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The Failed Promise of Foreign Direct Investment: Some Remarks on 'Malign' Investment and Political Instability in Former Soviet States

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Abstract

The policy of key international organisation continues to be informed by the assumption that Foreign Direct Investment (FDI) has an unambiguously positive effect on recipient nations. However, there is increasing evidence that, on a global scale, increased trade and investment flows from rich to poorer nations have not contributed to a convergence of levels of income and well-being. This is particularly apparent in the context of former Soviet states, many of which continue to experience a decline, in both relative and absolute terms, in per capita GDP alongside a diminution in the life expectancy of their populations. Examining data on FDI received by former Soviet States from 1997 to 2005, this paper notes, firstly, that these investments have been concentrated on a few, typical natural-resource-rich states. Secondly, it observes that even these resource-rich countries experienced massive fluctuations in terms of the amounts of FDI they received over this time period. Lastly, the paper examines the impact of FDI on a number of country risk indicators via a pooled regression model which includes data for twelve former Soviet countries, namely the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. This analysis indicates that FDI has either a marginally negative effect on individual country risk measures such as in the case of 'Overall Country Risk', or significantly negative effects as in the case of 'Economic Risk' and 'Legal Risk'. The paper concludes that there is strong case for questioning the existing orthodoxy which argues that problems of transition can be overcome via increased FDI and which continues to advise former Soviet states to pursue foreign capital at all cost.

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INTRODUCTION

The goal of this paper is to question the dominant orthodoxy of FDI which suggests that increased foreign investment will, in virtually all instances, benefit the recipient nation. This orthodox has an extensive academic pedigree (Balasubramanyam, Salisu, and Sapsford, 1996; Borensztein, De Gregorio and Lee, 1998; De Melo, 1999; Dyker, 1999) which loosely underpins a well established policy discourse which emphasises 'the creation of a positive investment climates' and the need to 'create institutions which are complementary to investment' (Guisinger, 1985; Mudambi and Navarra, 2002). Implied in this orthodoxy is the assumption that, firstly, the failure by certain regions to exhibit sustained growth can be attributed to a lack of?ability to attract foreign investment, and, secondly, that the inability to attract lasting foreign investment, itself, can be attributed to institutional deficiencies of the potential recipient country. Applied to former Soviet states, other than the Baltics, this narrative typically identifies corruption, lack of legal and institutional reforms and insufficient liberalisation as root cause for the insufficiency of economic and social development in these countries (Estrin, Hughes and Todd, 1997; Fabry and Zeghni, 2002; Bevan, Estrin and Meyer, 2004).

One of the obvious weaknesses of this narrative is that it oversimplifies the experiences of different countries within larger regions. Thus, there is significant evidence that, contrary to the assumption that the entire region has been an FDI laggard, FDI in former Soviet states has been highly concentrated in a number of countries which rank, by international standards, amongst the top FDI recipients (Meyer and Pind, 1999). Moreover, there is no consistent evidence that the top FDI recipients amongst former Soviet states also rank at the top in terms of social and institutional development and/or political stability (Abbott, 2002; Abbott and Beck, 2003). Lastly, there are some, largely qualitative analyses, which suggest that some countries which have been targeted by FDI have in fact experienced a deterioration in their institutional capacities (Marriott and Muttitt, 2005).

As an alternative to these conventional views on FDI, this paper examines the possibility that foreign investment in former Soviet states has not only failed to produce the expected effects, but also may have had a discernibly negative impact on certain regions. The paper is structured as follows. The first section briefly reviews conventional arguments on the benefits of trade and investment and contrasts these with recent developments in the region. The second section presents a more recent neo-institutionalist model of economic development together with some alternative interpretations of the impact of investment and trade on domestic economies. These alternative views form the basis for the empirical analysis of section three, which focuses on the link between investment flows in former Soviet states from the late 1990s to mid 2000 and levels of stability amongst these states, and highlights the potentially negative effect foreign investment may have had on the region. The paper concludes with a discussion of the policy implications of these findings.

CONVENTIONAL VIEWS ON TRADE AND INVESTMENT

Since the 1970s, much of the literature on economic growth has focused on the question as to why the 'West' has been able to accumulate significant amounts of wealth while other regions of the world suffer from comparable poverty (Lucas, 1988). Up until the mid 1990s this issue was widely disputed, not least on account of the different disciplinary approaches which contributed to this debate. However, partly due to the influence of the World Bank, International Monetary Fund and World Trade Organisation, a new consensus formed in the 1990s which emphasised trade as a principal source of wealth, and argued that the economies of wealthy nations could be distinguished from poorer ones primarily on account of their greater participation in world trade. Implicit in this new orthodox was a barely hidden policy agenda which advocated, for various reasons, the lifting of trade barriers and the expansion of global trade. Academically the new orthodoxy was underpinned most eloquently by the works of Jeffrey Sachs and Andrew Warners,

whose 1995 Brookings Paper *Economic Reform and the Process of Global Integration*, stated categorically that ".. Countries that are open to trade ... experience unconditional convergence to the income levels of rich countries". Apart from underpinning Sachs' unquestionably disastrous role in advising the collapsing Soviet Union on matters of economic restructuring, this view formed the groundwork for a host of policy initiatives which advocated the integration of transition and developed countries in the world economy as a means of combating poverty.

While political support for this orthodoxy has been strong, it has never been fully accepted amongst mainstream economists. Thus Rodrik's (2003) review of the literature on gains from foreign trade concluded that the evidence was clear that "trade yields relatively small income gains which do not translate into persistently higher growth". In as far as evidence for the positive effects of participation in trade and foreign investment was concerned, economists found that those directly employed by foreign companies experienced some, albeit fairly limited, welfare benefits. For instance, Aitkin, Harrison and Lipsey (1996) noted that foreign firms operating in developing countries tended to pay higher wages than indigenous firms; which they attributed to the possible application of superior technology. Similarly, Budd, Konings and Slaughter's (2004) investigation of multinational firms, led them to conclude that these firms engaged in patterns of rent sharing where the greater profitability of the parent company gave rise to higher wages. However, another study by Konings (2004) concluded that the employment effects of FDI itself were generally limited, primarily because employment relocation was mainly taking place between trans-national company parents which were located in similar, high-wage, countries. A study by Pavlinek (2002) on acquisitions and joint venture agreement in Central Europe was even more pessimistic in that it concluded that these activities did not result in improvements in employment conditions, but rather in the introduction of more effective managerial control and measures to enhance labour discipline (see also Woolfson and Beck; 2004).

While many of employment and wage effects of FDI suggest caution with regard to Sachs' proposition, it is on the level of aggregate data that the pro-trade/foreign investment hypothesis appears to suffer its greatest weaknesses. Although there is evidence of a long term, albeit inconsistent, growth in trade volumes over at least the last three decades, most historical studies of growth across regions find no evidence of an 'unconditional narrowing' of global income differentials. As one of the most comprehensive and thorough studies of long-term world income distribution, Maddisons's (2001) book *The World Economy: A Millenial Perspective*, instead strikingly observes an increase in inequality, in which the positions of 'Eastern Europe and the former USSR' and 'Africa' have markedly deteriorated (see Table 1).

Table 1) Interregional spread of per capita GDP (in USD, PPP, source Maddison, 2001, p. 126)

		1950	1973	1998
Western Europe		4,594	11,534	17,921
US, Canada, Australia, NZ	(1)	9,288	16,172	26,146
Japan		1,926	11,439	20,413
Asia (excl Japan)	(2)	635	1,231	2,936
Latin America		2,554	4,531	5,795
Eastern Europe & former USSR	(3)	2,601	5,729	4,354
Africa	(4)	852	1,365	1,368
World wide average		2,114	4,104	5,709
Ratio (1) to (2) Asia		14.5:1	13.1:1	8.9:1
Ratio (1) to (3) EE&USSR		**3.6:1**	**2.8:1**	**6.0:1**
Ratio (1) to (4) Africa		10.9:1	11.8:1	19.1:1

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Although Maddison's classification of 'US, Canada, Australia and New Zealand' into one group is perhaps somewhat counter-intuitive, his aggregate data permit some useful comparisons (see also

Berger, 2006 who discusses this data in some detail). Particularly interesting, in the light of the claim of 'unconditional convergence' are comparisons between the richest group (1) including the of 'US, Canada, Australia and New Zealand' with the three non-Western groups 'Asia' (2), 'Eastern Europe and former USSR' (2) and 'Africa' (3). Of these three groups only 'Asia' (2) experienced a significant reduction in income inequality from 14.5 to 1, to a still sizable 8.9 to 1 as compared to the richest group from the period from 1950 to 1998. 'Eastern Europe and the former USSR' (2), by contrast experienced an initial narrowing of its income differential to group (1) from 3.6 to 1, to 2.8 to 1 during the period from 1950 to 1973. From 1973 to 1998, however, the income differential of the 'Eastern Europe and former USSR' (2) group relative to the richest group more than doubled from 2.8 to 1 in 1973 to 6.0 to 1 in 1998. Although it can be reliably argued that 'Asia' experienced a massive expansion of trade during this period, the pro-trade argument breaks down when we consider that the 'Eastern Europe and former USSR' and 'Africa' groups also experienced increased trade and integration in the world economy. On the basis of aggregate data, then, there is not only evidence of a recent increase global polarisation, but also of trade having a polarising effect on at least two regions.

That this widening of income differential is not merely a matter of academic debate and economic data is perhaps best illustrated by linking this analysis to the, by now, well known phenomenon of the Russian mortality crisis. This data is reproduced in Table 2, not so much to illustrate the shocking decline of life expectancy among Russian males and the still quite pronounced decline among female which had occurred by 1994, but to point to the lesser known fact that the situation had not improved significantly by 2000.

Table 2)

Life expectancy in Russia and other countries (from Gavrilova, Semyonova and Evudkushkina, 2002, p. 20)

Country	Year	Life expectancy at birth	
		Males	Females
Russia	1991	63.5	74.3
	1992	62.0	73.8
	1993	58.9	71.9
	1994	**57.6**	**71.2**
	1995	58.3	71.7
	1996	59.8	72.5
	1997	60.8	72.9
	1998	61.3	72.6
	1999	59.9	72.4
	2000	**58.8**	**71.7**
India	1994-1997	62.4	63.4
China	1994-1997	69.0	73.0
US	1994-1997	73.6	79.4

Source Goskomstat, WHO

While the simultaneous occurrence of increased income inequality of the 'Eastern Europe and the former USSR' with the Russian mortality crisis is at least suggestive of a link, it would, of course, be difficult to draw direct causal connections. What is worth pointing out, however, is that there are several analyses which illustrate a close connection between the worsening economic position of the region post 1990 and indicators of well–being. One particularly striking study, conducted by Mesle and Vallin (2002), for instance, illustrates that, whereas in 1965 a ranking of male life expectancy included a mix of western and eastern nations, by 1995 a clear dichotomy had

occurred in which the top portion of the table was occupied exclusively by western nations, while the bottom was occupied by eastern ones (see Figure 1).

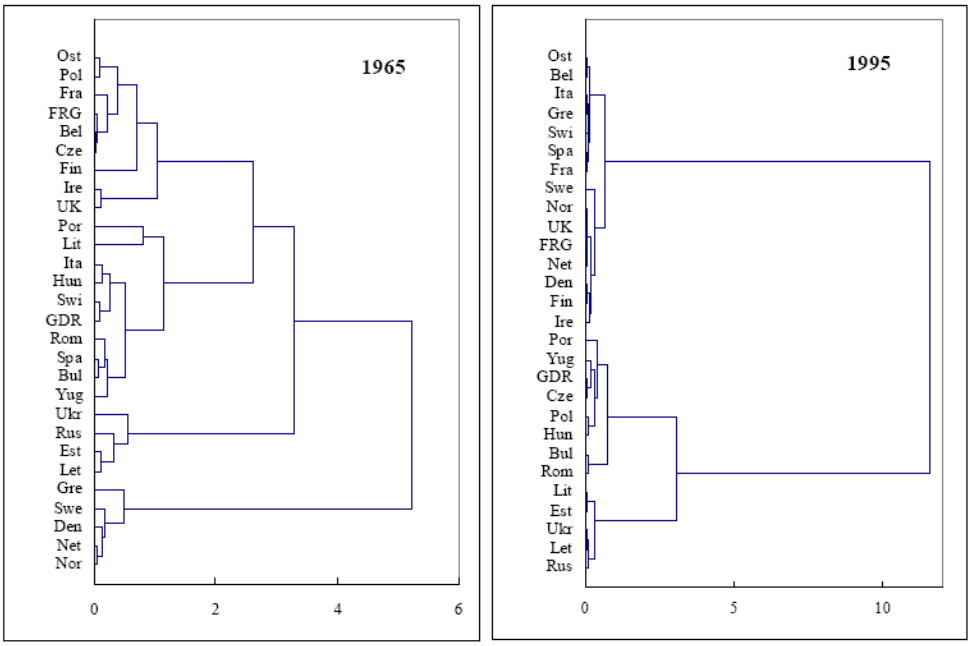


Figure 1. Dendrograms resulting from the hierarchical analysis of male age-specific death probabilities in 28 European countries, in 1965 and 1995.
Source: Meslé and Vallin, 2002

Taking into account these, and other, sources of evidence it is perhaps no overstatement to argue that the recent two decades of trade liberalisation have brought few tangible benefits to Eastern Europe and Russia as a region. What is more difficult to answer is the question as to whether trade liberalisation itself has damaged the region. To contextualise this question into a broader debate, the next section will review more recent neo-institutionalist theories of trade together with some of their more radical alternatives.

NEO-INSTITUTIONAL AND ALTERNATIVE MODELS OF TRADE AND DEVELOPMENT

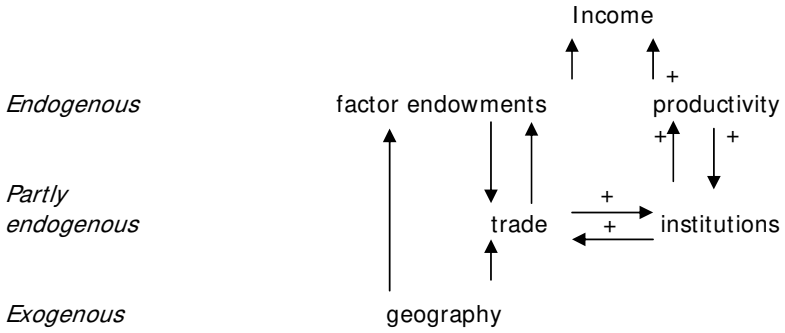
Contemporary theoretical approaches to the impact of trade on development no longer take an unambiguously positive role of trade and investment for granted. In particular there is now a broader acknowledgement of the fact that institutional structures mediate the impact of trade and investment. However, within this literature a number of micro-narratives continue to suggest that trade and investment are linked to increased growth and prosperity, even to the extent of having a 'unambiguously' positive impact on existing institutional structures. Specifically, the literature continues to recognise three mechanisms which allegedly create benefits from trade and investment. These include, firstly, strategic modernisation which describes a process where the recipient country gains access to the know-how and finance necessary to update equipment and bring about strategic restructuring together with an imposition of efficient corporate governance (Blanchard, 1997). Secondly, trade and investment are expected to create positive externalities which extend to a process where the introduction of new products and processes by foreign firms creates spillovers for the domestic economy (Teece, 1977). Lastly, and perhaps most controversially, increased trade and investment are expected to result in hardening budget constraints, where foreign participation in firms reduces financial links of local firms with government organisations, allowing central government to impose harder budget constraints and improve performance (Dewartipont and Maskin, 1995; Roland 2000).

At their core, neo-institutionalist narratives on trade and economic growth suggest that the integration of an economy into the work market cannot alone explain growth. Rather, growth is, apart from obvious factor endowments, dependent on the interaction of three factors, namely; i) participation in trade, ii) institutional development and iii) existing productive capacity (Rodrik, 2003). According to Rodrik, the income level of a country is dependent on its factor endowments which, in turn, are determined by the availability of physical and human capital. However, the effect of these factor endowments is mediated by economies' levels of productivity. In other

words, economies with similar levels of physical and human capital can differ significantly in terms of their wealth and growth potential on account of different levels of productivity. In Rodrik's model (see Figure 2) factor endowments and productivity are 'endogenous.' The elements which establish these endogenous levels of factor endowments and productivity include trade and institutions, which Rodrik describes as being 'partly endogenous.' In other words, the positive effect which trade is likely to have on an economy depends in part on the absorptive capacity of institutions, with institutions having a more pronounced influence on income levels than trade (see also Rodrik, Subramian and Trebbi, 2001). Ultimately, therefore, the principal source of wealth for an economy is its productivity, albeit that improvements in a country's trade position can lead to improvements in its institutional make-up, which, in turn, positive affect the crucial parameter of productivity. Lastly, both trade and factor endowments are affected by a country's geography which, as exogenous factor, can play a key role in shaping a national economy's competitive position.

In terms of its policy implications Rodrik's model represents a limited, but not insignificant, deviation from Sach's orthodoxy on at least two counts. Firstly, it suggest that trade is not sufficient to initiate growth through productivity enhancement, if institutional structures are deficient. Secondly, is an implicit assumption that trade and foreign investment are likely to have a impact on both institutional developments and only indirectly on productive capacity (see plus signs in Figure 2).

Figure 2) Rodrik's model of income generation



While Rodrik's model and similar neo-institutionalist narratives on income and growth have their appeal, particularly when compared with earlier uncritical assumptions with regard to the benefits of international trade, they have struggled to find convincing empirical support. Rodrik's own (2003) work entitled *The Search for Prosperity*, purports to include case studies in support of the model's core assumptions. Accordingly, the book includes fourteen country studies which are meant to illustrate how the interaction of institutions and trade either created, or failed to create, prosperity. Interestingly, none of these country examples include a post-Soviet country. Examples of a successful translation of trade into wealth include Australia, India, Botswana, Vietnam, Mauritius, Venezuela, Poland, China and Mexico. Examples of largely unsuccessful absorption of trade include the Philippines, Indonesia, Romania andBolivia, with Pakistan representing an 'undecided'. While it is futile to unpick these arguments at any length, it is probably worth mentioning that Botswana's economy recently faced a near complete collapse, triggered partly by its close economic ties with Zimbabwe. Similarly, Venezuela, despite its oil wealth underwent a major economic crisis in mid 2000 which brought a socialist government to power. The Philippines, Indonesia and Romania, rather than being condemned to hopeless underperformance, meanwhile, appear to experience moderate economic growth.

The fact that applications of neo-institutionalist models of growth do not perform unambiguously well when applied to concrete case studies, needless to say, does not necessarily discredit this intellectual enterprise. What is perhaps more troubling are other issues which include the fact that, as a theory, Rodrik's model is potentially overdetermined. In other words, it offers an opportunity to explain the absence or presence of trade-induced growth on the basis of institutional weaknesses, while institutional stagnation or development, in turn, can be linked to the presence of absence of trade. This offers the very real possibility that virtually any event or development with regard to a country's economic fate can be explained on the basis of at least some of the elements of the model. Perhaps even more troublesome, is the fact that the model ignores a significant intellectual tradition which views, and has viewed, trade as a potentially detrimental force in as far as the institutional, social and political development of developing and transition nations is concerned.

While it is beyond the scope of this paper to examine this alternative literature at any level of detail, it perhaps worth briefly mentioning some of its key milestones. Economists first voiced concerns over the impact of trade and investment on lesser developed economies in connection with the, largely continental, imperialism debate of the early 20th century. At the time an intense debate took place among leftist intellectuals who examined the instability of contemporary advanced capitalist systems and highlighted the economic role of colonialism and imperial expansionism as practised by the main European powers and the US (see e.g., Luxemburg's *The Accumulation of Capital*, originally published in 1913 and Bukharin's, *Imperialism and the World Economy*, originally published in 1916). Bukharin's work in particular hypothesised that export of capital by heavily industrialised nations would lead to the subjugation of the economic interests of the recipient country. In chapter seven of his *Imperialism and the World Economy,* Bukharin stated:

> Looked upon from the point of view of the spreading of the organisational forms of modern capital, capital export is nothing but a seizure and a monopolisation of new spheres of capital investment by the monopoly enterprises of a great nation or - taking the process as a whole - by the organised "national" industry, by "national" finance capital. Capital export is the most convenient method for the economic policy of finance groups; it subjugates new territories with the greatest ease.

In the 1970s a number of researchers attempted to re-examine earlier notions of imperialism within a structuralist context, with a view toward explaining the persistence of underdevelopment within certain regions. In his, at the time, widely read paper *A Structural Theory of Imperialism,* Galtung (1971) proposed a concept of 'core and periphery' in which Core, or industrialised, nations established core areas within the Periphery, or developing nations, in order to facilitate trade. According to Galtung, this core and periphery system superficially benefited both Core and Periphery nations, while, at a deeper level, sustaining a type of unequal trade and exchange which Galtung described as imperialism or structural violence. Specifically Galtung (1971, p.81) noted that:

> Imperialism will be conceived as a dominance relation between collectives—particularly between nations. It is a? sophisticated type of dominance relation which cuts across nations, basing itself on a bridgehead which the center of the Center [sic] nation establishes in the center of the Periphery [sic] nation, for the benefit of both. ... Briefly stated, imperialism is a system that splits up collectives and relates some of the parts to each in relations of harmony of interests, and other parts in relations of disharmony of interest, or conflict of interest.

While Galtung's analysis was primarily concerned with the role Western economic activity played in fermenting conflict within periphery nations, he attributed a crucial role to trade and foreign investment in supporting institutional structures which cemented existing relationships of exploitation and contributed to political instability.

Galtung's core and periphery theory was further developed by Wallerstein's (1979) who introduced the concept of the 'semi-peripheral state'. According to Wallerstein, semi-peripheral states played a key role in the capitalist system, on account of their ability to absorb products of richer nations. However, Wallerstein argued, there was no guarantee for the future prosperity of the nations and no evidence that these nations would benefit from a future expansion of trade. In his chapter *Dependence within and Interdependent World* (1979, p.71) , Wallerstein specifically argued:

> In a system of unequal exchange, the semiperipheral country stands between in terms of the kinds of products it exports and in terms of the wage levels and profit margins it knows. Furthermore, it trades or seeks trade in both directions, in one mode with the periphery and in the opposite with the core. Whereas at any given moment, the more *balanced* trade a core country or a peripheral country can engage in, the better off it is in absolute terms, it is often in the interest of the semiperipheral country to *reduce* external trade, even if balanced, since one of the major ways in which the aggregate profit margin can be increased is to capture an increasingly large portion of the *home* market for its *home* products. (emphasis in the original)

Wallerstein was not only reluctant to accept the assumption that foreign investment and trade will have a positive effects on the recipient economy, but went as far as to argue that foreign

investment which was led primarily by the needs of the developed country was destined to be detrimental to the recipient economy.

While the structuralist analysis of inequality has ceased to attract the attention of mainstream scholarship on development, a series of more recent papers have borrowed heavily from some of the core notions of this literature. A striking example of this is the work of Moran whose notion of benign and malign foreign investment relies heavily on earlier ideas about the potentially undesirable effect on unconstrained trade. In his book *FDI and Development: A New Policy Agenda for Developing Countries and Economies in Transition*, Moran (1998, p. 20) argues that:

> Instead of filling the gap between savings and investment, Multinational Enterprises (MNEs) may lower domestic savings and investment by extracting rents and siphoning off the capital through preferred access to local capital markets and local supplies of foreign exchange. Instead of closing the gap between investment and foreign exchange, they might drive domestic producers out of business and substitute imported inputs. The MNE may reinvest in the same or related industries in the host country and extend its market power. The repatriation of profits might drain capital from the host country. MNEs' use of "inappropriate" capital intensive technologies may produce small labour elites while consigning many workers to the ranks of the unemployed. Their tight control over technology, higher management functions and export channels may prevent the beneficial spillovers and externalities hoped for in more optimistic scenarios.

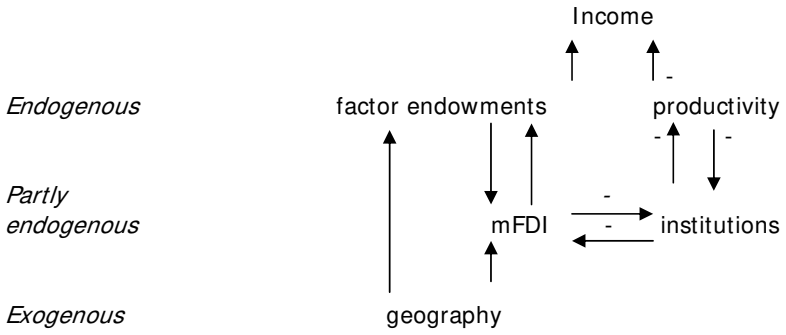
Implicit in Moran's analysis is the assumption that, rather than contributing to institutional development and productivity, certain types of FDI have the potential to undermine existing

institutional growth trajectories and, in so doing, forestall future economic growth and development.

Although analyses of the type presented by Moran still represents a minority view amongst development economists, it is interesting to note that even some researchers involved in contemporary international policy making have started to adopt a critical perspective on the institutional impact of foreign investment. One example of this are the economists Hausmann and Fernandez-Arias (2000) who presented a paper to the Annual Meeting of the Board of Governors, Inter-American Development Bank and Inter-American Investment Corporation which noted that "the view that capital inflows tend to take the form of FDI – share of FDI in total liabilities tends to be higher – in countries that are safer, more promising and with better institutions and policies was misleading". Specifically Hausmann and Fernandez-Arias found that, while some capital flows tended to target countries that were safer, more developed, more open, more stable and had better and advanced institutions and financial markets, the share of FDI in total capital flows to these countries tended to be lower that to less stable regions. This analysis not only suggested that FDI often targeted countries that were riskier, poorer, more volatile and more closed, but also that foreign investment quite possibly contributed to regional instability.

Collectively these alternative approaches to foreign investment suggest a model of trade and development which differs radically in its outcomes from the neo-institutionalist paradigm. Applying the notion of malign investment to Rodrik's framework, it can be argued that certain types of investment (here denoted as mFDI for malign FDI) can weaken existing institutions, while being themselves attracted to institutionally weaker environments. This potentially vicious cycle of institutional erosion and malign FDI inflows, in turn, is likely to adversely affect the domestic productive capacity of the recipient country productivity and, ultimately, its wealth (see Figure 3).

Figure 3) Malign investment and the erosion of domestic capacities



While there is no conclusive empirical study which documents the institution-eroding effects of malign investment, there is ample anecdotal evidence on how developing and transition countries suffered from institutional disintegration and political instability as a consequence of FDI (see, e.g., Marriott and Muttitt, 2005). This pattern appears to be particularly pronounced where these investments centre on primary and/or extractive industries at the costs of the recipient country's secondary and tertiary sectors.

The remaining sections of this paper will examine firstly, some of the key characteristics of FDI in former Soviet states. Secondly, it will seek analyse the potential link between FDI and political instability in some post-Soviet states.

FOREIGN DIRECT INVESTMENT IN FORMER SOVIET STATES

Since the collapse of the Soviet Union the FDI performance of its former constituents has been patchy. Table 3 lists absolute figures for FDI inflows into former USSR countries from 1997 to 2005. Perhaps unsurprisingly, this data indicates a massive acceleration of FDI inflows into the

Baltic countries in the run-up to their EU accession. By contrast, a number of former Soviet states with significant levels of industrial development, such as Belarus, Moldova and the Ukraine, either have experienced no significant increases in FDI inflows, or have received FDI inflows which are disproportionately low given their level of industrial development and population size; particularly in comparison with the Baltic states.[1] The two oil producing Central Asian countries, Azerbaijan and Kazakhstan, stand out in terms of FDI inflows and FDI growth with FDI figures for recent exceeding all other former Soviet states, including the Baltics, with the sole of exception of Russia. This contrasts dramatically with the other Central Asian countries, Armenia, Georgia, Kyryzstan, Tajikistan, Turkmenistan and Uzbekistan, which have experienced negligible FDI inflows.

Table 3) FDI inflows in million US dollar

*Foreign Direct Investment Inflows, $m**

Country	Years								
	1997	1998	1999	2000	2001	2002	2003	2004	2005
1. Former USSR Countries									
1. 1. *Central & Eastern Europe:*									
1. Belarus	352	203	444	119	96	247	172	164	305
2. Moldova	79	76	38	129	156	132	78	154	225
3. Russia	4865	2761	3309	2714	2469	3461	7958	15444	14600
4. Ukraine	623	743	496	595	792	693	1424	1715	7808e
1.2. *Central Asia:*									
5. Armenia	52	221	122	104	70	144	157	217	220
6. Azerbaijan	1115	1023	510	129	227	1392	3285	3556	1680
7. Georgia	243	265	82	131	110	165	340	499	450
8. Kazakhstan	1321	1152	1472	1283	2823	2590	2092	4113	1738
9. Kyrgyzstan	84	109	44	-2	5	5	46	175	47
10. Tajikistan	18	25	21	22	9	36	14	272	54
11.Turkmenistan	108	62	89	131	150	100	100e	-15e	62e
12. Uzbekistan	167	140	121	73	570	65	70e	1e	45e
1.3. *Baltic Countries/ New EU Countries:*									
13. Estonia	267	581	305	387	542	284	919	1049	2853
14. Latvia	521	357	347	410	164	254	292	699	632
15. Lithuania	355	926	486	379	446	732	179	773	1009

* Source: UNCTAD, (2003-2006), World Investment Report.
e Estimates

While it is obvious that in absolute figures, as well as in per capita terms, Azerbaijan and Kazakhstan, vastly outperformed other former Soviet states, it is important to note that even these

[1] This analysis excludes the most recent figure for the Ukraine which is a potentially unreliable estimate.

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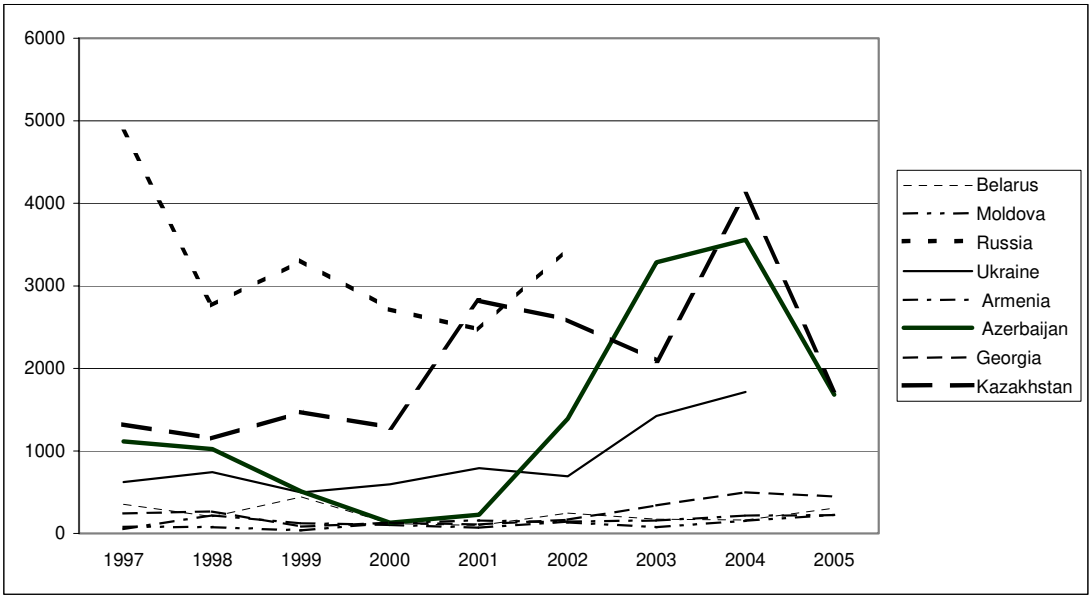
countries have experienced dramatic fluctuations in terms of the amounts of FDI they have received during this period. This pronounced instability of year-by-year FDI inflows is depicted in Figure 4, in which recent figures for Russia and Ukraine have been excluded in order to provide a more readable scaling of the trend lines. Apparently, in as far as there has been substantial investment in former Soviet states, this has centred on a very limited number of countries, who themselves could not rely on stable and regular inflows of foreign capital.

Figure 4) FDI inflows in million US dollar



Although there is a long history of complaints among potential foreign investors about the vagueness of government attitudes to foreign investment, the existing differences in FDI inflows can only be insufficiently explained by the attitudes and actions of these post-Soviet states. Rather, the unequal regional distribution of FDI in the post-soviet territories appears to be primarily determined by the presence, or absence, of natural resources.

Hitherto, natural resource and food industries have been the most attractive targets for foreign investment. In Russia, the fuel and food sectors lead in terms of share of total FDI inflows with 23% and 28%, respectively. They are followed by trade, transport and telecommunication. The machinery, timber and other sectors, meanwhile, have hardly received any investment at all. Large scale investments in the oil and gas sectors have included about 50 joint ventures and involved American, British, French, German, Canadian, Japanese and other companies. The scale of projects in the food sector is significant as well with foreign companies showing an interest in pastries and meat industries as well as the production of non-alcohol drinks, beer and tobacco (Yacheistova, 2001),

As an example of an industrialised state which has attracted only limited amounts of FDI, Ukraine had attracted less than 6 billion dollars in FDI by 2004, which comprised only about a seventh of the officially estimated 40 billion dollars required for restructuring its economy. A detailed analysis of FDI flows indicates that these were quite small and often used inefficiently. For example, foreign investment inflows in Ukraine during the first half of the year 2001 were 12.4% less then the amount of FDI inflows during the corresponding period of the year 2000. As in Russia, foreign investors targeted the Ukrainian food and agricultural processing industry. The FDI share into this sector comprised 19.8% of the total investment inflows. Wholesale and sale mediation attracted 13.9% of investment. Investment into machine-building industry, finance sectors and transport were equal to 8.2%, 7.9% and 6.8% of total investment inflows, respectively (State Statistics Committee of Ukraine, 2002).

In Azerbaijan the largest share of FDI was received by the country's main industry – oil. The high level of investment in this area, however, has hardly benefited other sectors. For instance, amidst complaints about corruption and unfair practices by officials, as well as declining traffic volumes, several international airlines have abandoned their operations in the country. Specifically, during the period of 1999-2000, six different companies, Austrian airlines, Pakistan Air, British Airways, KLM, Lufthansa and Emirates have ceased operations in Baku's Bina International Airport (WMRC, 2004a).

In Kazakhstan, which, by 2004 had received seventeen billion dollars in FDI since independence, there is evidence that foreign investment had a de-stabilising effect on the local economy, which has led to increased frictions between the states and foreign investors. Thus, a number of high profile international investors, such as TengizChevroil, Canada's Hurricane Hydrocarbons Ltd and the Carachaganak Petroleum Operating Company, have faced Environment Ministry accusations of opaque sales and environmental breaches. Moreover, a newly enacted Investment Law, approved in 2003, stipulates that new contracts negotiated with foreign companies will no longer contain a "grandfather clause" that shield the company from regulatory and tax changes. The law also prevents companies from resorting to international arbitration if the Kazakh government forbids this. Furthermore, the law eliminates preferences for foreign investors with a view towards "creating a level playing field between domestic and foreign companies" (WMRC, 2004b).

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Both Kazakhstan and Azerbaijan, meanwhile, appear to suffer from a rise of governmental authoritarianism and are even showing 'dynastic' tendencies. In October, 2003, for instance, for the first time, the rule of a post-Soviet state was passed from father to son as a result of Azerbaijan's presidential elections. In Kazakhstan, President Nursultan Nazarbayev's eldest daughter, the country's biggest media baron, is creating a new political party and is believed to be groomed for the succession of her father. These, and many other, events are indicative of the potentially adverse effects of the newly found foreign-sponsored wealth.

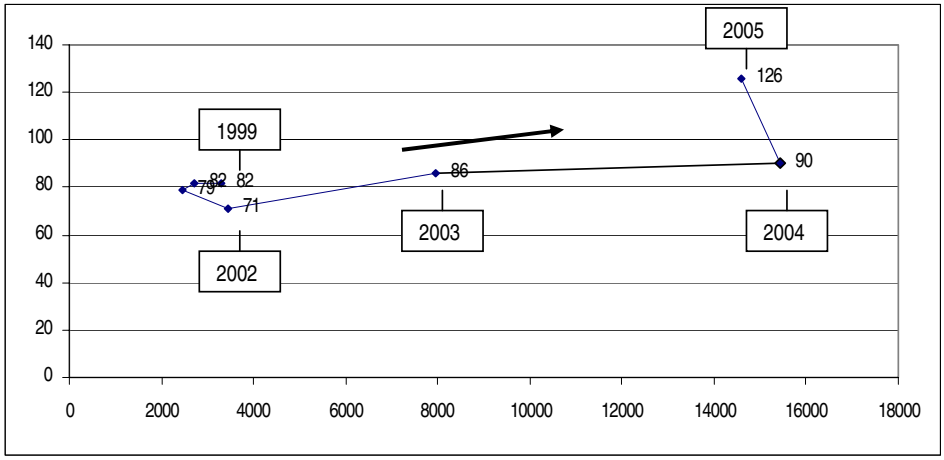
FOREING INVESTMENT, CORRUPTION AND POLITICAL INSTABILITY: AN EMPRICAL ANALYSIS

Today, any evidence regarding the link between foreign investment and increases in corruption and political instability remains largely anecdotal. Nevertheless, as far as former Soviet states other than the Baltics are concerned it is difficult to find instances in which foreign investment appears to have had a positive impact on the recipient countries political institutions. Put simply, FDI inflows have increased in a number of former Soviet states, and where this has been the case, so typically has corruption.

Figures 5 to 7 depict scatterplots of the *Corruption Perception Index* rank and FDI inflows for the period from 1999 to 2005 (Transparency International, 2006). The *Corruption Perception Index* is collected by the international voluntary association *Transparency International* and ranks countries according to a number of criteria, including bond ratings, as those which are internationally perceived as most or least corrupt.

As concerns the scatterplot for Russia, it can be noted that the country experienced a small decline in its corruption ranking alongside a decline in FDI. This situation, however, changed from 2002, when a massive increase in FDI inflows was accompanied by a modest increase in the country's corruption rank. Between 2004 and 2005, lastly, a small decline in FDI inflows occurred which was accompanied by a pronounced increase in the country's corruption perception ranking.

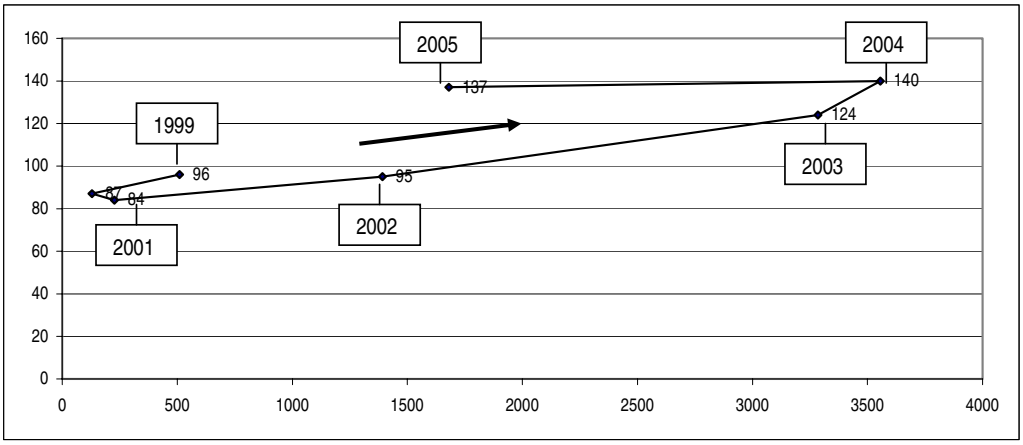
Figure 5) Russia: Scatterplot of *Corruption Perception Index* rank and FDI inflows, 1999-2005



This pattern is closely mirrored by the scatterplot for Azerbaijan. Here too an initial decrease in FDI was accompanied by a decline in the country's corruption ranking. From 2001 onwards,

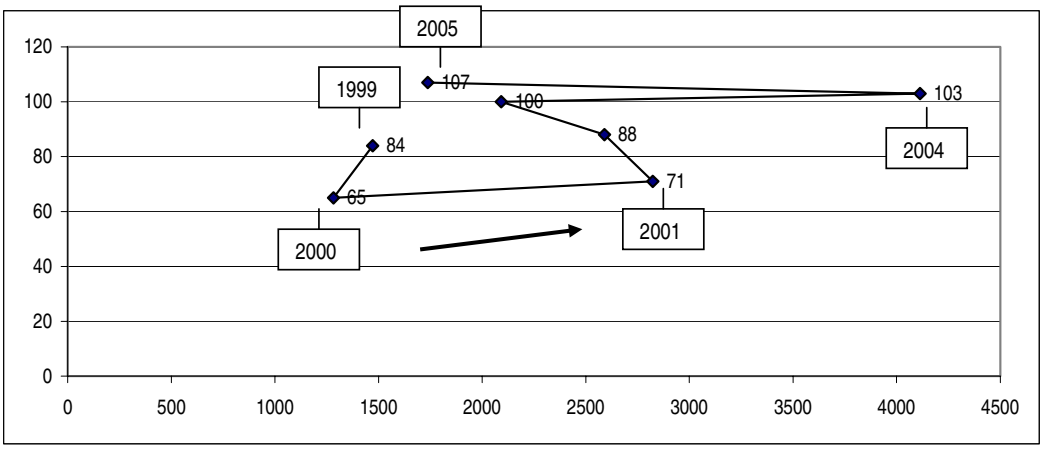
however, Azerbaijan experienced both a massive increase in FDI inflows and in its corruption ranking. This situation changed only between 2004 and 2005, when the annual FDI more than halved and the country's corruption perception ranking declined from 140th to 137th.

Figure 6) Azerbaijan: Scatterplot of *Corruption Perception Index* rank and FDI inflows, 1999-2005



The scatterplot for Kazakhstan deviates from the previous two patterns in several minor respects. Initially, Kazakhstan's corruption ranking decreased alongside a decline in FDI. From 2000 to 2001, both FDI inflows and the country's corruption rank increased. This was followed by a period from 2001 to 2003, when FDI inflows decrease while the corruption rank continues to increase. Between 2003 and 2004 a massive increase in FDI inflows took place which was again accompanied by an increase in the country's corruption perception rank, this time from 100th to 103rd. The period from 2004 to 2005, lastly, saw a decrease in FDI alongside a continuing increase in the corruption index, this time to 107th.

Figure 7) Kazakhstan: Scatterplot of *Corruption Perception Index* rank and FDI inflows, 1999-2005



Taken together these analyses lend limited support to the hypothesis that increased inflows in FDI are likely to be linked to increases in corruption and possibly political instability in the recipient country. Needless to say, the simultaneous occurrence of increased FDI inflows together with increased corruption, if this is indeed measured by this index, does not in itself imply a causality. What it does suggest, however, is that FDI has not had, as previously often assumed, a corruption-reducing effect on post-Soviet recipient states.

The remaining sections test the relationship between country risk indicators as reported by World Market Research Centre (WMRC) country reports and various economic variables (including FDI) for the above listed countries. This analysis deliberately excludes the three Baltic states, whose economic development was affected relatively early on by their eventual succession to the European Union (Hunya, 2004).

This analysis is conducted via a pooled regression analysis where data for twelve countries (namely the Central and Eastern European States of Belarus, Moldova, Russia, and Ukraine, and the Central Asian Republics of Armenia, Azerbaijan, Georgia, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan) and nine years (1997-2005) are investigated in terms of three models. These include Ordinary Least Squares (OLS), Least Squares Dummy Variables (LSDV) and the General Least Squares Error (GLSE) Model. Of these models, the LSDV model can be considered the most reliable since the OLS model is likely to produce overinflated t values on account of serial correlation, and the GLSE is likely to underestimate the significance of coefficient (Stimson, 1985).

In the following analysis, test are conducted for the WMRC variables, Overall Country Risk (OCR), Economic Risk (ER) and Legal Risk (LR).[2] World Market Research Centre (WMRC) defines:

- Economic Risk (ER): as degree of market orientation, policy consistency and forward planning, diversity and resilience of the economy, macroeconomic fundamentals;
- Legal Risk (LR): as a measure of a country's legislation, transparency, independence, and experience; and
- Overall Country (OCR): as a composite indicator of these risks plus Tax Risk, Operational Risk and Security Risk.

Despite the lack of more detailed data and the fact that these risk variables are based on a number of assumptions, the relationship between these variables and FDI is remarkably stable; with FDI having a significant positive (risk increasing) coefficient for most of the relevant LSDV model outputs.

[2] It should be noted that this analysis has excluded a fourth WMRC variable, namely political risk. The reason for this is that this variable shows a strong path dependency in the sense that the stability of democratic governance systems has strong historical determinants and appears to change only marginally over time. For the purpose of our argument regarding the potentially malign effects of FDI, both economic and legal risk appear to be the more suitable variables.

The first part of the analysis utilizes WMRC's score for 'Overall Country Risk' (OCR) as dependent variable (Table 4). Overall this analysis performs well for both the LSDV and the GLSE variant. For the more reliable LSDV variant, 53.1% of the total variation is explained by the five independent variables, 'FDI as % of GDP', 'Government Debt as % of GDP', 'GDP per capita', 'Unemployment rate' and 'Trade Balance as % GDP'. Of the independent variables both 'Government debt' and the 'Unemployment rate' have a significant, risk increasing, effect on overall country risk at the .05 level of significance or above. 'FDI as % of GDP' also has a risk increasing effect, but here the significance is more marginal (.12 level of significance).

Table 4) Overall Country Risk (OCR)

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP	.0295	.0249	.0065
	(1.915)	(1.544)	(.858)
Gov Debt as % GDP	.0106	.0197	.0048
	(4.160)	(5.281)	(2.885)
GDP per capita	.0003	.0002	.0001
	(3.275)	(1.119)	(0.644)
Unemployment rate	.0185	.0665	.0387
	(1.279)	(2.058)	(3.249)
Trade Balance as % GDP	-.0065	-.0019	-.0021
	(-.965)	(-.0168)	(-.512)
R square adjusted	28.9	53.1	21.5

While it is probably not surprising that government debt and unemployment would increase the overall riskiness or decrease its overall stability, it is interesting to note that, contrary to the assumptions of the benign model of FDI, the variable 'FDI as % of GDP' also exerts a negative influence on 'Overall Country Risk'.

This pattern of a risk increasing role of FDI is confirmed for the dependent variable 'Economic Risk' which is examined in the next set of models (Table 5). Again this analysis performs well for the LSDV model which yields an adjusted R Square value of 46.4%. In this model, 'Government debt' and the 'Unemployment rate' have again a significant, risk increasing, effect 'Economic Risk' at the .05 level of significance or above. 'FDI as % of GDP', meanwhile also has a significant risk increasing effects, however, at the lower .01 level of significance.

Economic Risk (ER)

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP	.0169	.0314	.0068
	(1.060)	(1.744)	(.915)
Gov Debt as % GDP	.0109	.0191	.0027
	(4.150)	(4.597)	(1.592)
GDP per capita	.0003	.0001	-.0001
	(2.717)	(1.080)	(-1.729)
Unemployment rate	.0300	.0768	.0530
	(1.999)	(2.1297)	(4.175)
Trade Balance as % GDP	-.0112	-.0037	-.0023
	(-1.596)	(-.301)	(-.558)
R square adjusted	30.0	46.4	21.6

Perhaps the most interesting results are gained by re-examining this model with the third dependent variable of 'Legal Risk'. This variable, which assesses a country's system of legal and commercial governance, probably most closely mirrors the assumptions of the previously discussed opposing models of benign versus malign foreign investment, as it focuses on country-specific governance competencies. Again the result of these models closely mirrors those of the previous analysis, with the LSDV model performing well and yielding an adjusted R square value of 48.9%.

However, in case of the dependent variable 'Legal Risk', the independent variables 'Government debt' , the 'Unemployment rate' and 'FDI as % of GDP' have a significant, risk increasing, effect at the .05 level of significance. The significance of the 'FDI as % GDP' in this model in particular, lends strong support to the previously discussed hypothesis of a malign effect FDI in terms of political stability in the context of post-Soviet states.

Legal Risk (LR)

Model	OLS	LSDV	GLSE
Indep Variables			
FDI as % of GDP	.0263	.0337	.0126
	(1.494)	(1.916)	(1.552)
Gov Debt as % GDP	.0070	.0197	.0031
	(2.408)	(4.7064)	(1.540)
GDP per capita	.0004	.0012	.0001
	(3.587)	(1.494)	(1.316)
Unemployment rate	.0070	.0363	.0250
	(.419)	(1.003)	(1.822)
Trade Balance as % GDP	-.0054	-.0047	.0002
	(-.694)	(-.037)	(0.033)
R square adjusted	32.0	48.9	30.1

Although the previous regression analyses are inevitably affected by any weaknesses in the underlying data, they strongly point to the possibility that, at least for the period during which these countries were examined, FDI was having an overall destabilising effect on domestic institutional competencies. While this analysis does not necessarily the confirm the hypothesis of a malign effect of foreign investment, it certainly contests the conventional assumption that FDI will positively impact on the institutional structures and the stability of recipient countries.

CONCLUSION

The paper has sought to examine the conventional assumption of a benign role of foreign investment, together with its opposing hypothesis of malign FDI in the context of post- Soviet states. Although our results point to the possibility that, on the whole, foreign investment may have had negative effects on the region, this analysis must necessarily be interpreted with caution. Specifically some of the factors which limit the generalisability of these findings include the fact that the regression analysis in particular covers a limited time frame during which some parts of the region, such as Georgia and Azerbaijan were, *ab initio*, characterised by involvement in conflict and instability. Secondly, during the period examined here a very large amount of foreign investment was concentrated on a small number of natural resource-endowed states, which could have a distorting effect on the overall data analysis.

Despite these caveats it is probably valid to note that this analysis throws doubt on the, often politically motivated, advocacy of FDI which presupposes that the interests of multinational investors are identical with those of recipient states. Without more concrete evidence in its support, the assumption of a benign effect of foreign investment is no more than speculation, irrespective of how many international organisations pay lip service to this; and what is more, it is an assumption that needs to be very carefully and critically examined.

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