

Session VII: Foreign Investment During the Transition: How to Attract It, and How to Make the Best Use of It

Mr. U.T. Isayev, General Director
Foreign Investment Agency, Kyrgyz Republic

Direct foreign investments (DFIs) are one of the driving forces of the process of globalization and are a defining element of the modern-day world economy. DFIs promote the restructuring of industry at the regional and global levels and thus ensure the integration of a national economy into the world economy more effectively than trade. DFIs stimulate economic growth and development, providing economies in transition with not only financing for development, but also new technologies, better management techniques and access to international markets. In addition, DFIs integrate production systems with one another. In this way, DFIs can play a key role in the development of transition economies and in their rapid integration into the world community.

The global flow of direct foreign investments has reached a record level in recent years (on the order of US \$400 billion), expanding at a faster rate than trade and serving as the most important form of capital inflow into economies in transition. This is due mainly to the heightened integration of national economies brought about by economic liberalization and reforms in all regions of the world, market reforms in transition economies, the integration of financial markets, the technological revolution and growth of global competition, the opening of new spheres for investment, transnational corporations' strategy of streamlining production and entering new and growing markets, and the signing of regional trade and investment agreements. As never before, more and more corporations and firms are broadening their geographical boundaries through direct investments abroad, and today virtually all countries compete for DFIs. According to the Organization for Economic Cooperation and Development (OECD), DFIs from the OECD nations have averaged US \$250 billion over the past three years, compared to an estimated average of US \$110 billion in previous years. Nearly a third of this sum has been invested in the OECD countries themselves. This is attributable primarily to changes in the OECD countries' policies with respect to DFIs. Although the interest of OECD-nation investors in economies in transition has grown considerably, the share of DFIs in these countries remains small as yet, amounting to less than 2% of all DFIs. At the same time, the bulk of these DFIs have been made in the countries of Eastern and Central Europe, which have succeeded in attaining macroeconomic stability more quickly and have made significant progress in structural reforms, as well as in countries having enormous oil reserves.

According to specialists' projections, the prospects for continued growth in the global flow of DFIs are very encouraging. Mounting competition in international markets for goods and services, on-going attempts to boost production and diversify exports, and the development of new technologies that reduce the cost of communications and shipping are likely to strengthen the upward trend in DFIs.

Since most of the economies in transition have resumed growth, made considerable progress in structural and institutional reforms, and achieved macroeconomic stability, the influx of foreign investments into these countries is growing significantly.

I would like to point out that the desire to attract DFIs is becoming one of the main driving forces of the reform process in transition economies. Although the speed and scope of reforms vary with the circumstances in each country, the orientation of the reforms is the same, on the whole, and liberalization of trade and investment regimes remains an integral part of the reform process. At the same time, it should be noted that despite changes that transition economies are making in their policies on DFIs, these policies still contain such obstacles to DFIs as unstable tax systems, lack of transparency, bureaucratic interference, weak legal institutions, the existence of sectors that are closed to foreign investors or open to them only partially, inflexible labor markets, and so on. High taxes on wages are an onerous burden on enterprises and detract from the appeal of cheap labor in many economies in transition, and so the establishment of a legal foundation that stimulates and encourages foreign investments, efforts to simplify tax systems, and respect for legality in the economy are some of the most important tasks facing countries in the transition period.

The growing competition for DFIs is certain to have an impact on the course of economic development of economies in transition and will encourage the pursuit of continued reforms to improve the investment climate and attract greater foreign investment. The combination of such factors as the presence of strategic resources, highly educated populations, highly skilled workers available at low cost, comparatively well-developed infrastructure and social-welfare sectors, and proximity to the Eurasian market undoubtedly confers advantages on most of the countries with transition economies in attracting DFIs. However, experience has shown that the existence of these factors alone is not enough and that it is essential to carry out comprehensive structural reforms and to have an active government policy on attracting foreign investments.

Foreign investment laws have been enacted in economies in transition in order to encourage and protect foreign investments. Some countries, such as Kazakhstan, Uzbekistan and Kyrgyzstan, have now adopted revised foreign investment laws that offer investors essential guarantees and protection. The Kyrgyz Republic's new Law "On Foreign Investments" provides foreign investors with a just and equal legal regime, full and continuous protection, guarantees of nondiscrimination, protection against expropriation of foreign investments, and the right to freely dispose of their investments and of income from them, as well as compensation for losses to foreign investors in the event of armed conflict or other such circumstances. Consequently, efforts in these countries to improve legislation on foreign investments are oriented toward the creation of an overall legal system that is consistent with international standards and that incorporates elements regulating domestic investments as well.

Transition economies have also concluded numerous international agreements on investment protection. Most of the elements of these agreements are reflected in their foreign

investment laws. Nevertheless, these international agreements on investment protection take precedence over the countries' national foreign investment laws, since guarantees and concessions for investors, in keeping with national legislation, can be rescinded by the enactment of a different law, while guarantees and concessions established by an international treaty cannot be altered or rescinded by a host country unilaterally. Therefore, economies in transition need to be more active in signing international treaties on investment protection and in harmonizing their own foreign investment laws with such treaties. The OECD countries recently signed a multilateral agreement on investments that contains strict criteria as regards liberalizing investment and investor-protection regimes and includes effective dispute resolution procedures and many key elements of international treaties and agreements on investment activity that are already in effect. The treaty is open for signing by all interested countries, including transition economies. Since the world community is moving in the direction of recognizing international standards and criteria to govern foreign-investment regimes, it is extremely important that economies in transition have the same base elements in their foreign investment legislation.

In the opinion of many international experts, bureaucratic interference and corruption, weak corporate management, and underdeveloped financial institutions are the main problems that hinder DFIs in transition economies. Therefore, in order to effectively solicit foreign investment in the future, economies in transition must simplify their registration procedures, reduce price controls to a minimum, dismantle trade barriers, foster favorable conditions for private sector development, put an end to bureaucratic interference, strengthen financial institutions and banking supervision, create a commercially oriented infrastructure, and give foreign investors a greater opportunity to participate in privatization.

The low level of foreign participation in enterprise privatization is one of the main shortcomings of the privatization programs of most of the transition economies in Europe and Central Asia. With the exception of Hungary and Estonia, foreign exchange proceeds from privatization have proved to be rather limited, in contrast to other parts of the world, notably Latin America, where privatization in particular has been a principal source of foreign investment.

Most of the transition economies have opted for mass privatization methods that have maximized the speed of privatization but minimized proceeds from it. Although privatization in the countries of Eastern Europe and Central Asia is now in its final stages, there are still a number of strategically important enterprises the individual privatization of which could attract major foreign investors and generate enormous revenue for the state.

One of the causes of the low level of foreign participation in privatization is the fact that transition economies have insufficient expertise in attracting foreign investors. As a result of these countries' inexperience and a lack of assistance in searching for foreign investors, the task of finding qualified foreign buyers for enterprises has proved to be a serious problem. In addition, existing restrictions on DFIs and a lack of information about enterprises being offered for sale have had a negative effect. For this reason, as they continue to implement

privatization, economies in transition need to do a better job of marketing, identifying potential foreign investors and providing them with complete information about investment opportunities.

Multilateral financial institutions and international development agencies can play an important role in attracting DFIs in transition economies. Specifically, the Multilateral Investment Guarantee Agency (MIGA), the Foreign Investment Advisory Service (FIAS) of the World Bank, and the Private Sector Development Center of the OECD are providing great assistance in molding a positive image for a country, improving its investment climate and effectively promoting its investment opportunities. Recently, active efforts in this area have been made by the European Bank for Reconstruction and Development (EBRD) in conjunction with International Finance Corporation (IFC). For example at the beginning of this year the EBRD, with the assistance of the Japanese Center for International Finance (JCIF), successfully held a conference in Tokyo for Japanese businessmen on investment opportunities in Central Asian countries. The conference was unique in that it included presentations by both high-ranking officials of the governments of Central Asian countries and representatives of their private sectors.

The IFC and the EBRD can serve as catalysts for DFIs in transition economies, attracting private foreign capital in promising enterprises and helping to finance them. However, it should be pointed out that the capabilities of these institutions are at present limited, and that the involvement of at least one foreign partner is one of the conditions for IFC or EBRD participation in an enterprise's charter capital. Therefore, the IFC and the EBRD first attempt to find a foreign firm that intends to invest in a given enterprise and only then consider the possibility of making their own investments. As a result, in the absence of an interested foreign partner, neither the IFC nor the EBRD can, for all practical purposes, invest its own capital even in an enterprise that has rather good prospects. Meanwhile, there are quite a few such enterprises in transition economies, and with the involvement of the IFC and EBRD they could be more attractive to foreign investors. In this regard, one important mechanism for supporting promising enterprises in the economies in transition is the creation of charter capital funds and venture funds. Such funds can also be created with the assistance of the IFC and the EBRD and can be managed by a foreign firm.

Efforts to attract DFIs in transition economies are also likely to be promoted by new initiatives being undertaken by the World Bank and the EBRD, such as the provision of guarantees for foreign investments and programs for direct investment in small businesses. These innovative tools have great potential from the standpoint of their effectiveness and flexibility and should therefore be introduced in transition economies as quickly as possible.

According to the findings of a study conducted by a group of OECD experts, economies in transition can attract more DFIs when they have effective state agencies that assist foreign investors. Although investment promotion agencies (IPAs) have been set up in virtually all the transition economies, not all of them have been effective in attracting DFIs. As was pointed out at the most recent OECD forum on promoting DFIs in transition economies

in Europe and Central Asia and at the annual meeting of heads of investment promotion agencies from those regions in early 1998, one of the main problems confronting most investment promotion agencies is inadequate financing.

Many IPAs that are operating successfully in the OECD countries are wholly financed by their governments. This enables them to concentrate all their attention on the implementation of government policy on attracting foreign investment. Meanwhile, in transition economies, such agencies are only partially or insufficiently financed by the government and are compelled to seek out means of financing themselves. This means that an agency has to devote most of its attention to short-term measures that generate profit, as opposed to its main objective of soliciting foreign investment and promoting its country's image. An example is the now-defunct Kyrgyz Project Promotion Agency, which received no government funds, was completely self-supporting, and engaged primarily in rendering paid consulting services to the detriment of its main function--promoting promising investment projects in the Kyrgyz Republic and providing assistance to foreign investors. By decision of the President of the Kyrgyz Republic, the Foreign Investment Agency was created late last year, and the Government was directed to fund the agency. Since the Foreign Investment Agency's establishment, efforts to attract and promote foreign investment in Kyrgyzstan have intensified. In a relatively brief period of time, several international investment conferences and seminars have been held, contacts have been made with potential foreign investors, and materials detailing the country's investment opportunities and enterprises have been prepared. Needless to say, the funds the Government has allocated for the Agency are not enough to mount a full-scale effort to solicit foreign investment, and so a search for supplementary sources of financing is under way.

It should be said that international financial institutions could play a greater role in solving the problem of financing investment promotion agencies. As many officials of investment promotion agencies in Europe and Central Asia have pointed out, in most cases international and multilateral financial institutions and development agencies promote the concept of creating investment promotion agencies without due regard for the financing sources available for these agencies and for training their specialists in the planning and attraction of DFIs. In this regard, one hopes that these remarks will be taken into account by international financial institutions and that they will provide assistance in financing investment promotion agencies.

A strategy for attracting DFIs in economies in transition is virtually impossible to implement without the introduction and use of modern information technologies. Therefore, investment promotion agencies should base their activities on the effective use of information technologies and new program tools. Such tools include the Investor Tracking System, an electronic system for tracking investors and documenting the process for attracting investments, and the IPAnet international information network, which were created by MIGA. The IPAnet system uses the Internet to link investment promotion agencies, enterprises, and investors in various countries of the world into an integrated network, thereby facilitating the dissemination of information about investment opportunities and the establishment of contacts

between investment promotion agencies and investors. In order to help transition economies involve foreign investors in the privatization process, the World Bank Group, specifically MIGA, has created a new network known as PrivatizationLink. This network will be linked with the IPAnet and will enable foreign investors to obtain current information about investment opportunities arising in the course of privatization. Consequently, the PrivatizationLink network can be used by economies in transition as a key marketing tool in providing information support for their privatization programs and in establishing contacts with potential investors.

Studies conducted by international experts indicate that in transition economies, foreign investment is influenced by many governmental institutions and that optimum results in attracting DFIs in a country can be achieved only when these governmental institutions effectively interact with the investment promotion agency. For this reason, it is extremely important that such institutions, without whose support investment promotion agencies could not their job, appreciate their role and coordinate their efforts and activities with investment promotion agencies.

Another serious problem in attracting DFIs in transition economies is the extremely limited number of local consultants. Backward administrative systems and the lack of administrative personnel with a mastery of modern managerial techniques impede the attraction of foreign investors for restructured enterprises. The enterprises themselves cannot afford the services of foreign consultants, while local consultants are in short supply in the transition economies. In this regard, it is vital that greater numbers of local consultants be trained with the help of international financial institutions and that steps be taken to involve them in the implementation of promising investment projects.

A system of incentives and tax concessions for investments is of great importance to foreign investors. In order to attract foreign investors, incentives must be automatic and free of bureaucratic obstacles. By simplifying incentives and making them automatic for all investors acting within the framework of tax and customs legislation, economies in transition could make their investment climates more attractive. Tax concessions for investments have demonstrated their effectiveness in many of the OECD countries, making it possible to write off investment expenses expeditiously and offering investors long-term arrangements.

Foreign investors have an interest in improved regional integration, since this promotes more efficient production and offers greater opportunities for sales. Countries that do not receive large amounts of foreign investment because their markets are small or because they lack such natural resources as petroleum and natural gas which are attractive to investors, or because foreign investors have little confidence in their investment opportunities, have much to gain by becoming parts of regional markets. For this reason, transition economies, and above all the countries of Central Asia and the CIS, only stand to gain and will be able to attract more direct foreign investment on the basis of regional integration. Regional integration in Central Asia could enhance production efficiency on the basis of functional specialization and economies of scale.