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The Role of FDI in Trade and Financial Services in Transition: Are Transition and “Development” Different?¹

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Michael Keren and Gur Ofer²

1. Introduction

It is often said that once the communist system has collapsed, TEs (transition economies) have become plain DEs (developing economies). A cursory look at the statistics of FDI in retail and wholesale trade and in financial services in both groups of countries shows how different they are, at least on this score. As can be observed in Table 1, the shares of incoming FDI in commercial services and financial services in total FDI, which were close to naught before the start of transition, are now, at the end of the 1990s, higher than all groups of DEs. The share of FDI in commercial services, at an average of 13 percent of total FDI in TEs, as compared with around 4 percent in DEs and 15 percent in developed economies. The case of financial services is only somewhat less striking. Here too their share in TEs has risen to 11 percent on average, that while lower than in developed economies (above 20% and rising), it is much higher than in DEs, where the share has shrunk from close to 10 percent in the 1980s to under 2 percent a decade later. Our aim in this paper is to explain why this is so, to show why FDI in these service branches has such a crucial role to play, a role that it does not have in DEs and that underscores the great differences between the relatively developed TEs and the DEs.

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Table 1: FDI Stocks by Industrial Groupings (Share, %)^a

	<u>Developed countries</u>		<u>Africa</u>		<u>Asia</u>		<u>Latin America</u>		<u>Total developing</u>		<u>World</u>		<u>Central and Eastern Europe</u>
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)
	1988	1997	1988	1997	1988	1997	1988	1997	1988	1997	1988	1997	1999
PRIMARY SECTOR	11.9	7.6	51.8	53.4	8.4	3.4	8.8	5.7	10.3	3.8	11.7	6.3	3
MANUFACTURING	38.2	33.4	20.8	26.8	61.7	61.5	67.3	38.8	62.1	59.5	41.4	42.5	38
SERVICE SECTOR	44.6	55.9	27.4	19.8	29.2	32.8	23.8	55.5	27.2	34.7	42.3	48.5	56
Trade and Repairs	13.9	13.8	-	2.4	4	3.2	4.3	6.6	4	3.5	12.6	10.2	12
Hotels and Restaurants	0.6	1.2			2.6	2.1		0.1	1.6	1.9	0.7	1.4	1
Financial Intermediation	16.5	21.3	0.3	0.4	12.6	1.1	5.3	7.5	9.5	1.7	15.5	14.4	11
Real Estate and Business Activities	3.7	3.2			2.1	16.3	0.7	1.7	1.5	15	3.4	7.3	7

Sources: Columns (1) to (12) from UNCTAD, *World Investment Report 1999*: columns (1), (3), (5), (7), (9), and (11)—Annex Table A.I.18., FDI Inward Stock by Industry, 1988, in UNCTAD, *World Investment Report 1999*. Columns (2), (4), (6), (8), (10), and (12)—Annex Table A.I.19., FDI Inward Stock by Industry, 1997, in UNCTAD, *World Investment Report 2000*. Column (13): Figure II.30, in UNCTAD, *World Investment Report 2000*.

a. Totals do not add up to 100% because of omitted items.

The apparent higher interest of foreign investors in investment in trade and financial services in TEs stems from three main factors, opportunities to contribute to the transition process and therefore earn profits. These opportunities are very difficult for domestic providers to provide. The first opportunity stems from the poor quality of C&FS (commercial and financial services) during the years following the collapse of the socialist system. Under the socialist system these services served the centrally planned system and the nature of its operation and were therefore very different than in the capitalist world, and unsuitable for the market environment of transition. Both trade and financial services served essentially technical roles of transfers of goods and money according to plan, and didn't bother about such functions as "marketing" or "risk based lending". Also the physical infrastructure, especially of trade, and the service environment were extremely poor. As a result most of the domestic services that developed during the first years of transition were of low level of know-how, technology management and organization, and provided poor quality of service. Indeed these branches had to be built anew, even if a physical logistical infrastructure of the services, like stores or 'banks' did exist. They can be provided in a much better fashion by those who possess the missing know-how and experience, foreign trading houses and real banks respectively, or at least with their active assistance and guidance. Second, as crucial a role of these services in the process of transition is the forward and backward linkages that they create with the rest of the economy. It is the backward linkages of commercial services, the trade networks which compel domestic suppliers to adopt a culture of market and consumer orientation, encourage them to develop modern technologies and management, guide them to improve their products and change their mix and forces them to adjust to market conditions. Former culture, know how and techniques may, however hinder the needed changes. In the sphere of financial services it is the forward linkages of financial intermediaries that can force their customers, local firms, to restructure their production and

to adopt a market oriented and transparent governance pattern and structure, an essential phase in their transformation into market-serving enterprises. By providing such linkages foreign C&FS can both contribute to transition and increase their own profits.

A third factor that contributes to the comparative disadvantage of TEs in C&FS stems from the fact that the structure of the production sector, inherited from the 'old regime' is very 'modern'. Modern in the sense that it is made up of large enterprises that use inputs from a large network of suppliers and sell (or can sell), nationally and internationally. This makes this sector highly dependent on modern trade and commercial networks for supply and sales and on modern financial institutions for their short and long run finance needs. Since the modern sector exists, and since it is also in an urgent need for production and managerial restructuring, the potential demand for modern C&FS is large and very urgent. At the same time most TEs are highly urbanized with many large cities, also in need of modern commercial and financial services.

In DEs the situation is very different: modern C&FS are being developed gradually as the share of the modern sector expands, partly on the basis of skills and experience accumulated in smaller scale organizations offering similar services to the developing traditional sector. The understanding of the functioning of markets and their culture is much higher than in TEs, even if the level of formal human capital is much lower. Finally, the modern production and the modern urban sectors are relatively small and most of the traditional economies don't use modern commercial or financial services. A much more detailed description and analysis of the comparative disadvantage of TEs in C&Fs also in comparison with DEs, can be found in Ofer, 1999, Keren and Ofer, 2000 and references there, Estrin et. al, 2000.

Table 1 above contains information on *actual* FDI stocks rather than on the potential demand or supply of such stocks under ideal conditions of free movement of funds and

entrepreneurship. In order to reflect only differences in relative comparative (dis-) advantage between TEs and DEs, one has to take account of factors that may hinder, or encourage, the FDI flows beyond their pure impact as listed above. A most important encouraging factor, affecting both TEs and DEs, is the recent fast expansion global trade and FDI in many services, faster than that of goods, an expansion that made it much easier for countries in demand to take advantage of them. This is a fortunate historical incident for TEs, the needed services are there just across the border for their use (Ofer, 1999; Keren and Ofer, 2000 and references there). Specific encouraging factors may be barriers to trade in similar services, like forcing foreign banks to move in order to get local business. True, such barriers are clearer when applied to goods and are less straight forward to services (see below). There are also schemes to encourage foreign investment. Barriers to FDI are plenty and can range from policy decisions to protect the corresponding domestic actors and the existing business organizations in the host countries against new entrants, in particular against foreigners. Other barriers can comprise of various features of the business and market environment in the host countries. We discuss these at length below. If the basic statement on the relative comparative disadvantage in C&FS between TEs and DEs is well founded, then it is in the interest of TEs to encourage such FDI and to minimize the barriers. However, TE governments, like governments everywhere, may not always follow their countries' best interests, due to political economy reasons and/or the inability to provide the necessary business environment.

The aim of this paper is to study in greater detail the factors that help determine the extent of FDI flows in C&FS to TEs and DEs, and to examine the available empirical evidence that may support the theoretical considerations. To what extent do TEs use the advantages of such FDI, what are the obstacles and why do they exist? The papers follows two papers by the same authors on the same general topics, Ofer, 1999 and Keren and Ofer,

2000, and it draws on them to some extent. The paper concentrates on FDI in services to TEs (and DEs), It takes the point of view of potential foreign multinational investors that are looking for investment opportunities abroad and are confronted with a variety of barriers in different countries, especially TEs. In this we follow the writings of Markusen and partners (1999, 2000) and the literature that they are using.

The paper proceeds as follows: Section 2, establishes a conceptual basis that determines the supply of FDI to different countries, and the barriers to its flow, including to TEs and DEs. Section 3 compares the industrial structure of FDI to TEs and DEs in detail. Section 4 positions TEs and DEs in the conceptual framework by developing a set of hypotheses on the relation between various structural and governance parameters and service FDI in TEs. Section 5 confronts these hypotheses with empirical evidence on these parameters and tests them against actual FDI flows. The following two sections, present empirical studies of the actual relation between parameters of governance and FDI, both total and in commercial services (section 6), and section 7 estimates the productivity advantages of FDI in C&FS in Russia over domestic providers. Section 8 concludes and lists additional needed research.

2. FDI: A conceptual framework

Like trade, FDI across borders comes to exploit a profit potential that cannot be captured in one's own country. The theory of FDI follows in many respects the theory of international trade, except that it has also to explain why FDI rather than trade is used in order to capture the potential profit. In both cases the motivation is that of a (potentially) multi-national firm that is looking for profit opportunities abroad. Like in trade there are two distinct patterns of FDI: the 'vertical' or inter-industry pattern, often found in FDI from developed to developing countries, exploiting industry-wide comparative advantages (as in Helpman, 1984). The

second pattern is 'horizontal' or intra-industry, where usually relatively specific advantages within given industries between developed countries are exchanged. As in trade, most FDI is of the latter type. Our interest in this paper, which deals with emerging and transition markets, is in the first type or in a combination of the two.

Production across borders is advantageous if it combines inputs from two countries that are cheaper, better or unavailable in one of them and if such inputs are either non-tradable for some reason or if there are artificial barriers for trade in them. Artificial barriers for trade in many technology-intensive products, under the policy of import substitution were an important motivation for FDI in many countries during the second half of the 20th century. Despite the fact that import substitution has lost its appeal, it is still quite common. Trade barriers are still very common in the sphere of business and financial services, though the trend for more openness and globalization made important inroads in these spheres too. Situations where non-tradability of production inputs prevails are, however, not less important and theoretically more interesting, also in the sphere of business services, like C&FS and similar services, the topic of this paper.

Before moving to the non-tradability issue, it is important to point out that a poor business environment in the host country, the absence of adequate business services, as well as an effective 'rule of law', is a major barrier for FDI in all lines of production, goods and services alike. This makes FDI in such services of special importance, in addition to its direct contribution to the domestic economy, also as a leverage for FDI in other lines of production. Furthermore, before the issue of tradability is raised it is important to note that for many business services the main barriers are sometimes not the ones mentioned above, that is barriers to trade, but the categorical refusal to permit FDI in the financial, commercial and business services. In many countries there are restrictions on the extent of foreign ownership of banks, insurance companies, trade networks, real estate and the like. As a result domestic

producers in demand for high quality services turn to the importation of such services, by working with foreign banks and other providers abroad. Such imports improve the performance of the clients, which can use them but hardly contribute to the improvement of the business environment inside the country. True, there are usually also barriers against the use of foreign banks abroad, and indeed they are used, illegally for the purpose of siphoning foreign currency abroad.

One of the most important inputs provided by FDI is *knowledge capital*, managerial services, engineering services, financial services (not necessarily finance per se), marketing services and information services, and similar intermediate business services. These services are centered in the headquarters of multinationals, of the developed countries of origin. They require high levels of human capital, they enjoy returns to scale (due, among others to the high information content in them), which is the source of the comparative advantage in their provision by developed countries. They are also known to have very important positive impact on production and growth, through the 'agglomeration' effect of their externalities.

According to Markusen et al. (2000) the business services included under the knowledge capital, are also not easily tradable, and therefore requires FDI in order to be transferred abroad. They are non-tradable because their dissemination requires the presence of the people with the appropriate skills in the host country, in order to work closely with local people and to be able to keep intensive and meaningful interaction with the headquarters abroad. Much of it is tacit knowledge, disseminated through learning-by-doing and not through formal instruction or by foreign experts. Markusen et al. (2000) emphasize that the knowledge capital imported through FDI complements rather than substituting and replacing local human capital in countries where the domestic level of human capital is high. This may be true in general but it is certainly true in the case of TEs, where the formal level of human capital is high but the specific skills for the provision of business services in a market

environment is very low. FDI to TEs therefore is even more beneficial. To these points one may add that a close cooperation and complementarity on location between local people who have what may be called the 'specific' knowledge capital inside the FDI project, seem to be the optimal formula.

In general FDI is driven by two motivations, to increase the export capacity of the host country and to penetrate its domestic market. While the use of knowledge capital is important in both cases, it is more pronounced when export is the main goal, since in such cases it is common to also find in DEs larger gaps in human capital. The penetration of the domestic market is more important in countries with large potential domestic markets, that is, large countries. The most common pattern of FDI in DEs was the development of an export capacity of important natural resources. FDI among developed countries is mostly aimed at market penetration. In TEs, both motivations work. Even if we abstract from the rich endowment of natural and energy resources of Russia and a number of other CIS countries, TEs comprise a very large potential domestic market and at the same time an important source of potential exports. This, together with their particular characteristics of human capital, make TEs a preferred target for FDI in C&Fs, even before taking into account their deep disadvantage in their provision.

The application of these models to TEs and DEs can be summarized as follows: TEs, with 'modern' economies and urban, highly educated societies, have a much higher demand for FDI in C&Fs. From the long tradition of central planning they inherited a completely different ways of providing such services and a different culture and approach of the incentives that drive them. In addition to the complete ignorance on how to provide C&Fs in a market environment, TEs also face difficulties of fighting against the old habits. We therefore expect to find still higher dependency on FDI, but also higher barriers for such FDI to come in.

In contrast to TEs, DEs have less human capital that can absorb the needed knowledge but they have better supply of intermediate level C&FS, developed over a long period of evolutionary development. DEs also have less demand for such services due to the smaller share of the modern sector in their economies and the lesser needs for its restructuring. At least part of the smaller 'modern sector' is run according to modern management, financing and marketing norms. Both TEs and DEs suffer from bad governance and weak laws and the rule of law. For both groups these weaknesses come from lack of experience in market economy under a democratic regime. TEs carry with them the traditions of central planning and autocratic regime. In DEs they come from different forms of traditional regimes that didn't experience industrialization and modernization. In this paper we try to observe the differences and their significance for the topic at hand. A comparative study of governance and the rule of law in TEs and DEs deserves a separate study.

3. The structure of FEI in services in TEs and DEs.

Table 2 presents the same type of data as table 1 above, on the industrial distribution of incoming stock of FDI for individual TEs, as well as an aggregate for the Czech Republic, Hungary and Poland. It uses data from two sources, OECD (2000) which provides data for members of OECD only and UNCTAD (2000) which provides data for almost all TEs. We have used the most recent data available for each country. Considering the time difference between the two sources the data are quite consistent. This is so especially if one allows for rapid growth of the share of FDI in trade and in financial services in the Czech Republic and Poland, and other business services in the Czech Republic during the second half of the 1990s.

The figures for the entire service sector, include, in addition to the services specified in the table, also FDI in utilities and in transportation and communications. These

infrastructure services are extremely important for a well-functioning modern economy, market or planned. Their level and quality in former socialist countries was in general quite low, transportation and even more so in communications. But we do not focus in this paper on these services, and they are therefore excluded from the discussion. Given the poor level of the entire service sector in TEs, it is not surprising that the share of FDI in it is higher than in most DEs (but similar to its level in Latin America: see **Table 1** above).

Table 2: FDI Stocks by Industrial Groupings (Share, %)^a

	<u>Cz+H+P</u>	<u>Czech Republic</u>		<u>Hungary</u>		<u>Poland</u>		<u>Estonia</u>
	OECD 1996	OECD 1996	UNCTA D 1998	OECD 1996	UNCTA D 1998	OECD 1998	UNCTA D 1999	UNCTA D 1999
PRIMARY SECTOR	1.4	1.3	1.0	2.0	1.4	0.4	0.3	1.5
MANUFACTURING	42.8	45.0	45.8	39.1	37.3	38.9	49.2	22.8
SERVICE SECTOR	45.2	49.7	53.2	58.8	61.4	32.1	50.5	75.2
Trade and Repairs	10.8	8.1	17.3	12.9	10.6	12.3	9.7	15.7
Hotels and Restaurants	1.0	0.0	0.1	2.5	1.8	0.2	1.2	1.0
Financial Intermediation	9.4	6.6	14.8	10.5	10.9	13.6	22.4	23.5
Real Estate and Business Activities	3.7	0.0	5.5	8.3	9.4	3.0	0.5	5.0
Unspecified services	0.2	0.0	0.1	0.8	0.0	0.2	0.0	0.0
UNALLOCATED	10.6	4.1	0.0	0.0	0.0	28.5	0.0	0.5

	<u>Latvia</u>	<u>Slovenia</u>	<u>Slovakia</u>	<u>Bulgaria</u>	<u>Croatia</u>	<u>Romania</u>	<u>Russia</u>	<u>Ukraine</u>
	UNCTA D 1999	UNCTA D 1998	UNCTA D 1998	UNCTA D 1998	UNCTA D 1999	UNCTA D 1999	UNCTA D 1999	UNCTA D 1998
PRIMARY SECTOR	1.2	0.0	1.4	1.6	3.4	3.0	10.7	4.2
MANUFACTURING	17.1	51.5	49.1	49.4	41.1	43.8	35.3	43.5
SERVICE SECTOR	72.7	48.5	49.6	49.0	44.2	53.1	35.5	39.7
Trade and Repairs	16.3	16.8	18.7	23.0	1.6	24.1	16.0	15.8
Hotels and Restaurants	1.4	0.6	1.2	2.1		0.8		
Financial Intermediation	18.9	15.4	20.3	11.4				7.1
Real Estate and Business Activities	7.4	12.3	3.5	5.4	10.8			
Unspecified services	0.0	0.0	0.0	0.8		23.6		1.3
UNALLOCATED	9.0	0.0	0.0	0.0	11.3	0.0	18.4	12.6

Sources: Annex Table A.II.2., in UNCTAD, *World Investment Report 2000*. Czech Republic, Hungary and Poland:

a. Service subtotals do not add up to service shares because of omitted items.

The share of FDI in trade (including hotels and restaurants) ranges from 11 percent in Poland, in the upper teens in most TEs and above 20 percent in Bulgaria (Table 2). These figures are between two and four times higher than the average for DEs. Similar figures, of between 11 and 23 percent of the entire FDI stocks are recorded for financial services, many times higher than for DEs at the end of the 1990s, but even significantly higher than the stocks in DEs during the 1980s. The exceptions are Ukraine, with 7.1 percent, and most likely Russia, where there is no definite information. Finally, the shares for other business services (including real estate) are quite significant too. Although not exceptionally higher than in DEs, it is our guess that the business services part is indeed larger in TEs.³ The FDI shares in C&FS in TEs are very similar to those among developed economies and this despite the fact that the flow to TEs is definitely of the ‘inter’ rather than the ‘intra’ industry type. Some FDI in services, like IKEA and McDonalds may look as if they are of the intra-branch type, but this is not the case. They introduce completely new type of commercial retail services, and there are no similar networks of trade in different lines of business that TEs are exporting (in the form of FDI) to the developed countries. In any case such FDI are of interest because of the backward linkages they form, i.e., because in TEs they become inter-industrial projects. It must reflect the higher demand for these services, explained partly by the fact that in TEs there exists a large modern production sector that demands similar levels of services as in developed economies.

4. Structural differences between TEs and DEs: Hypotheses

As mentioned in section 2 above the actual FDI figures are the outcome of the opportunities to make profits (the supply of FDI) on the one hand, and the barriers and costs, or incentives, on the other, obstructing the investment or encouraging it. In what follows we use (mostly)

³ At this point we cannot explain the 16 percent in this category in Asia in 1997, which dominates the figure for DEs.

the body of data assembled for the WDI *World Competitiveness Yearbook 2000* where hundreds of characteristics, contributing or hampering global competitiveness are assembled for 47 countries, including 5 TEs and 13 DEs, the remainder, being developed economies. The data include variables that reflect the economic level and structure, the state of the domestic business service industries, specific government policies that create barriers and or incentives to entry. In this paper a selection was made among these variables with special relevance to FDI and to FDI in services. In the source almost all variables are presented in two ways: first, as a grade, on a scale of 1-10—in some obvious cases quantitative measures like GDP or FDP per capita are used instead, and second, as a rank among the 47 surveyed countries. We use mostly the second, and as a rule, compare average ranks of clusters of variables between TEs and DEs.

Markusen and Maskus (1999, p. 16) list a number of vectors of potential barriers to FDI in general. We use many of these in the analysis. Among the barriers, however, they also include the level and performance of commercial and financial services, the very services with low level in TEs and in need of FDI. The implication is that successful FDI in C&Fs may also serve as a leverage and a door opener for FDI in goods for the production enterprises in need of restructuring and improvement in their management, marketing etc.

In what follows we describe the main clusters of variables used and their hypothesized impact on FDI in services in TEs. The entire discussion compares the differential impact of the various clusters of variables between TEs and DEs, but in order to simplify and avoid repetition, from now on we mean the differential impact when we explicitly discuss only TEs. Most of the variables refer to the late 1990s, mostly 1999. In the case of TEs it means that they reflect already ten years of transition with their achievements and retreats, including possible contribution of FDI. This will be taken into account in the discussion.

Cluster 0: **The level of economic development:**

The variables:

- GDP per capita (PPP)
- The Human Development Index. (HDI of the United Nations Development Program, UNDP).

These variables serve as a control or calibration for the comparison of the other clusters of variables. They are estimated, like all other variables at a recent year (mostly 1999) and therefore embody the changes over the first transition decade, the decline, and in some cases renewed growth of GDP and the deterioration, wherever that happened, of social services.

Cluster 1: **The level of modernization of the production sector:**

The variables:

- Percent of Urban population
- Percent employed in Industry (manufacturing, construction, transportation)

The hypothesis: *A more modern production economy, as inherited from the old regime, demands more and higher level of C&FS.*

Cluster 2: **The level of Human Capital**

The Variables:

- a. General educational level
 - Secondary education enrollment (% of relevant age cohort)
 - Educational achievement (test scores, 8Th grade)
 - Illiteracy (%)
- b. Education and skills fit for a market economy
 - Higher education
 - Economic literacy
 - Skilled labor
 - Brain drain

The hypothesis: *Higher human capital, inherited from the old regime, is complementary to FDI in C&FS.*

- i. In TEs the general educational level is higher , but*
- ii. the specific, market oriented skills are absent*

a. indicates that there is a promising potential of general skills, but b. indicates how much FDI in market services are needed.

Cluster 3: **The conditions and environment of the domestic distribution and trade sector**

The variables:

- Distribution infrastructure
- Advertising expenditure
- Customer orientation
- Marketing culture

The hypothesis: *The level of and environment for distribution services in TEs are lower than in DEs.*

Cluster 4: **The state of the financial sector**

The variables:

- Credit (flows easily from banks to businesses)
- Size of banks (number of banks among the largest 500 in the world)
- Banking sector assets (% of GDP)
- Interest rate spread
- Legal regulation of financial institutions
- Confidentiality of financial transactions
- Financial institutions transparency
- Education in finance
- Availability of financial skills
- Country credit rating

The hypothesis: *The state of the financial sector is lower in TEs.*

Clusters 1-4 together reflect a higher latent demand for and higher potential level of profitability of FDI in business services in TEs.

Cluster 5: **The level of protectionism of goods and services and of FDI in general**

The variables:

- Protectionism of imports of goods and services
- Exchange rate policy
- Foreign investors discriminated against
- Foreign and domestic companies are not treated equally
- Public sector contracts discrimination
- Cross border ventures require government intervention
- Investment protection schemes, available
- Investment incentives, attractive or not.

The hypothesis: *Barriers against imports of goods and services often encourage FDI by providing the opportunity to produce the same goods inside the country under their*

protection. In the case of trade and financial services, the effect of the general protection barrier is less clear. The restrictions on the importation of such services seem to hamper, rather than encourage FDI. The other variables listed here relate to constraints and incentives for FDI of both goods and services, including C&FS.

Cluster 5a: Specific barriers against trade and FDI in financial services

The variables:

- Foreign financial institutions are barred from entry
- Access to local capital markets by foreign companies
- Access to foreign capital markets by domestic businesses

The hypothesis: *The higher the limitations embodied in these variables, the higher is the latent demand for financial sector FDI. However, these constraints also impose costs on financial FDI, since free financial activities of all kinds across borders are very important for them.*

Cluster 6: The governance efficacy of the state

The variables:

- Parallel (black-market, barter, unrecorded) economy
- Performance in restructuring
- Tax evasion
- Legislative activity of the parliament
- Consensus about policy direction
- Transparency
- Implementation of government decisions
- Political system, adapted to economic challenges
- Independence of public service
- Bureaucracy
- Bribery and corruption

The hypothesis: *Lower grades for these variables represent a poorer level of business infrastructure and a worse market environment and therefore deter FDI from coming. We would like to assume that FDI in business services are more sensitive to the business environment than FDI in the production of goods. At the other hand, lack of needed elements of business environment increase the demand and profitability for FDI.*

Cluster 7: **The extent of positive government involvement in the economy**

The variables:

- Government subsidies (% of GDP)
- Unemployment legislation (encourages employment)
- Flexibility of labor market regulations
- Competition laws

The hypothesis: *The lesser the micro-involvement of the government and the more market friendly is legislation, the higher the incentives for FDI of all types to flow in.*

Cluster 8: The level of justice and security

The variables:

- Fairness in justice
- Personal security and private property
- Social cohesion
- Risk of political instability
- Serious crime
- Rights and responsibilities of shareholders
- Insider trading
- Legal framework
- Social cohesion
- Risk of political instability

The hypothesis: *Better justice enforcement and security, and more appropriate social norms encourages FDI. Financial services are particularly sensitive to these issues.*

Table 3: Conditions for FDI in Services, TEs and DEs

Region	GDP PER CAPIT A (PPP), 1998, US\$	Urbaniza Level of developm ent	tion and industrial structure	Human capital: adjustm ent to market		Market orientat ion	Financial sector developm ent	Discrimina tion in favor of local business	Discrimina tion in local capital market	Efficacy of state governa nce	Governm ent micro-interventi on	La w and order	Rank of FDI inwar d stock	Rank of FDI inwar d stock
				s, % of GDP in PPP	s, % of GDP in PPP									
	1a	1b	2a	2b	3	4	5a	5b	6	7	8			
Developed economies	22887.3	12.0	22.3	11.7	16.6	13.8	15.9	18.2	15.5	15.7	21.9	15.8	8.5	16.4
High-income countries	14026.2	27.0	22.5	25.2	27.4	28.0	24.5	24.9	28.6	25.7	22.4	26.0	7.8	23.3
East-Asian lower income countries	4526.8	42.3	39.5	37.4	32.2	34.0	32.8	31.0	33.0	33.6	23.6	33.8	7.2	36.8
Latin American economies	7842.5	35.6	20.9	37.1	31.2	34.2	33.1	26.2	25.9	34.4	23.4	34.9	8.2	26.3
Asia	2096.0	46.5	42.5	41.5	28.5	43.8	30.9	38.0	41.7	38.9	30.3	30.0	6.2	46.0
Transition economies	3063.0	44.0	43.0	32.5	43.5	37.8	32.6	36.1	46.0	29.8	29.0	27.3	3.7	35.0
Czech Republic	11132.8	31.1	18.3	15.4	27.3	33.1	33.7	30.5	35.2	33.0	26.3	33.6	6.9	27.8
Hungary	12368.0	30.0	15.5	12.5	25.3	37.0	37.9	27.9	31.3	38.9	26.8	38.3	7.7	28.0
Iceland	10236.0	32.5	17.5	12.0	18.5	31.0	25.2	16.0	26.3	23.2	16.8	25.5	8.3	17.0
Slovenia	7619.0	34.5	20.0	26.0	32.8	36.0	35.8	35.9	37.7	32.4	24.3	36.8	6.9	34.0
Poland	14308.0	27.5	20.0	11.0	32.5	28.3	35.9	42.3	45.3	37.7	37.5	33.8	4.7	32.0
Asia	6467.0	39.0	11.0	4.5	41.8	43.3	45.5	46.1	46.7	43.3	37.0	40.9	4.6	44.0

Notes: The list of countries in each group is presented in Appendix 1. A list of variables by their numbers in the source is in Appendix 2.

Sources: International Institute for Management Development (IMD). *World Competitiveness Yearbook Report, 2000* various tables.

5. Barriers to FDI in C&Fs: The data vs. the hypotheses

Table 3 presents a comparison of the average ranking of several groups of countries, developed, DEs and four TEs (excluding Russia), classified by level of development and geographical region. Included are 46 of the 47 countries surveyed in the *Yearbook*. The classification and more detailed data are presented in Appendix Table 1. In addition, each of the four TEs, as well as Russia and China, is also listed separately. We also have a line for China, which demonstrate a completely different pattern of transition. While there is no ready comparable data for other CIS countries, it may well be assumed that the findings for Russia are among the better than most. As can be seen, GDP per capita and the level of economic development, columns 1 and 2, move monotonously down along the table for non-TEs. The level of development of the TE group is somewhere between the mid-income group (MI) and the Latin American DEs, (LADEs) and the level of development of Russia is located between the latter and the group of Asian DEs (ADEs). The relatively low location of the western TEs reflects the retreat in the levels of education and health in the '90s, and for Russia, in addition, also the decline in output during the 1990s (Which the TEs have mostly regained by the end of the century).

Clusters 1b and 2a of Table 3 demonstrate the marked difference in 'modernization' between TEs and DEs, as measured here. Cluster 1b, the high level of urbanization and the high percentage of employment in industry, and cluster 2a, the much higher level of general education. On both these scores all TEs are ranked at the top or near it, even above the levels of the developed countries and far above most DEs. These emphasize the much larger potential demand in TEs for C&FS.

Cluster 2b, per contra, underscores the fact that the educational system and curriculum, and the training of labor are not yet adapted to the needs of a market economy.

This is true for all TEs, but more so for Russia. While the number of students is large and the level of literacy is very high, education and training in business, economics and law and the like, as well as the format of the educational system, lag behind modern requirements. In the other TEs the combination of traditions surviving from pre-communist days and a faster adjustment to the new conditions, brought the fitness of their educational and training systems to a level in par with the MI group and above most DEs. The high level of 'brain-drain' out of some of the TEs, again especially from Russia, also contributes to this negative result. As mentioned above, the structural 'advantage' of DEs, increases the demand for, and the potential contribution (and profitability) of FDI in C&FS, and its urgency. The high level of general education is also an advantage, which is, however diminished by the conservatism of the entrenched old professional groups, economists, financial-sector executives, lawyers and legal workers, who endeavor to protect their status and traditions.

It is interesting though not surprising to note that the inherited advantages are more pronounced in Russia than in the other TEs. The opposite is true almost across the board for all the other variables representing mostly constraints and barriers to the introduction of FDI in general and in C&FS in particular. As mentioned above, some of these barriers also represent opportunities for FDI in C&FS. There are the policy barriers, also, as a rule, more severe in Russia, that prevent FDI in C&FS from exploiting the opportunities to improve the business environment in Russia. Despite the differences, many policy restrictions exist also in the other TEs.

Cluster 3, which represents the specific environment for distribution and trade, reflects a relatively high position of the TEs other than Russia. The latter is ranked lowest here as well, together with India. The other TEs are positioned at par with the two groups of DEs. We read into this an improvement in TEs that may also reflect the large influx of FDI and joint ventures coming in to replace the distribution and the old network system of central planning.

It also testifies to the low level and quality of retail trade, the initial large price differentials across regions and sectors, and, not the least, the newly created opportunities for international trade. In a previous paper we mentioned the entry and contribution of chains like McDonald and IKEA, as well as FDI in supermarket chains in a number of countries (Hungary, the Czech Republic, Keren and Ofer, 2000) as examples of investment in retail services. We also mentioned Skoda and Volkswagen (in the Czech Republic), as examples of FDI in consumer-near industries that lead to the introduction of new supply networks in production (ibid; see also Bohata, 2000 and *The Economist*, April 1,01). Since the writing of that paper one can cite more examples of fast development of and plans to introduce supermarket chains into Russia and Poland (*The Economist*, May 17, 01 on Poland; and *Moscow Times*, January 18, and September 7, 2000) and many others. In both Russia and Poland there is some resistance of the part of small retailers, including small supermarket chains, but the penetration of modern retailing, especially in the capital cities is very fast. There are many other examples.

In what sense does the role of commercial services differ in TEs and DEs? The backward linkages, the networks that trading firms have to create, are quite different in the two types of economy. In TEs old supply networks exist from socialist days; in DEs they have to be built anew. In TEs the old suppliers, once freed from their old transformation-inhibiting ties and presented with the opportunity to reform themselves as market-serving firms, can be converted at a relatively low cost. The technical human exists, and has to be freed and found a suitable productive role to be unleashed as an effective high quality producer. This is why investments of large multi-national-firms with access to markets can be so productive in a TE, and this is why some such investments have proven a boon to both investor and host country economy. Observe that the same applies to other ventures with strong backward linkages, such as the assembly of vehicles. This is not the case with DEs. Here the suitable human capital has to be formed, the suppliers have to be organized, and costs of deepening

production are very high. How come that here too supplier networks are being formed? The answer lies in legal conditions that require a given percentage of domestic value-added to qualify for essential benefits (Bohata, 2000). Even so there is a growing evidence on the penetration of supermarkets, hypermarkets and department stores to middle income countries in Asia and in other regions (*The Economist*, May 4, 01).

The case of financial services is quite different. One of the great hindrances to transformation in Eastern Europe is the backwardness of local so-called banks. These organizations were used to serving as passive lenders to loss-making enterprises, and were a basic link in the softening of the budget constraint. Come transition, they lack the know-how of checking the liquidity or solvency of firms. But they usually also lack the will to harden the budget constraint and to improve the governance of enterprises with which they have built mutually beneficial connections during the old regime. Mutually beneficial connections that were essential for the running of the creaking planned economy have become a social grindstone inhibiting change and reconstruction in the market economies. It has proved very difficult to change the old state 'banks' into market-adjusted banks; Poland has achieved some success in this regard. But foreign banks possess the know-how and are free from the transformation-inhibiting connections, and would therefore be the ideal catalysts of change, if they were only allowed to enter and perform their task. The problem of course is that entrenched forces use nationalist slogans to hinder their entry. And the result is that promising forward linkages, that could force credit-hungry firms to become more transparent and improve their governance, are forgone.⁴

This, however, may be the appropriate place to mention that while typically the providers of FDI are expecting to make profits, not all of them also contribute in a positive way to the market environment in the host countries. Some of them may join negative

⁴ See "Banks in Central Europe: The banks that don't lend", *The Economist*, Apr 26th 2001, and Black (2001).

activities that take advantage of the lack of the necessary conditions for a proper functioning of markets, like weak legal infrastructure and law enforcement. It is difficult to distinguish statistically between ‘good’ and ‘bad’ FDI, but one may assume that the latter thrives more in weak market environments than in stronger ones.⁵ Also one may assume that distribution and trade are more likely areas of activities in the negative direction. All these may partly explain the large share of FDI in trade into low-transformation TEs, including Russia and Ukraine (Table 2), in that a higher proportion of the ‘bad’ type may be involved in these two countries. This may partly explain the low ranking of Russia in spite of the substantial number of joint ventures in trade. It is also important to mention here that FDI in distribution, especially in the form of joint ventures, are least affected by protectionist policy and discrimination against FDI.

The specific infrastructure for financial services (cluster 4) receives in TEs a slightly lower rank than that for distribution services. Russia, is almost at the very bottom, but even the ‘other TEs’, which are doing much better stand much below the middle income countries and slightly below the other groups of DEs. As mentioned above financial services are probably among the most sensitive to the existence of a proper market infrastructure. Typically, investments in financial institutions are longer term (than trade and other business services, like consulting) and many kinds of fraud are more easily perpetrated against them, unless there are strong regulatory and legal systems. It is interesting to note that the financial environment receive a lower rank in TEs than that for most of the more general governance criteria (see below). This is especially surprising in the case of the western TEs, where government policy and the legal systems are ranked much higher. Hungary is the exception: while the other TEs stand below all other groupings, even below China, Hungary has reached

⁵ In countries with weak legal infrastructure and where ‘connections’ are more important, FDI may prefer to establish a joint venture with a domestic partner. The risk is, of course, of being cheated by the partner. FDI with more sophisticated technologies and more sensitive transactions (like financial services) the higher this risk and therefore the higher the barrier to enter. See Smarzynska and Wei (2000).

the level of the MICs. The causality is not very obvious but as can be gleaned from cluster 5b: TEs are worse discriminators against FDI than all other country groups, except for India and China, in financial services, and the most ardent protectors of their, poorly functioning financial sectors.⁶ In Russia, the protection of the domestic financial sector is as strong as its protectionism in general and practically at the lowest possible rank, significantly below the other countries surveyed (at an *average* of 46.7 out of a possible 47). The banking sector in Russia, made up of a major state bank, *Sberbank*, and a number of major banks headed by a new elite of bankers and managers that benefited personally from the process of privatization in Russia, is a very strong lobby against any opening-up to foreign competition. In this the banks are assisted by the central bank of Russia (Mohacsi Nagy, 2000 p. 128). Russian banks still manage to resist any intrusion from the outside. This is despite the demise of many Russian banks, the crisis of 1998, and the fact that Russian banks cannot perform the proper role of providing credit for the restructuring of the production sector and transferring funds to lubricate current transactions.⁷

The three clusters that relate to the quality of governance, government policy and the legal system (clusters 6-8), position Russia at the bottom, but the other TEs just on par with the two bottom groups of DEs. One may consider this a great achievement, and it certainly helped attract more FDI to the western TEs than to Russia and the other CIS countries. However, considering the needs and the high level of human capital, there is room to also emphasize the empty half of this glass. It seems more difficult than initially assumed to put aside the corrupting impact of the old regime. Finally, the other TEs follow a more open policy regarding trade and less discriminatory policy against foreign investors than Russia, at

⁶ On the legal infrastructure for financial markets in TEs see Shleifer and Vishny, 2000 and *The Economist*, March 3m 01.

⁷ See also Ofer, 1999 and references there. On how *Sverbank* operates see *The Economist*, March 3, 01. On problems faced by foreign banks see *The Economist*, February 1, 01.

par with the Asian DEs (cluster 5a). As mentioned above a much more open policy with respect to FDI, especially in C&FS is warranted.

The last two columns of the table, 13 and 14, contain data on the stock of total inward FDI to the various groups of countries, levels as percent of GDP and rank, respectively. It can be seen that the TEs manage to position themselves just below the mid-income and LA groups. This has not yet happened for Russia, which is lagging behind. The high shares of FDI in C&FS in these countries demonstrate most of all the high demand (or profitability) of these services, despite the high level of barriers.

Table 4: Total FDI and FDI in Trade: the Effects of Corruption and Transition

Dependent variable	Total FDI			FDI in Trade			FDI in Trade, revised		
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)
Explanatory variables									
Constant	-3.11	-13.11	-0.37	1.84	7.66	5.02	2.52	7.61	5.27
Corruption Perception Index^a	5.26			0.26			0.16		
	3.21			0.54			0.31		
Commercial law^b		8.73			-1.44			-1.34	
		1.54			-1.09			-0.95	
Financial regulations^c			5.52			-0.71			-0.71
			1.57			-0.80			-0.80
R²	0.44	0.15	0.16	0.02	0.08	0.05	0.01	0.06	0.05
Significance, per cent	0.69	14.70	14.12	60.01	29.45	43.53	75.80	35.94	43.53
Number of observations	15	15	15	15	15	15	15	15	15

Sources: a. Corruption Perception Index of Transparency International. b. Legal Transition Indicators: commercial law, Table A.2.2.1 in *Transition Report 2000*, EBRD, p. 34. c. Legal Transition Indicators: financial regulations, Table A.2.2.2 in *Transition Report 2000*, EBRD, p. 36. The FDI data, i.e., the dependent variables: columns (1) – (3), Annex Table B.6., Inward and Outward FDI Stocks as a percentage of gross domestic product by region and economy, various years, in UNCTAD, *World Investment Report 2000*. Columns (4) - (6) = (1) – (3) times the percentages of FDI in “Wholesale and retail trade & repair of motor vehicles” in Annex Table A.II.2. Sectoral and industrial distribution of inward FDI stock in Central and Eastern European countries, latest date available (percentage), in UNCTAD, *World Investment Report 2000*. For the Czech Republic, Hungary, and Poland an average of this percentage and that obtained from OECD, *International Direct Investment Statistical Yearbook 1999* was used. Columns (7) – (9) are identical to (4) – (6), except that a correction was made for unallocated items.

6. FDI and the rule of law: Differences among TEs and between FDI in different branches

In section 5 above we have seen very wide differences in aspects of governance and the rule of law between different TEs, not only between Russia and the other TEs for which data was presented. We also have noted the possible connection between the low share of FDI in financial services in Russia and Ukraine and the low level of general governance and high level of barriers to these services. However, these differences in governance and barriers did not seem to create corresponding differences in the shares of FDI in trade, which were high in most TEs (Table 2). This raises the possibility that has already been referred to above, that some of the FDI in trade may thrive on, rather than suffer from, a low level of governance. It may be that the role of commerce in the more advanced TEs and the more backward ones is quite distinct. In what follows we try to test this hypothesis on the basis of the limited data for 15 TEs that we have managed to garner. There is not enough data to test the same hypothesis for financial services. We have also tested again the more general finding, demonstrated in many studies, of the positive relationship between FDI and the quality of the market environment in the host countries

The empirical estimation was performed through regressions of the following form:

$$y = a + b_x \cdot x + b_z \cdot z \quad (1)$$

where y is either total FDI (regressions 1-3 in Table 4), FDI in trade (4-6), and a corrected measure of the share of FDI in trade, which we created by distributing the unallocated FDI proportionately among all industrial sectors. In all cases the FDI data relates to the ratio of the relevant FDI stock in 1998 to the GDP of the same year. The coefficient of the constant term, ' a ' is reported because its relative sign gives some idea of the elasticity of FDI with respect to the explanatory variable. Three alternative

explanatory variables, 'x', are used: Transparency International's *Corruption Perception Index*, 2000, and the two Legal Transition Indicators of the EBRD, the indicators of *commercial law* and that of *financial regulations* for 2000 (*Transition Report, 2000*). The first indicator runs from 0 for the most corrupt to 10 for the least, and the other two, ranging from 1 for the least transformed to 4 for the most, were normalized to span the range between 0 and 10, for the sake of comparability. The regressions are run with 15 observations of TEs for which the data was available.

Table 4 reports the results: total FDI is best explained by the corruption index, which is significant at better than 1 percent. The two transformation progress indices did not produce significant results, although all three coefficients are positive and indicate an elasticity of more than unity with respect to the governance indicator. FDI in trade is not well explained by any of the three governance indices. The coefficient of the corruption index is slightly positive but very close to zero, and those for the EBRD indicators are even negative, i.e., indicating a (highly insignificant) *reduction* of trade FDI as transition advances. In sum, the message of Table 4 is quite clear: investment in most branches of the economy, including the "productive branches" on which we usually focus, is highly dependent on investors' trust in law enforcement, but FDI in trade is not

This is not easy to explain. It may be explained if indeed the category labeled Trade and Commercial Services in UNCTAD's *World Investment Yearbook* is composed of at least two distinct sets of ventures: ventures that thrive on lawlessness, and those that require good governance and the security of property and contract to prosper. It is the latter that we are interested in, because we believe they have a special mission to fulfill in transition economies. Furthermore, one may assume, based on the conceptual framework advanced in section 2 above, that FDI in trade is

potentially highly productive, provided the investor is a possessor of the necessary know-how and skills. We tend to think that it is mainly large multinationals that are capable to produce the positive externalities we indicated. To draw these large investors it is important to assure that they will not be cheated out of their capital, by either theft of know-how or expropriation by local partners. Thus the productive investors are likely to come in only if such assurances are present. When they are not, a different class of investors may flock in. The large ones may come in just to build a bridgehead while gambling only on small investments. And the remainder may comprise of different classes of investors, out for a fast buck.

7. The productivity of FDI in trade and financial services—Russia.

We have recently reported⁸ some empirical results obtained from a data set provided by RECEP in Moscow. This is the services part of an extensive registry of joint ventures in Russia and we are very grateful to RECEP for allowing us to use the data set. We have used these data to try to gauge the effect of FDI on the productivity of commercial and financial services, in a manner similar to that used by Yudaeva et. al (2000). The equation we estimated is similar to equation (1), which we repeat:

$$q = a + b_x \cdot x + b_z \cdot z ,$$

where q is either total firm output or value added, x represents FDI variables, and z other relevant variables—here dummies for the service branches. Yudaeva et al. included a set of observations from a data set with no foreign investment. We have no such data at our command. The set we have does however include a significant number of observations with zero foreign participation. We believe that these

⁸ In Keren and Ofer (2000).

observations may refer to projects that intended to cooperate with foreigners. They may therefore suffer from a selection bias, but they can surely not be affected by any significant input of foreign management skills. Our regressions do therefore check whether an increase of foreign ownership affects performance. The results are reported in Table 5.

Before reporting the results, a few words on the data are warranted. The observations cover the time period from 1992 to 1996. They are, unfortunately, very incomplete. Data on the value of capital assets appear only for the beginning and the end of 1995 and 1996, and many of these data are missing. We have therefore used the average of the observations that do exist, and discarded the many observations that have no data on assets. Employment data are also incomplete. Since many observations have no information on purchases, we could not always create value-added figures, which is one reason for using output instead. Another reason is that in several cases input purchases exceeded the value of output, and these too had to be excluded from the value added regressions.

Table 5: The productivity of FDI in commercial and financial services, Russia: branch dummies excluded

Dependent variable	Log real output per worker						Log real value added per worker					
	Commercial Branches			Financial Services			Commercial Branches			Financial Services		
	-1-	-2-	-3-	-4-	-5-	-6-	-7-	-8-	-9-	-10-	-11-	-12-
(Constant)	9.48*** 103.4	9.44*** 84.89	9.50*** 103.52	9.15*** 16.1	9.72*** 13.51	8.99*** 15.65	9.23*** 79.84	9.34*** 65.79	9.23*** 79.73	9.44*** 14.66	9.50*** 11.59	
Ln of assets per worker	0.16*** 7.94	0.15*** 7.57	0.15*** 7.38	0.68*** 4.81	0.71*** 4.86	0.73*** 5.05	0.18*** 7.29	0.18*** 7.22	0.17*** 7.09		0.43* 2.65	
Dummy for 1995 output	-0.55*** -5.8	-0.53*** -5.59	-0.53*** -5.58	1.92*** 3.93	1.92*** 3.8	1.93*** 3.87	-0.22* -2.22	-0.22* -2.23	-0.22* -2.20	-2.22* 1.52	0.80 1.36	
Foreign ownership (%)	0.0077*** 6.5	0.0075*** 6.31	0.0055*** 3.31	-0.013*** -1.67	-0.0120*** -1.46	0.0062*** 0.47	0.0047** 3.15	0.0048*** 3.24	0.0057** 2.72	-0.013 -0.14	-0.0003 -0.03	
Dummy for western FDI		0.15 1.58			-0.82 -1.27			-0.01 -0.81			-0.11 -0.15	
Dummy for East European FDI		0.07 0.58			-0.03 -0.01			-0.01 -0.61			1.82 0.93	
Dummy for UDC FDI		-0.30* -2.45			-1.33 -1.02			-0.44** -2.81			-0.49 -0.40	
Western FDI ownership share (%)			0.003* 2.47			-0.02* -1.85			-0.0005 -0.27			
East European FDI ownership share (%)			0.002* 1.29			0 0.01			-0.001 -0.40			
Asian, African + OPEC FDI ownership share (%)			0.002 -1.18			-0.03 -1.22			-0.005* -2.33			
R Square	0.06	0.07	0.07	0.35	0.37	0.39	0.04	0.05	0.05	0.17	0.20	

N	2278	2278	2278	74	74	74	1678	1678	1678	46	46	46
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Legenda: *** significant at 0.1 percent; ** significant at 1 percent; * significant at 0.1 percent. T-values in italics.

Sources: see text.

A general comment: the commercial services regressions explain a very small part of the total variance of the commercial services regressions, only some 6-7%. But some of the explanatory variables are nevertheless highly significant. We explain this by the poor quality of the data, full of errors in both the independent and dependent variables. The financial services regressions suffer from a small number of observations, and although they explain over 35% of the variance, their results are more problematic.

Following Yudaeva, we first used total output as our dependent variable. The first panel of Table 5, columns 1-6, reports on the output regressions. The FDI share variable in the commercial services regressions in columns 1-3 is highly significant. Total foreign ownership adds between 6 and 8 percent to the productivity of output. Our attempt to examine whether the origin of FDI affects performance has been less successful. The basic equation (i.e., the excluded origin dummy or share) is FDI originating in one of the CIS countries. When the geographic origin is included as a dummy, only FDI whose origin is in an OPEC and like country is marginally significant and negative. When the origin is included as an ownership share, Western (and also Eastern European) origin is marginally significant and positive. This was our expected result, but it is extremely weak. The real value added regressions, columns 7-9, are not significantly different from those of the real output regressions, except that most results are even weaker.

We have only 74 observations for the financial-services regressions and, given our reservation regarding the quality of the data, the results should be treated carefully. They are, however, striking. Here foreign ownership in general and Western ownership in particular, where statistically significant, reduces productivity. If any sense is at all to be read into these results, it may be that discrimination in Russia against foreign financial services is extreme and harms their productivity. It is thus not surprising that financial FDI in Russia is so low.

To sum up, it is hard to draw firm conclusions from these regressions, both because of the quality and the nature of the data. The quality has been discussed above. As for the nature, we would need similar data from other transition countries whose policy with respect to foreign entrepreneurs was more hospitable, say, Hungary or Poland, to be able to be able to make hard conclusions regarding the productivity of FDI in services. All we can say on the basis of the present sample, is that it seems that an increasing foreign control in commercial projects does raise their productivity. This may mean that their external effects are positive and that some of them are netted by the projects themselves. The same seems not to be correct when we look at the financial services, for which it seems that the environment is too unfriendly to foreign control.

8. Conclusions

TEs and DEs show many similarities, but they differ in many essential characteristics. If the level of per capita income were all that mattered in defining development, then the TEs, after between five and seven decades of socialist development are positioned today where economies that have hardly started to budge forward stand. But this disregards critical structural and systemic characteristics, some of which may enhance development while others may hamper it. We have shown in this paper that these various characteristics have been quantified by various international agencies, and can be used to gauge the development enhancing and development blocking factors.

We have also shown the central position of FDI in branches that do not usually occupy the star position in studies either of transition or of FDI in TEs or elsewhere, i.e., service branches, and outliers like commerce and finance to boot. The very fact that socialist economies have grown in a stunted way means that special steps can be taken which may lead to a much faster growth than in DEs. The TEs can be viewed as a network of railway lines, where a few links are missing, and instead of rebuilding the whole network, all that may be

necessary is to supply the missing links, the links to the consumer. The formation of these links requires special catalysts, which foreigners skilled in commerce and banking can provide. Thus FDI by these skilled foreigners in C&FS can have externalities that encourage the transformation of all backward or forward linkages that these branches create.

Both branches are an essential bond in the chain that links the economic actors. Without the market outlets which commerce provides, no modern firm can survive, and without credit, liquidity and the conveyance of money firms are strangled. It is the network-forming qualities of commerce, the backward linkages, which can be used to force producers, who have grown up in isolation from the market, to learn to adapt themselves to the wishes of the consumer. And it is the forward linkages of finance, the ability of skilled providers of financial services to withdraw their services from firms whose governance does not inspire their trust, to force firms into greater transparency. Transparency and adjustment to the market are the first necessary steps of transformation for TE firms. For these reasons the encouragement of commercial and financial FDI by those who possess the relevant skills is so important.

We have shown that the reform of the governance of the state's services is the necessary conditions for the creation of an environment favorable to FDI by the owners of the skills in the desired service branches. It is true that our regressions have shown that FDI in commercial services in TEs is not sensitive to governance factors, whereas total FDI is very sensitive. We tend to believe that our statistics are not able to separate FDI into predatory projects, that have negative externalities and thrive in conditions of poor law and order, and the positive externality-forming projects, that require a law-abiding environment. Poor governance draws the former sort, while effective government draws the desirable type of FDI.

Another finding has been that even in a country like Russia, whose government cannot be accused of imposing a well-functioning rule of law, FDI in commercial services seems to increase productivity. We take this to mean that such FDI projects tend to net some of the external benefits that they create. The same cannot be said for financial services: here apparently the poor state of property protection leads to a reduction in the productivity with the rise in the share of FDI.

The conclusions of the previous paragraph were drawn on the basis of the data that were extant. Clearly, to put them on a firmer basis additional study based on better and wider bodies of data is needed. In particular, we would need data that are comparable to the Russian data from other countries, to see whether in countries whose transition has proceeded farther and more smoothly we find similar, stronger or weaker effects of the weight of FDI in firms. If we do not find that there the effects of FDI are even stronger, then we may be building too much into our assumptions.

As this paper is getting ready to be sent to Dubrovnik, we came across a paper by Gros and Suhrcke (2000) on “Ten Years After: What is Special About Transition Countries?” The paper follows much of the footsteps of Ofer 1999, and comes to the conclusion that “the countries that are candidates for EU membership seem to have **partly** completed the transition” (and all the others not yet, see the abstract, p. 1). That while their ‘hardware’ the structure of their economies still resembles that under the socialist system, their ‘software’, that is market infrastructure are not different that those of Brazil, Mexico and the like. As we have seen in this paper this may be almost true in general about 3-4 among the most advanced TEs. We beg to claim that even for them, given the large potential demand for C&Fs, they still suffer from specific problems inherited from the *ancien regime*

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Appendix 1: Classification of country groups in Table 3

Developed Countries: Australia, Austria, Belgium, Canada, Denmark, Finland, France, Germany, Hong Kong, Ireland, Iceland, Italy, Japan, Luxemburg, Netherlands, Norway, Singapore, Sweden, Switzerland, United Kingdom, United States.

Middle Income: Greece, Israel, Korea, Portugal, Spain, Taiwan.

Euro-Asian lower income countries: Indonesia, Malaysia, Philippines, Thailand, Turkey

Latin American DEs: Argentina, Brazil, Chile, Colombia, Mexico, Venezuela.

Not included in any group and not shown: South Africa.

Appendix 2: The variables of Table 3, by cluster, and number in WCY, 2000

Cluster 1a

1.04 GDP per capita (PPP)

8.38 Human Development Index

Cluster 2a

8.23 Secondary education enrollment (% of relevant age cohort)

8.26 Educational achievement (Test scores, 8th grade)

8.30 Illiteracy (%)

Cluster 1b

8.33 Percent of Urban population

Percent employed in Industry

Cluster 2b

8.25 Higher education

8.32 Economic literacy

8.12 Skilled labor

8.13 Brain drain

Cluster 3

5.02 Distribution infrastructure

6.18 Advertising expenditure

6.32 Customer orientation

6.33 Marketing culture

Cluster 4

4.05 Credit (flows easily from banks to businesses)

4.18 Size of banks (No. Among the largest 500 in the world)

4.19 Banking sector assets (% of GDP)

4.20 Interest rate spread

4.21 Legal regulation of financial institutions

4.22 Confidentiality of financial transactions

4.23 Financial institutions transparency

4.24 Education in finance

4.25 Availability of financial skills

- 4.26 Number of credit cards issued
- 4.03 Country credit rating

Cluster 5b

- 4.06 Foreign financial institutions are barred from entry
- 4.07 Access to local capital markets by foreign companies
- 4.08 Access to foreign capital markets by domestic businesses

Cluster 5a

- 2.33 protectionism of imports of goods and services
- 2.24 exchange rate policy
- 2.34 foreign investors discriminated against
- 2.35 foreign and domestic companies are not treated equally
- 2.36 public sector contracts discrimination
- 2.37 cross border ventures require gov't intervention
- 2.38 investment protection schemes, available
- 2.39 investment incentives, attractive or not.

Cluster 6

- 1.09 Parallel (black-market, barter, unrecorded) economy
- 1.28 Performance in restructuring
- 3.25 Tax evasion
- 3.28 Legislative activity of the parliament
- 3.29 Consensus about policy direction
- 3.30 Transparency
- 3.31 Implementation
- 3.32 Political system, adapted to economic challenges
- 3.33 Independence of public service
- 3.34 Bureaucracy
- 3.36 Bribing and corruption

Cluster 7

- 3.39 Government subsidies (% of GDP)
- 3.40 Unemployment legislation (encourages employment)
- 5.20 Flexibility of labor market regulations
- 3.41 Competition laws

Cluster 8

- 3.42 fairness in justice
- 3.43 personal security and private property
- 3.44 social cohesion
- 3.45 risk of political instability
- 3.46 serious crime
- 4.15 rights and responsibilities of shareholders
- 4.16 insider trading
- 3.27 legal framework

- 2.31 Direct investment stocks inward (\$USb)