financial transactions; it can be excessive owing to

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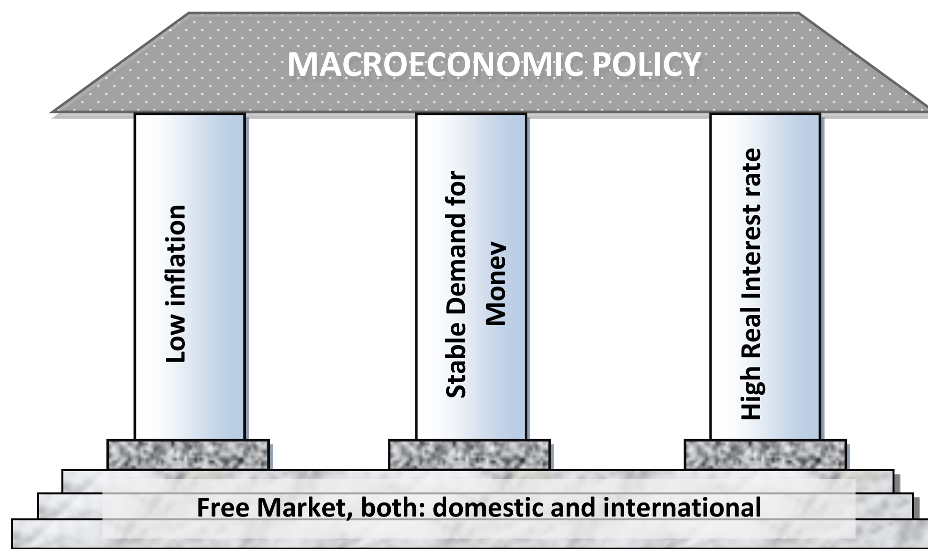
adverse selection and fire sales; its benefits can be limited by leverage; and a high share of FDI in a country's total capital inflows may reflect its institutions' weakness rather than their strength. Though the empirical relevance of some of these sources of risk remains to be demonstrated, the potential risks do appear to make a case for taking a nuanced view of the likely effects of FDI. Policy recommendations for developing countries should focus on improving the investment climate for all kinds of capital, domestic as well as foreign.

Weak financial institutions and inadequate banking regulations were linked to moral hazard problem. Uncontrolled foreign borrowing and unwise spending was no other than crony capitalism.

In 1998, during the Washington Consensus neo-classic economists recommended a macroeconomic solution to prevent an economy form being hurt by malicious capital inflows (Figure 2)

FIGURE 2: **Macroeconomic Recommendations from neo-classics during the Washington Consensus for capital lucrative states:**



The Washington Consensus in 1998, ended up with a bunch of suggestions for significant capital recipient countries in which neo-classic's was remarkable. They said that those countries should build their economy up on the modified free market base with strong institutionalism and three important pillars which are maintaining low inflation rate, stable demand for money and high real interest rate

Based on: Lecture notes of Ph. D. of economic development Philip PARK, Waseda University

There also should be a proper balance between foreign direct investment and domestic investment. This ensures our country to have its own capital funds to avoid unexpected bad days. Because, foreign direct investment doesn't necessarily be of benefit to a host country, soon or later nobody guarantees that they someday in future will leave for the other "hot" places. However, local firms would remain with this country in attempt to dismantle the bad days.

The domestic investors and producer shouldn't be worse off by substantial privileges given to

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FDI enterprises. The policies should simply facilitate a virtuous balance keep the economy more stable and perspective.

The single lesson for Central Asian countries that they should take following action in the pursuit of FDI efficiencies:

- Any FDI inflows should be scrutinized regardless its capital capacity so that it won't cause a trouble for local producers and the economy as a whole. The rudimentary implication here is the higher capital in a FDI inflow, the higher risk for a host country. It means big FDI projects however have less net effect;
- There should be a watchdog institution on FDI or capital flows. Or we least strong regulations to avoid short-term foreign investors. For example Tobin tax is one of these measures. It is a small transaction tax levied on short-term liquid assets to slow short-term capital flow down. Apparently, if there is a tax imposed on an investment, an investor is unwilling to pull out his capital as long as he will be required pay a certain part of the initial investment once he claims back before the contract period;
- And of course, there should be strong institutional change. The stronger institutionalism, the more effective economic activities is. In this sense, Central Asia has accumulated significant experience to improve changes recently;
- Central Asia countries should gradually figure out such policies that can make it possible shift foreign investors to other spheres where we are less efficient without their partnership. For example, we can still do better in raw material extraction or mining sphere even without them.
- There should be even more stable monetary system to facilitate the efficiency of investments from both foreign and domestic.

The share of FDI in total flows tends to be larger in countries that are riskier, more distant, resource rich, financially underdeveloped, institutionally weak and suffering from original sin. Hence, it is hard to argue that the rise in the share of FDI is an indication of good health.

I have been continuingly mentioning that there is no reason to say that the rise in FDI is not the best thing that could have happened, given the prevailing conditions. However, this does not mean that the rise in FDI is a sign of bad health. On the contrary, the rise of FDI is an indication that markets are working poorly, that institutions are inadequate and that risks are high.

A famous economist-analytic, Peter J. Williamson once mentioned: "Asian region is now more dynamic. What is worked before would not do so now? Businesses should merge their traditional background and current skills in order to be successful in the region". The issue related to foreign direct investment keeps us in a dilemma: to simply criticize its shortcomings or recommend proper policies. As the Williamson mentioned above, we need new-type policies. Since it is new emerging issue, it still leaves us bunch of questions like what and how.

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