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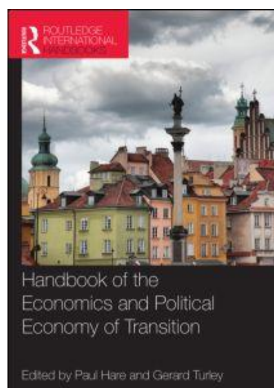

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The Exchange Rate and Foreign Direct Investment

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14

THE EXCHANGE RATE AND FOREIGN DIRECT INVESTMENT

Two paths to globalization

Josef C. Brada

Introduction

A major objective of the transition economies was to put their external economic relations on a new footing by replacing central planning and trade agreements with other communist countries with market forces to determine trade flows. Doing so required creating a functioning exchange rate, one that translated foreign prices into domestic ones, allowing domestic consumers to purchase from abroad what could be had more cheaply on the world market and producers to export what they could profitably sell on world markets.

Also absent in the pre-transition economies was the multinational corporation (MNC), whose role in transferring capital, technologies, skills and products to all corners of the globe had grown rapidly in the post-Second World War period. If the transition was to integrate the countries of the former Soviet Bloc into the global economy, establishing a functioning exchange rate and finding ways for MNCs to play a constructive role in the transition were critical.

The exchange rate

Early steps to create an exchange rate regime

The currencies of the communist countries were inconvertible; despite various efforts at reform, they could not be freely converted into other currencies, nor was it possible to purchase goods with them in the domestic economy without the consent of the planners. Moreover, the exchange rate did not play its fundamental role of translating foreign prices into domestic prices. Rather, imported goods were sold on the domestic market at prices set by planners that did not reflect the prices of these goods on the world market. Similarly, producers of exports received arbitrary domestic prices for their products regardless of what these exports sold for on world markets.

In the Central European countries, eliminating the trade apparatus that had existed during the communist regime so that all firms could freely engage in international trade, and reorienting their trade away from an excessive dependence on trade with other socialist countries, became an important early priority, along with price liberalization and stabilization. In the case of the

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former Soviet states, there was an initial effort to maintain old trade ties with other Soviet Republics through the creation of a rouble sphere, but this proved unworkable.

Trade was to be determined by the forces of supply of exports and demand for imports, and these forces had to be mediated by a functional exchange rate, something that had not existed in the planned era. The problem facing the reformers was what sort of exchange rate regime to adopt and how to set the exchange rate. While the problem of choosing an exchange rate could be left to the market if a country adopted a freely floating exchange rate, some transition countries were reluctant to adopt such a regime because they believed that, owing to economic and political uncertainty, the exchange rate would be too low and too volatile, hampering trade and investment. Moreover, a floating exchange rate could not serve as a nominal anchor to promote domestic anti-inflation policies.

A number of East European countries adopted exchange-rate pegs. Since there had been no functioning exchange rate in the past, the rate at which to peg was controversial. Purchasing power parity suggests that an exchange rate that equalizes the price of a bundle of tradeable goods valued in domestic prices and in the domestic currency to the price of the same bundle of goods priced at foreign prices and in a foreign currency is a good approximation of a sustainable rate. However, domestic prices in the transition economies were badly distorted by various subsides, the quality of goods was not comparable to goods available in market economies, there was a large monetary overhang and pent up consumer demand that threatened massive domestic inflation, and some of the transition economies were deeply indebted, so they needed trade surpluses rather than balanced trade. Some observers recommended adopting the black market rate of exchange as a better benchmark, although the nature of that market implied a serious undervaluation of the currency.

In the event, East European peggers set exchange rates that significantly undervalued their currencies, with convertibility for the current but not the capital account (Czechoslovakia being an exception, with early capital account liberalization). This excessive undervaluation was seen as useful in that it would both restrain imports of consumer goods to satisfy household demand and enable socialist-era firms to redirect their exports to the West and to improve their products and technologies in order to become more competitive on world markets. A cost of this was that imports of consumer goods and intermediate products such as fuels, components and machinery rose sharply, raising the level of retail prices and the operating costs of firms, thus providing an additional inflationary impetus to the economy. Combined with the high levels of inflation set off by domestic price liberalization, this led to an instantaneous and sustained real appreciation of the peggers' currencies, which continued for some years as inflation in these countries remained high.

Hungary and Poland adopted crawling pegs to accommodate their high levels of inflation, Czechoslovakia a deeply depreciated peg to the DM and US$. By the mid-1990s, as inflation declined, these countries expanded the band around the fixed or crawling rate to give market forces a greater role in setting the exchange rate. The Czech Republic faced a currency crisis in 1997 that forced it to float the koruna, and the Russian crisis of 1998 put pressure on the zloty and forint as well. While the pegged exchange rate functioned as a nominal anchor to give credibility to anti-inflation policies, tight monetary policy led to high interest rates and large capital inflows that had to be sterilized.

The Baltic states faced the additional problem of eliminating the Soviet rouble from circulation and introducing their own currencies. Once this was accomplished, they pegged their currencies, Estonia and Lithuania through currency board regimes, and these arrangements survived the rouble crisis of 1998. Bulgaria was noteworthy for switching from a floating exchange rate to a currency board arrangement in 1997 to give credibility to its hitherto unsuccessful stabilization efforts.

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Most of the CIS countries adopted a managed float with heavy government control, including requirements that exporters sell their foreign currency earnings to the central bank. Russia experienced a crisis in 1998 when the government was unable to borrow sufficient funds to service its debt and finance its operations. The rouble was driven out of its trading band, floated and declined in value from about 5–6 roubles/US$ to as much as 30 roubles/US$. While other countries that have floated their currencies have not experienced crises of similar magnitude, the Russian experience does suggest that the lack of an nominal exchange rate anchor to prop up anti-inflation policies contributed to the persistence of inflation. In some countries with flexible rates the sustained depreciation of the currency has led to dollarization or Euroization of the economy and to capital flight as residents seek a more stable repository for their liquid assets.

The exchange rate and EU accession

Transition economies that join the EU will have to adopt the Euro as their currency at some point in the future, and to do so they have to meet numerical targets, *inter alia*, for inflation, the interest rate and exchange rate stability. Thus the nexus between inflation and the exchange rate will become more critical for these countries. As the transition economies grow more rapidly than the 'old' EU members, they have higher inflation due to the Balassa–Samuelson effect, which posits that higher income countries have higher price levels and that real convergence must therefore lead to price convergence and thus to higher inflation rates in the countries that are catching up. This creates an advantage for countries that have chosen to float their currencies because they can offset part of domestic inflation through the appreciation of their currencies. For example, Horváth and Koprnická (2008) estimate that, for the Czech Republic, a 5 per cent appreciation of the koruna reduces inflation by 1 per cent. The Czech Republic, Slovakia and Romania have experienced both real and nominal appreciation post-accession, but Hungary and Poland have experienced nominal depreciation, possibly the result of poor macroeconomic policies that exacerbated their inflation rates.

If the Maastricht criteria are met, then the country must spend two years in the European Exchange Rate Mechanism (ERM2) regime before it can adopt the Euro. During that time, the country is required to keep its currency from fluctuating no more than 15 per cent against the Euro, with intervention mandatory at the limits of the band; not to devalue its currency against any EU member; and to eschew the use of currency controls. Countries are free to assume more stringent obligations if they wish. If a country does not meet the Maastricht criteria, then it has greater latitude in its exchange rate regime outside the framework of ERM2, thus enabling it to deal with domestic and external shocks by means of both macroeconomic policies and changes to its exchange rate.

Three transition countries have already met the Maastricht criteria and successfully completed two years in ERM2, enabling them to adopt the Euro as their currency: Slovenia in 2007, the Slovak Republic in 2009 and Estonia in 2011. Latvia and Lithuania are currently in ERM2 and thus may be able to adopt the Euro in the near future. The other new members of the EU have not as yet become part of ERM2. In some cases, this is because they do not yet meet the Maastricht criteria and because they still need to catch up with the EU levels of per capita GDP, a process that will continue to keep inflation rates high. Poland and the Czech Republic appear reluctant to make concrete commitments to Euro adoption, and other countries such as Bulgaria and Hungary do not meet the Maastricht criteria.

The global crisis of 2008 and the subsequent debt crises within the eurozone have negatively impacted transition economies' progress toward Euro adoption in several ways. First, the global

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recession has worsened government finances, making it harder to meet the Maastricht criteria relating to the government deficit. Second, policy makers and the populations of the transition economies view the eurozone much less favourably than they did before the crisis hit, and, third, policy makers now see some value in retaining an independent monetary policy and exchange rate flexibility to cushion external shocks to their economies.

Foreign direct investment

Introduction

Foreign direct investment (FDI) means investments in foreign countries that enable home-country investors to acquire control over productive assets in the host countries. Such investments, which have given rise to the multinational corporation (MNC), take two forms. One is the so-called greenfield investment, where the foreign investor builds a completely new factory or other productive facility in the host country. The other way of undertaking FDI is through a merger or acquisition (M&A), where the foreign firm purchases a controlling interest in an existing firm in the host country. FDI has been a major engine of globalization in the post-Second World War period, growing much faster than global output and international trade, and it has extended the reach of some MNCs to virtually all countries. The attractiveness of FDI for MNCs is two-fold. On the one hand, it enables the MNC to benefit from firm-specific advantages in new markets without transferring those advantages to potential rivals, and, on the other hand, it enables the MNC to break up its production process so that different components are produced in countries where it is cheapest to do so, while retaining a measure of control and coordination over the production process that would not be possible through subcontracting or international trade alone.

The communist countries missed out entirely on this development. This was partly due to ideology; the presence of privately owned capital meant the exploitation of labour, which they could not allow. Moreover, foreign control over domestic economic activity was inconsistent with central planning. True, the Soviet Union had briefly experimented with ‘concessions’ to foreign firms for the development of natural resources in the 1920s, and, starting with Yugoslavia in 1967, East European countries passed legislation allowing joint ventures between state-owned enterprises and Western firms, but these few experiments were more curiosities than effective means of globalizing the communist economies. As a result, the countries of East Europe and the former USSR began the transition without the presence of inward FDI or multinational firms. This section reviews the volume and pattern of FDI inflows into the transition economies and then examines the contribution that FDI made in three areas: privatization, capital accumulation and economic performance.

The volume and distribution of FDI in transition economies

Investment in the transition economies was attractive to MNCs for a number of reasons. On the one hand, the region represented a potentially large and untapped market. Consumers in the region had suffered from poor quality, lack of variety, obsolescence and shortages of consumer goods. Even through incomes in the region were low, the potential was great. Other MNCs were interested in the region as a place where they could locate production facilities that would capitalize on the region’s proximity to the EU market and on the presence of skilled workers who were paid a fraction of the wages paid to workers in Western Europe. In addition there were opportunities for investment in franchise sectors such as telecommunications and banking, and, in some countries, in the exploitation of natural resources.

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Investment flowed first and in greatest amounts to the countries of Eastern Europe, because of their more successful efforts at both political and economic transition, because they had more attractive industrial assets to offer foreign investors, because they offered relatively large domestic markets with higher incomes than did the transition economies farther to the East and because they were close to EU markets and thus their products could be more easily integrated into MNCs' supply chains. Table 14.1 shows the magnitude of the inflows both in absolute amounts and, to put them in perspective, in relationship to their GDPs. Those transition economies that have joined the EU have clearly received massive inflows of FDI, so that their stock of FDI relative to GDP is higher than the EU average of 42 per cent despite the fact that the old EU members have been receiving FDI for many more years. The countries of

Table 14.1 Inward FDI of transition economies

Country	*Stock of inward FDI in 2010 (mill US$)*	*Stock of inward FDI as % of GDP in 2010*
EU members		
Bulgaria	47,971	100.2
Czech Republic	129,893	67.6
Estonia	16,438	85.6
Hungary	91,933	71.0
Latvia	10,838	45.2
Lithuania	13,449	37.1
Poland	193,141	41.2
Romania	70,012	43.9
Slovakia	50,678	58.1
Slovenia	15,022	31.5
South-east Europe		52.0
Albania	4,355	36.7
Bosnia and Herzegovina	7,152	42.5
Croatia	34,374	56.8
Montenegro	5,456	138.2
Serbia	20,584	46.5
Macedonia	4,493	48.0
CIS		31.4
Armenia	4,206	44.7
Azerbaijan	9,593	17.6
Belarus	9,940	18.3
Georgia	7,821	67.1
Kazakhstan	81,352	61.1
Kyrgyzstan	974	21.6
Moldova, Republic of	2,837	49.2
Russian Federation	423,150	28.7
Tajikistan	915	16.2
Turkmenistan	8,186	40.7
Ukraine	57,985	42.5
Uzbekistan	4,460	11.7

Source: UNCTAD, FDI/TNC database (www.unctad.org/fdistatistics).

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south-east Europe have fared less well, in part due to regional instabilities, to their distance from the EU market and the relatively small size of their domestic markets.

The CIS countries present a more diversified picture. Some, such as Georgia or Kazakhstan, have benefited from major investments in oil and natural resource exploitation and the construction of oil and natural gas pipelines. Other countries, lacking resources or controlled by elites who wish to keep foreign investors out, have received only minor inflows of FDI. Nevertheless, in 2000–09 only the emerging countries of Asia saw greater inflows of FDI.

FDI and privatization

At the start of transition, many countries looked to foreign investors to purchase state-owned firms and to restructure them, in the process raising money for the state. Hungary was the most aggressive in seeking out 'strategic investors' who would purchase state-owned enterprises (SOEs), upgrade their technologies, restructure their operations and turn them into viable businesses, and as a result, was an early leader in FDI inflows. Most privatization programmes allowed for the participation of foreign investors in some way, but FDI inflows were slowed by economic nationalism, with concerns that valuable assets were being sold to foreigners at excessively low prices or that land and natural resources should not be sold to foreigners and by debates over whether SOEs should be restructured to make them more attractive to buyers and thus fetch a higher price or sold on an 'as is' basis. Privatizations that left insiders, either former managers or workers, in control of privatized firms tended to limit possibilities for foreign investors to purchase newly privatized firms from local owners. Many countries created Ministries or special units to sell off SOEs to foreign investors, the most prominent of them being the German Treuhand, charged with selling off the SOEs of the former East Germany.

Among the more noteworthy of the early acquisitions were General Electric's purchase of the Hungarian light bulb manufacturer Tungsram and Volkswagen's purchase of the Czech car maker Skoda. Despite many successful acquisitions, there were also conflicts between foreign investors and the host country when foreign investors shut down local research facilities, reduced production and employment, scaled back product lines, or failed to make promised investments in the firms they had acquired. The number of SOEs that were attractive to foreign investors was also limited, and thus mergers and acquisitions as a form of privatization declined in importance through the 1990s.

M&A activity was particularly important in the telecommunications and banking sectors. In the case of telecommunications, the communist-era national telecom monopolies were sold off to foreign telecommunications firms, usually in a bidding process organized by the home-country government. Improvements in the telecommunications infrastructure were seen as critical for economic restructuring, and the existing networks were outdated and inadequate in coverage. These multi-billion dollar transactions were particularly complex because the buyers had to commit to large investments in upgrading the network while the governments had to make promises about the future regulatory environment, tariffs and the introduction of competition from new entrants.

Commercial banks emerged in the transition economies from the breakup of the communist-era State Banks. As a result, the new commercial banks also inherited the debts that SOEs had owed to the State Bank, and many of these loans became non-performing as the transition recession deepened. Governments were concerned that the state-owned banks needed injections of capital as well as of expertise in evaluating and making loans, so that they would not continue to finance loss-making firms. Foreign banks, while realizing the potential of the transition economy market, were concerned about the quality of the assets that their acquisition

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targets held, and in many cases governments had to expend significant sums to clean up the banks' balance sheets before they could be sold to foreign investors. Nevertheless, in the EU member transition economies, foreign-owned banks, especially those owned by banks from Austria, Germany, Italy and France (and Sweden in the Baltic states) dominate the banking sector, holding no less than two-thirds of all banking assets, and in many cases more (Slovenia is an exception). Much the same pattern holds for Southeast Europe, but, in the CIS, the role of foreign banks in the privatization of the banking sector was much less.

FDI and capital formation

Because FDI takes two forms, M&A and greenfield investments, its contribution to capital formation is difficult to judge. If foreigners acquire an existing local firm by, say, buying it from the government through privatization, no increase in the country's capital stock takes place. In the case of greenfield investments, the foreign investor does build a new facility, and thus the country's stock of productive capital increases by the amount of greenfield FDI.

The overall ratio of FDI to fixed capital formation in the transition economies has varied widely over time, but for those transition countries that have joined the EU, the ratio in many years has been in excess of 30 per cent and at times even higher; for south-east European countries, it has rarely exceeded 20 per cent per year and for the CIS countries it has come to exceed 10 per cent only since 2003. At the same time, as privatization has run its course in these countries, investment has increasingly taken the form of greenfield investment, thus affecting capital formation more directly. In CIS countries that are rich in energy and natural resources, foreign investments have been largely for energy exploration, development and transportation, with much less interest in industrial projects. Most of the transition economies invest more than they save, and thus FDI has been an important source of financing to close this gap and an important contributor to their efforts to catch up to living standards in more advanced countries.

FDI and economic performance

FDI has important effects on economic performance, and evidence of this can be seen in the transition economies. FDI has both a direct and an indirect effect on capital formation. The direct effect is the greenfield (and to a lesser extent M&A) FDI itself, and the indirect effect is the impact of FDI on the volume of domestic investment, known as crowding-in and crowding-out. Crowding-in is the result of domestic investments that are induced by FDI inflows. Such induced investment can be infrastructure investments or capacity expansion by domestic businesses who supply parts, components or business services to the foreign investor or who use or distribute its output. Crowding-out results when the foreign investor pre-empts business opportunities that might have been seized by domestic firms or when the foreign investor competes directly with domestic firms, reducing their profit and market share and thus driving down their willingness and ability to invest. The magnitude of these two effects, of course, depends to some extent on the nature of the investments coming into the country and on the ability of domestic firms to respond to both opportunities and threats. Mileva (2008) finds that, in the transition economies, the crowding-in effect is quite significant, with US $1 of FDI inducing US $1 of domestic investment. Moreover, studies of the crowding-out effect (Mišun and Tomšík, 2002; Mileva, 2008) find it to be non-existent or negligible in these economies.

Foreign investors are also expected to bring with them skills, new technology and products, and connections to global markets. This should make foreign-owned firms more productive, thus raising the overall productivity of the economy. Early studies of foreign-owned firms,

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mainly in the East European transition economies, found them to be more profitable, more export oriented and faster growing than domestically owned firms. Later studies confirmed that this was not just the result of foreign investors purchasing only the best-performing firms available in the privatization process but rather of the advantages conferred by foreign owners on their affiliates. FDI also produces productivity spillovers to domestic firms. Suppliers of inputs to the foreign firm as well as users of the firm's products experience productivity gains; the former from the need to upgrade their products to meet the MNCs higher standards, the latter from the availability of higher quality inputs supplied by the foreign-owned firm. Additional productivity gains occur from the knowledge that the MNC brings which is diffused in various ways, such as the hiring of its workers and managers by local firms or by the imitation of its better business practices.

Finally, foreign investments can promote structural change, creating or restructuring entire sectors of the economy. Perhaps the most striking example of this effect is in the motor vehicles sector. Although a number of East European countries had indigenous car manufacturing capacity prior to the transition, this was badly outdated and had little chance of surviving in a global market; other transition economies had no such capacity. Investments by car makers from both Europe and Asia have made automobiles and automobile parts the leading export category from most of the Central European countries. In the Czech Republic, this occurred through Volkswagen's acquisition and complete revamping of Skoda, but other countries such as Hungary and Slovakia, which started with little or no car manufacturing capacity, also benefited greatly in terms of exports and jobs from foreign investments in the automotive sector.

Conclusion

While the transition economies are now globalized to different degrees, with some being highly integrated into the global economy and others less so, the differences appear to be much more due to their level of economic development, endowments of natural resources, location and domestic policies and politics than to the specifics of either what exchange rate regime to choose or how to allow for inflows of foreign direct investment. In the case of the exchange rate, countries with fixed exchange rates have borne higher costs due to the need to sterilize capital inflows and to use fiscal policy to offset external shocks, suggesting that once inflation was tamed and the national currency's credibility was established, floating the currency may have been a preferable policy.

In the case of foreign direct investment, differences in national strategies toward privatization did result in some differences in the volume of FDI at the beginning of the transition process, but over time, fundamentals, including location, market size and overall business climate have come to the fore in determining each country's ability to attract foreign investors. Especially for the Central European countries, FDI has been a major force for their integration into the global economy and their convergence to the living standards that prevail in more developed EU member countries.

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