UNIVERSITI PUTRA MALAYSIA

FOREIGN DIRECT INVESTMENT, FINANCIAL DEVELOPMENT, EXPORT PERFORMANCE AND ECONOMIC GROWTH IN SELECTED TRANSITION ECONOMIES

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By

IRINA RAKHIMOVA

Thesis Submitted to the School of Graduate Studies, Universiti Putra Malaysia, in Fulfillment of the Requirements for the Degree of Master of Science

October 2013

Lovingly dedicated to Timur Sabitov, six years old, in the hope that he will be excellent lifelong learner
and my parents, Isamiddin Rakhimov, and Elena Rakhimova.

Abstract of thesis presented to the Senate of Universiti Putra Malaysia in fulfillment of the requirements for the Degree of Master of Science

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October 2013

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The purpose of this study is twofold. The first objective is to investigate the nature of relationship between FDI and export in selected transition economies of Former Soviet Union. Specifically, the aim is to test whether they are substitutes or complements. The second objective is to test empirically if financial sector development has any effect in mediating the positive effect of FDI on growth.

Employing the panel data on 12 transition economies over the years 1993-2010 and using Pooled OLS, Fixed and Random effect estimation methods, the results show that there is a substitution effect between FDI and exports. This implies that increase in FDI will reduce export. This finding is valid for all estimation techniques. To test the second objective on the possible role played by financial market development in

mediating the impact of FDI on output growth, a panel of 12 countries of Former Soviet Union is selected. Using data over the period 1997-2010 and Pooled OLS, Fixed and Random effect estimation methods, the results show that financial market development in these economies is an important pre-condition for them to reap the positive spillover effects from MNCs presence. The result also indicates that the direct effect of FDI on the host economies is negative.

The evidence of substitution effect of FDI on export performance in FSU countries suggests a possible "crowding out" effect of foreign capital inflows on domestic firms, probably exporters. It also indicates that the motive of foreign entry is not an export, but the size of domestic market. In addition, it is found that better developed financial markets can boost the effect of FDI in FSU economies. The findings of this study recommend following policy implications such as improving macroeconomic and political stability, developing FDI-welcoming strategies and providing favorable investment climate for foreign investors.

Abstrak tesis yang dikemukakan kepada Senat Universiti Putra Malaysia sebagai memenuhi keperluan untuk Ijazah Master Sains

PELABURAN LANGSUNG ASING, PEMBANGUNAN KEWANGAN, PRESTASI EKSPORT DAN PERTUMBUHAN EKONOMI DI EKONOMI PERALIHAN YANG TERTENTU

Oleh

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Terdapat dua objektif untuk kajian ini. Objektif pertama adalah untuk mengkaji sifat hubungan di antara FDI dan eksport di negara-negara bekas Kesatuan Soviet yang melalui ekonomi peralihan yang terpilih. Secara khusus, tujuannya adalah untuk menguji sama ada kedua-dua aspek ini adalah pengganti atau pelengkap. Objektif kedua adalah untuk menguji secara empirik jika pembangunan sektor kewangan mempunyai apa-apa kesan yang mempengaruhi kesan positif kepada pertumbuhan FDI.

Dengan berpandukan data panel 12 ekonomi peralihan untuk tempoh tahun 1993-2010 dan menggunakan kaedah anggaran OLS terkumpul, kesan tetap dan rawak, keputusan menunjukkan bahawa terdapat kesan penggantian di antara FDI dan

eksport. Ini menunjukkan bahawa peningkatan dalam FDI akan mengurangkan eksport. Penemuan ini adalah sah untuk semua teknik anggaran. Untuk menguji objektif kedua mengenai peranan yang mungkin dimainkan oleh pembangunan pasaran kewangan dalam mempengaruhi kesan FDI pada pertumbuhan pengeluaran, panel 12 negara-negara bekas Kesatuan Soviet telah dipilih. Dengan menggunakan data untuk tempoh tahun 1993-2010 dan kaedah anggaran OLS terkumpul, kesan tetap dan rawak, keputusan menunjukkan bahawa pembangunan pasaran kewangan di negara-negara ini adalah pra-syarat penting bagi mereka untuk meraih kesan limpahan positif daripada kehadiran MNC. Keputusan juga menunjukkan bahawa kesan langsung FDI di negara tuan rumah adalah negatif.

Bukti kesan penggantian FDI kepada prestasi eksport di negara-negara FSU mencadangkan terdapat kemungkinan kesan "kesesakan" aliran masuk modal asing ke atas firma tempatan, berkemungkinan pengeksport. Ia juga menandakan bahawa motif kemasukan asing adalah bukan eksport, tetapi saiz pasaran domestik. Di samping itu, didapati bahawa pasaran kewangan yang lebih baik dapat meningkatkan kesan FDI bagi ekonomi FSU. Hasil kajian ini mencadangkan supaya menurut dasar implikasi seperti meningkatkan kestabilan ekonomi makro dan politik, membangunkan strategi yang mengalu-alukan FDI dan menyediakan suasana pelaburan yang menggalakkan pelabur asing.

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To those who indirectly contributed in this research, your kindness means a lot to me.

I certify that a Thesis Examination Committee has met on 3 October 2013 to conduct the final examination of Irina Rakhimova on her thesis entitled "Foreign Direct Investment, Financial Development, Export Performance, and Economic Growth in Selected Transition Economies" in accordance with the Universities and University Colleges Act 1971 and the Constitution of the Universiti Putra Malaysia [P.U.(A) 106] 15 March 1998. The Committee recommends that the student be awarded the Master of Science.

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DECLARATION

I hereby declare that the thesis is based on my original work except for quotations and citations which have been duly acknowledged. I also declare that it has not been previously or concurrently submitted for any other degree at UPM or other institutions.

IRINA RAKHIMOVA

Date: 3 October 2013

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LIST OF ABBREVIATIONS

CIS	Commonwealth of Independent States
CEE	Central Eastern Europe
EU	European Union
FDI	Foreign Direct Investment
FSU	Former Soviet Union
FTA	Free Trade Area
IMF	International Monetary Fund
GDP	Gross Domestic Product
MNC	Multinational Corporation
MNE	Multinational Enterprise
OECD	Organization for Economic Co-operation and Development
OLI	Ownership Advantage, Location, Internalization
OLS	Ordinary Least Squares
TNC	Transnational Corporation
UNCTAD	United Nations Trade and Development Conference
USSR	Union of Soviet Socialistic Republics
WDI	World Development Indicators

CHAPTER I
INTRODUCTION

1.1 Introduction

Foreign direct investment (FDI) is a significant factor, as it enhances economic growth of the country. FDI has several positive effects: domestic companies may benefit from the existence of foreign firms through technology imitation (Wang and Blomstrom, 1992), transfer of knowledge and skills or through labor mobility (Fosfuri et al., 2001). Attracting foreign investment contributes to an increase in output of certain products that become competitive in foreign markets, to the expansion of exports and more. Cooperation with foreign partners has a positive effect in terms of development of foreign experience in market and training. Multinational companies (MNCs) may also benefit host countries by establishing linkages with domestic suppliers and customers of intermediate inputs produced by foreign affiliates (Rodriguez-Clare, 1996). Experiences of many countries such as the Southeast Asian "dragons" and "tigers" – Indonesia, Malaysia, Taiwan, South Korea, the Philippines, etc. – and the economic giants like Japan, China and India, show the importance of foreign investment for development and modernization of the economy. Therefore, exploring the investment climate and observing the dynamics of foreign investment in the region of Foreign Soviet Union (FSU) republics are one of the main interests of international experts. The results of the studies are published by international leading organizations (IMF, World Bank, EBRD and UNCTAD) and serve as a database for investors and decision – makers to invest in the above mentioned states.

The importance of FDI is not only in ensuring that there is financial capability in taking over new factories and equipment, but also to provide a technological transfer and managerial skills from a relatively more advanced economy. The MNCs presence may also positively influence the local economy through training, imitation and competition. Nevertheless, there may occur a negative effect from FDI, where domestic enterprises are forced to liquidate, since they are not able to get financial support to upgrade their technology. However, it is also possible that spillovers to the rest of the economy may not occur at all if there are institutional obstacles or deficiencies in the absorptive capacity of domestic enterprises (Borensztein et al., 1998).

The literature on FDI finds that positive effect on the nation's economic development of inward FDI can be obtained through imitation of new technology and spillover efficiency (Balasubramanyam et al., 1996; Borensztein et al., 1998; Xu, 2000). This positive influence fully depends on the absorptive capacity of the host economy. Several researches that debate on the significance of absorptive capacity and success of FDI focus mainly on human capital and trade regime. However, several recent studies indicate the role of financial sector development as a link between FDI and economic growth (Alfaro et al., 2010; Azman-Saini et al., 2010; Nwosa et al., 2011). These studies report that the impact of foreign capital inflows on economic growth depends on the level of financial development in the recipient's economy and suggest that nations with better-developed financial sector tend to benefit more from FDI.

1.2 The Former Soviet Republics (Commonwealth of Independent States)

The Commonwealth of Independent States (CIS) was established in December 1991 after the collapse of USSR. Participating countries of CIS are former Soviet Republics such as Republic of Belarus, the Russian Federation, Ukraine, Armenia, Azerbaijan, Kazakhstan, Kyrgyzstan, Moldova, Turkmenistan, Tajikistan, Uzbekistan and Georgia. Three countries, the Baltic states of Estonia, Latvia and Lithuania, which are now the EU members, decided not to join. Total area of CIS is 22,100,843 km^2. According to July 2012 estimates, the population of CIS is 277,7 mln people[1]. Nominal GDP (PPP) in 2012 was $3,760 billion and GDP per capita was near to $12,616[2]. Despite CIS members having a common historical and institutional background (at least in most of 20th century), their development strategies, political system and economic policies after gaining independence have become totally different from each other. In 1994, the Free Trade Area (FTA) agreement has been approved by CIS countries, but it was never signed. The new agreement was succeeded in 2009 to establish a FTA by early 2011. The Republic of Belarus, Russian Federation, Kazakhstan, Kyrgyzstan and Tajikistan signed a treaty and formed the Eurasian Economic Community (EAEC) in May 2001, which originated from customs union between these countries. In October 2005, Uzbekistan has also decided to join. The main function of EurAsEC is to establish a common energy market and to explore a more efficient use of water in Central Asia. Besides, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan created the Central Asian Commonwealth (CAC) in 1991, which was renamed as Central Asian Economic Cooperation (CAEC) in 1998. Russia entered CAEC in May 2004. This organization is currently merged with Eurasian Economic Community.

1.3 Economic Development of Former Soviet Republics

The economy of the Soviet Union was based on a system of state ownership by the means of production, collective farming, industrial manufacturing and centralized administrative planning. The economic structure was distinguished by the state's control of investment, public ownership of industrial assets, and throughout the last 20 years of its subsistence, spreading corruption and socioeconomic stagnation (Gregory and Stuart, 2001). Dissolution of Soviet Union on December 25, 1991 caused the split of the countries into individual governments and economies. At the initial stage, political independence of Former Soviet republics was accompanied by the collapse of a single economic space. There were effects of the structure set up in the industry under communism and the predicaments that came with restructuring to a market economy. The movement to a market economy, privatization of state – owned firms and fast development of private sectors brought a lot of prospects for foreign investors. Raised administrative borders at the same time were an obstacle for free flows of goods, services, capital and labor. To overcome these obstacles, the

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[1] United Nations, Department of Economic and Social Affairs (2013). World Population Prospects: The 2012 Revision, CD-ROM Edition. POP/DB/WPP/Rev.2012/POP/F011 http://esa.un.org/unpd/wpp/Excel-Data/population.htm

[2] Statistical figures on FSU countries are obtained from official website of Interstate Statistical Committee of the CIS http://www.cisstat.com/eng/

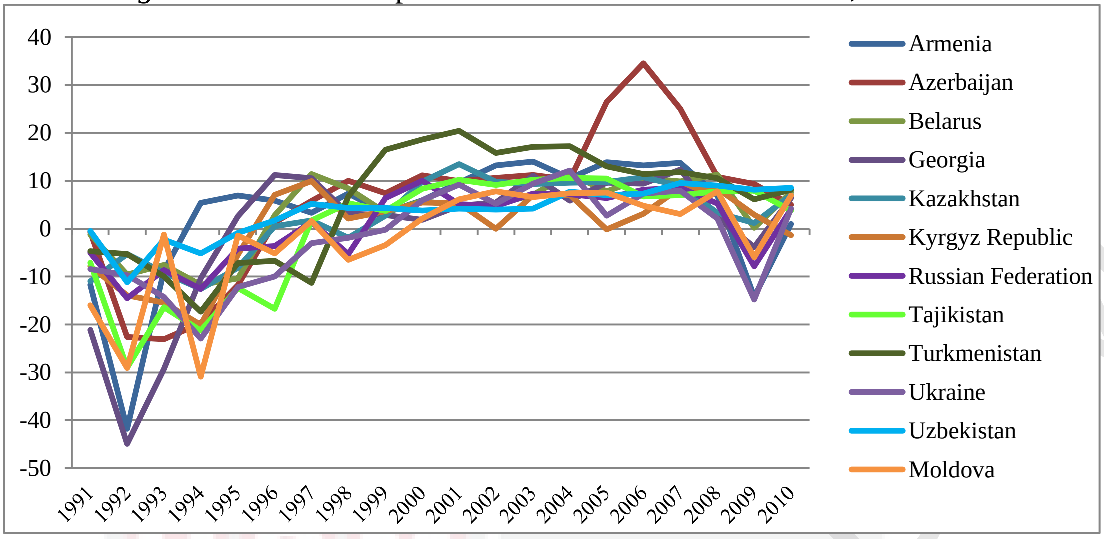
FSU countries, taking into consideration their preparedness, complex set of economic and political factors, have created a number of various sub-regional associations, such as Union of Belarus and Russia, Eurasian Economic Community, Central Asian Economic Community, including Kazakhstan, Kyrgyzstan, Tajikistan and Uzbekistan; an informal union of four countries (Azerbaijan, Georgia, Moldova and Ukraine (GUAM)). The four states (Belarus, Kazakhstan, Russia and Ukraine) are going to create a single economic space. The participation of Belarus, Kazakhstan and Russia in Eurasian Economic Community and the EEA brings these associations closer to each other (Tiusanen and Kinnunen, 2005; Kokushkina and Misakyan, 2006).

USSR had a centrally planned economy. In 1991, all countries of FSU have started economic reforms, generally characterized by: liberalization of prices and foreign trade, the desire for convertibility of national currencies, privatization of state properties and in particular: to overcome external dependency on raw materials, food, military and other fields. However, price liberalization has led to many inefficiencies of cooperation, liberalization of foreign economic activity has identified the lack of competitiveness of most industries. Privatization of property gives rise to lack of control and irresponsibility in the economic sphere. However, the examples of other countries that shifted to the open market economy have shown that they benefit from market economies, specialization and profit maximizing efficiency on macro and micro aspects. Experiences of other nations have led governments to learn from policies of other governments and individual firms can gain from Foreign Direct Investment (FDI) (Gorodnichenko et al., 2007).

FSU countries have great economic and natural potential that gives this region a significant competitive advantage. These countries cover 16.3% of world territory, 5% of world population, 25% of world natural resources, 10% of industrial production, 12% of scientific and technological capacity and 10% of world resource generating goods. Oil and natural gas, coal, timber, nonferrous and rare metals, potash and other minerals as well as forest tracts suitable for agriculture and construction are most demanded in world markets. The explored oil pools in Russia account for 13% of the world, Azerbaijan has more than 10% and in Kazakhstan and Turkmenistan - about 10%. Russia has about 35% of world natural gas reserves, Azerbaijan, Turkmenistan, Kazakhstan and Uzbekistan - almost 20% altogether. Overall production of black and brown coal in Russia, Ukraine and Kazakhstan is ranked as a second in the world. The main reserves of diamonds, bauxite, copper, nickel, cobalt and tin ores are located in Russia. As well as large amount of iron, bauxite and copper ores are located in Ukraine, Kazakhstan and Georgia. Russia and Belarus have the world's largest forest tracts (1/4 the world's woodland)[3]. Figure 1 represents the annual GDP per capita growth rate of FSU countries.

[3]The general data on FSU countries is taken from the official website of Interstate Statistical Committee of the CIS and it's available on http://www.cisstat.com/

Figure 1. GDP Per Capita Growth Rate of FSU Countries, Annual %



Note: Data is taken from World Development Indicators database website

Evidence shows that the economic growth occurred in FSU countries only during the past decade. The negative consequences of the collapse of USSR has resulted an average GDP fall by 34% in FSU countries during the period of 1993 – 2000, industrial output – by 40%, the agriculture – by 28% and investments in fixed assets – by 67%. Almost all Former Soviet countries have not yet reached pre – reform level of key economic indicators. In 2000, the average GDP of FSU was equivalent to 66% of the level of GDP in 1991. The foreign capital inflows were insufficient; industries remained at a low technological level and were not able to start producing competitive goods. Only during the recent years, the GDP growth rate has been stabilized.

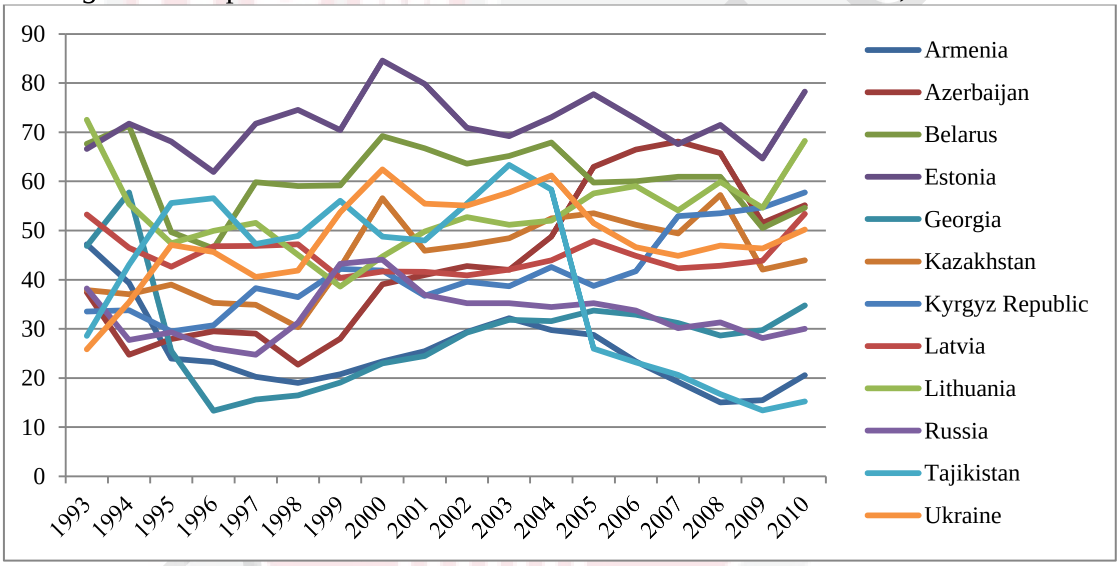
Development of international trade

At the initial stage of the transition of FSU republics, international trade with the rest of the world did not change significantly, moreover in Azerbaijan, Kyrgyz Republic, Moldova, Uzbekistan and Kazakhstan volume of trade remained constant. The possible explanation for this might be: firstly, the fact that centrally-planned economy of USSR considered no direct trade with foreign countries, member republics were primarily trading with each-other, Russia was the only republic whose trade was less inward-oriented; as well as due to the low level of economic openness the volume of international trade was negligible compared to domestic trade between republics. Secondly, the FSU countries, especially those with existence of energy and raw materials, quickly redirected their intraregional exports outside the region, in particular with developed economies, in order to obtain currency earnings. Therefore, total exports to the rest of the world of Former Soviet Republics grew at a faster rate than intraregional (Freinkman et al., 2004).

However, it should be noted that development of international trade was suppressed by introduction of trade barriers, restrictions on exports in forms of quotas, licenses and taxes for the most important types of export products in order to protect domestic market from imports and maintain the internal prices at low level (Freinkman et al., 2004). Revocation of these restrictions was implemented in 1995. In addition, collapse of single economic space and manufacturing industries, introduction of national currencies caused decline in intra-republic trade by 65% for exports and by 72% for imports in 1993.

Since 1993, there is a steady improvement in volume of international trade in FSU countries. According to World Trade Organization's International Trade Statistics report (2012) exports of FSU increased by 20%, indicating the main destination markets as Asia, Europe and Middle East (WTO, 2012). Figure 2 represents the dynamics of FSU republic's export performance during the period of consideration 1993-2010, indicating substantial variation of exports share among the countries. The economies of this region that achieved greater openness and large increase in share of exports in their GDPs between 1993 and 2010 are reported as Estonia, Ukraine, Belarus and Lithuania, whereas the lowest export flows have been reported in Tajikistan.

Figure 2. Exports of Goods and Services of FSU over 1993-2010, % of GDP



Note: Data is taken from World bank's World Development Indicators database.

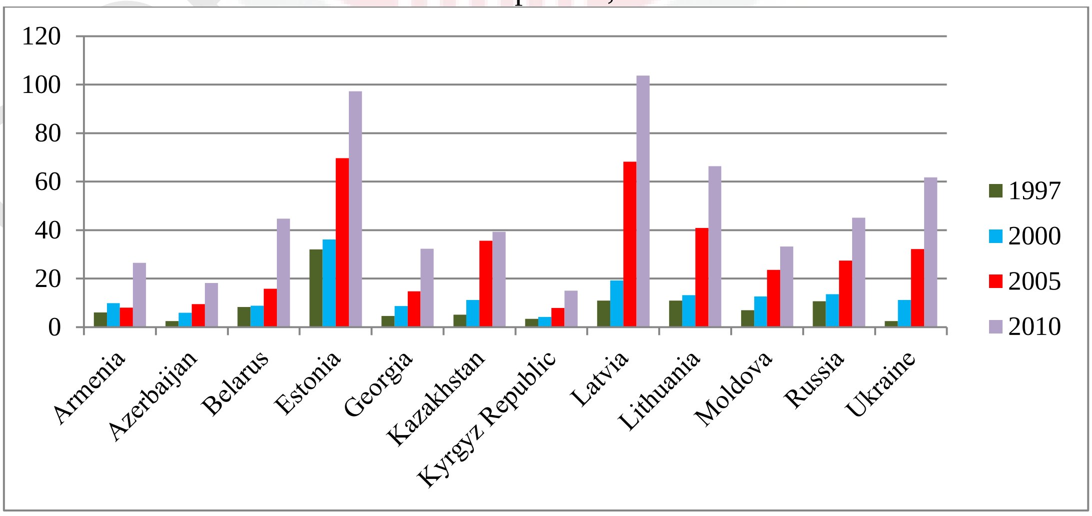
<u>Development of domestic financial system</u>

The function of financial sector of USSR as a sector of centrally-planned economy was primarily as an accounting system for allocation the funds according to the plan and was not designed to allocate credits to their most productive sectors. Disintegration of Soviet Union has led to restructuring of state-led financial sector with large state-owned banks to a market-based liberalized financial system. Macroeconomic situation caused by onset hyperinflation was characterized as unstable; countries carried out monetary and fiscal policies and introduced national currencies in order to replace monobanks with two-tier banking system, reduce inflation and stabilize the exchange rate. However, the fast growing number of commercial banks was not able to prevent dramatic increase in unwillingness of enterprises to borrow from banks due to the high interest rates (from 50% to 145% annually) in their post-communist economic transformation (Golodniuk, 2005).

During the first years of liberalization of banking system, economies of FSU faced series of problems and fundamental difficulties. Ineffective regulatory framework and bank supervision, inadequate accounting and auditing systems for firms, lack of enforcement mechanisms, little experience of managers and lack of confidence in the sustainability of macroeconomic stability hampered financial sector restructuring (Cojocaru et al., 2011). Thus, in 1997-1998 countries began addressing these primary issues by introducing accounting system reforms and international supervisory practices, better management of non-performing loans and strengthening of creditor rights that made success in attempts to rationalize financial systems. For instance, the share of non-performing assets in Kyrgyz Republic had decreased to 7% in 1999 from 75% in 1994 (Bokros, 2001); Armenia, Georgia, Moldova and Ukraine had tightened their minimum capital requirements for commercial banks in order to improve transparency of financial sectors; International Accounting standards were introduced in Armenia, Ukraine, Moldova and Kyrgyz Republic (Golodniuk, 2005).

The later development of financial intermediation in this region shows diverse progress among the countries, for example, in Kazakhstan and Russia loans have grown annually by 50% over the last five years, compared with much slower growth in other FSU republics. In Armenia, Kyrgyz Republic, Moldova, Tajikistan and other lower initial per capita income countries independence of commercial banks in credits allocation decisions is influenced by Central Bank and government imposition preferring state-owned companies. The evolution of stock markets is still lagging behind, small and not sufficient to contribute to financial development, information on investment opportunities is accessible to certain monopoly groups promoting the interests of insiders with higher prices. The main reasons that are common for all FSU countries are high level of corruption, weak investor protection, high interest rate and risky macroeconomic environment (Golodniuk, 2005). In addition, the size of other non-banking financial institutions such as pension and investment funds, insurance companies in FSU is insignificant to consider their role in capital markets.

Figure 3. Domestic Credits to the Private Sector 1997, 2000, 2005 and 2010 in FSU Republics, % of GDP



Note: Data is taken from World Development Indicators database.

Figure 3 illustrates the values of financial depth indicator – domestic credits to private sector (% of GDP) – to demonstrate the evolution of banking sector in FSU economies during the period of interest of this study. At the initial stage of their transition, financial systems were at relatively low level of development almost for all countries except for Estonia. The banking sector grew steadily in Georgia, Kazakhstan, Moldova and Russia while significant increase in share of domestic credits is observed in Baltic countries – Estonia, Latvia and Lithuania – and Ukraine.

1.4 Foreign Direct Investment Flows into Former Soviet Union Republics

Foreign Direct Investment refers to investment made to acquire lasting interest in an enterprise operating outside the economy of the investor (Kornecki, 2008).The main target of the investor is to gain an efficient right in the management of the company. Spar (2009) specifies foreign direct investment as a total flow of capital and technology across international borders or a transfer of resources from one location to another. The International Monetary Fund (2009) defines FDI as the acquisition of at least 10 percent of the ordinary shares or voting power in a public or private enterprise by nonresident investors.

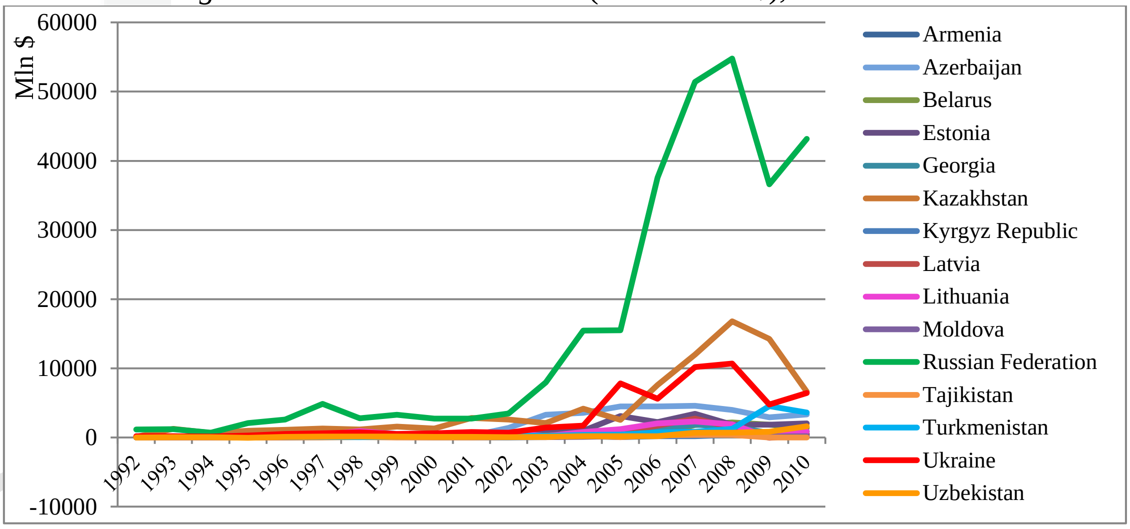
Foreign investment is a relatively new branch of economy of FSU. According to the administrative – command system existed in Soviet Union, there was a state monopoly of foreign trade activities and investment sector was closed for foreign capital. These activities were limited to a certain amount of export – import contacts, operated by specialized trade – the government organizations. At international financial markets, USSR acted as a heavy borrower of foreign currency loans, but for businesses, USSR was closed to international financial markets as well as to establish joint activity with foreign investors. Only a few investment projects were implemented in Soviet Union before 1990s namely, joint factory of Italian "Fiat" and Volga automotive plant, the factory for the production of famous beverages such as "Pepsi – Cola" and several other major investment programs.

During the last 20 years, the importance of countries with transition economies as investment destinations where MNCs have taken vast market and production opportunities has raised significantly. Among the transition economies, the region of the Commonwealth of Independent States (CIS) – Former Soviet Union republics – experienced boom in foreign direct investment in recent years (Kudina and Jakubiak, 2008). FDI is believed to have positive effects such as productivity gains, technology transfers, exposure to new processes, managerial skills, employee training, international production networks and access to markets (Borensztein et al., 1998). Governments obviously expect that MNC can be an appropriate source to fight against unemployment, to increase the revenue of taxes, exports, transfer of technology and knowledge, job creation and higher wages. Many nations' governments have lowered the restrictions for foreign capital entry and provide various investment stimulating programs just to motivate foreign investors to invest in their countries. It can be fiscal incentives such as tax holidays and low taxes for foreign investors, or financial incentives such as grants and preferential loans to MNCs (UNCTAD, 1996), as well as measures like market preferences, infrastructure, and sometimes even monopoly rights (Brewer and Young, 1997).

Macroeconomic studies have shown that FDI is good for growth in an economy with financial markets that can manage the flows, but it is argued that these analyses are not careful enough in their calculations for things like simultaneity and country-specific effects (Carkovic and Levine, 2002; Azman-Saini et al., 2010). The restructuring of the economy to where the public is now responsible for finding their niche in the marketplace, gives rise to growth to its natural market potential. Convergence will bring less developed nations up to speed with the other markets. If nations with slower GDP do catch up, then we should see that CIS is growing quickly (De la Fuente, 1997).

FDI's coming to the Former Soviet Union republics has promoted a major growth for the productivity of local industries and services through modern technologies spillover and managerial skills (Kudina and Jakubiak, 2008). This led to enhanced productivity sequence and stabilization of the macroeconomic situation and hence, social welfare, which provides a favorable environment to accelerate the pace of financial sector reforms. On the other hand, further economic growth will increasingly depend on the level of financial intermediation and attraction of new investment (Alfaro et al., 2004). Thus, for CIS countries, the challenge to improve the reliability of the financial sector and acceleration of its reforms are becoming increasingly important. Figure 4 provide statistics for FDI inflows into Former Soviet Union countries over the period of 1992 – 2010.

Figure 4. FDI Inflows into FSU (millions US$), 1992-2010



Note: Data is taken from World Development indicators database website.

Figure 4 shows that FDI inflows in Kazakhstan, Russian Federation and Ukraine have increased considerably on average from 1.8 billion US$ to 9 billion US$ and 2 billion US$ to 43 billion US$ in 1992 and 2010 respectively. The less attractive countries for foreign investors are Tajikistan and Uzbekistan. The approximate reason for this might be the fact that most FDI inflows to Former Soviet Union countries are concentrated in oil and gas extracting countries. Another reason can be a weak macroeconomic stability and the investment climate of these economies.

The positive effect of FDI on structural change as a transfer of capital and technology for transition economies depends fundamentally on the initial conditions of the recipient or the host country (Ellingstad, 1997), there is an evidence that FDI flows to transition countries are not always beneficial in long-run as expected (Lipsey, 2002) due to strong dependence on foreign capital but weak indigenous efforts. In the literature, the factors in attracting FDI are explained by three motivations for FDI:

1. Market – seeking – with the aim of establishing business that serves a local market because of its size or to overcome the trade barriers (Horizontal FDI)
2. Resource – seeking – it is when investors are triggered by the availability of natural resources in the host country (Vertical FDI)
3. Efficiency – seeking – in order to achieve efficiency gains, investors take advantage of local assets such as less expensive and skilled workers, cheaper assets and infrastructure (Dunning, 1993). According to the factors indicated above, more FDI can be attracted into the economy if it has favorable conditions such as low-labor cost, large domestic market, richness in natural resources and close proximity to western developed countries.

After the collapse of USSR, the total investment in FSU countries declined dramatically. However, Baltic countries received relatively more attention from foreign investors (Claessens et al., 1998). Generally, in energy exporting countries such as Russia, Kazakhstan, Azerbaijan and Turkmenistan, FDI inflow has been concentrated in energy sector. Development of FDI in those countries depends on the investment climate such as corporate governance, rule of low, transparency and etc. Major FDI inflows to Moldova, Georgia and Armenia engaged in oil pipeline construction projects or energy sector privatization. In Ukraine, FDI inflow has been more various due to industrial structures. In Tajikistan and Kyrgyz Republic, FDI has been restricted mostly to one large gold mine project in each country with limited inward FDI flows elsewhere in the economy (Shiells, 2003). In Uzbekistan and Belarus, FDI inflows have been extremely limited, except invested capital into construction of the Yamal pipeline in Belarus. Net FDI inflow in Uzbekistan accounted for less than 1 percent of GDP in 2005.

According to the previous studies (Lankes and Venables, 1996), the reason for foreign capital inflows to FSU countries has been primarily “resource seeking”, however FDI inflow to more advanced countries with transition economy has been more often “efficiency seeking”, for instance, focusing on product exports based on low labor cost. FSU countries with large domestic market such as Russia, Kazakhstan and Ukraine may be potential for market seeking FDI, which is oriented to produce and sell within domestic market. Nevertheless, the effect of FDI may vary among economies according to a number of supporting factors (Shiells, 2003). The size of spillover impacts is also influenced by domestic political system, economic policies, threshold level of human capital, managerial skills and others.

1.5 Problem statement

The transition of Former Soviet Union countries at the period of 1990’s has begun from communist states to market economies. One of the most important aspects of transition of those countries was liberalization of markets, opening the markets for foreign goods and services through trade and direct investments. FDI has played important role covering the gap between high levels of investment and domestic savings required to support economic growth in countries with transition economy. Besides, FDI has been providing external financing in equity form rather than debt, mostly in export and import sectors which supported improvement of external position. The move towards economic liberalization complied with low cost of labor may have contributed to growth of FDI in FSU countries (Shiells, 2003).

Since the emergence of new theories of economic growth, many economists have been interested in investigating the relationship between FDI and economic growth (Lyroudi et al., 2004; Carkovic and Levine, 2002; Campos and Kinoshita, 2002). The results have contributed following policy implications. Should the FDI positively affect the economic growth of a nation, then a recipient country should encourage FDI flows by proposing tax incentives, infrastructure subsidies, import duty liberations and other measures to attract investors. If the effect of FDI is negative, then a recipient country should take precautionary measures to discourage and confine such capital inflows (Lyroudi et al., 2004). Most researchers examining the effects of FDI on economic growth have focused on the Eastern European and South Asian economies. Less understood, however, is the impact of FDI inflows on exports in Former Soviet Union republics and how the response of economic growth to FDI differs with the level of development of financial sector in this region. Due to the significant growth of FDI in this region this study provides important evidence and aims to complement existing literature.

The objective here is to understand how FDI relates to exports in Former Soviet Republics. Since the middle of 20th century, FDI is known as an important aspect in financial globalization, volume of international trade, mobility of capital and goods across the borders, hence the process of catch up with advanced economies (Alguacil and Orts, 2001). Existing literature is not conclusive about the relationship of substitutability or complementarity between FDI and trade as the effect depends on the motives of FDI (vertical or horizontal) and initial country specific circumstances (Fontagne and Pajot, 1999). Experience of East Asian economies and large FDI flows into the region has demonstrated benefits of export orientated policies and participation of developing countries in international trade as a strong engine to achieve economic growth (Sachs, 1995; Omran and Bolbol, 2003; Johnson, 2006).

On the other hand, foreign capital inflows can have several indirect effects on FSU economies, such as spillover of technical and managerial knowledge, enhancing efficiency of domestic firms – local input suppliers, productivity spillover through imitating of operational process of MNCs (Lipsey, 2002). Thus, given the evidence of increasing volume of FDI into FSU, for policy makers it is crucial to have a good comprehension associated with the effect of FDI on exports in order to choose appropriate policies promoting economic development. Therefore, understanding of current picture on FDI – export performance relationship is of special importance. The contribution of this thesis is to indicate whether FDI and exports are positively or negatively correlated in Former Soviet countries with transition economies over the period of 1993 – 2010. To our knowledge, up to the present, very few empirical studies have been conducted for FSU economies with transition using the aggregate macroeconomic level data to investigate the effect of FDI on exports for Former Soviet Union countries (Vavilov, 2008; Ibrahimova, 2010). Econometric findings of this research can be associated with the predominant institutional frame, and hence motivate academic and policy discussions.

Another aspect of the study is investigation of FDI – growth relationship and impact of level of development of financial system of Former Soviet Union countries with transition economies over the period of 1997 – 2010, since financial development has facilitated significant economic growth in a number of developing economies. In addition, it has been suggested that countries which are relatively more financially developed are better able to benefit from FDI (Hermes and Lensink, 2003).The impact of financial development on economic growth might occur through capital accumulation (Liang and Teng, 2006). Well-developed domestic financial sector can promote efficient allocation of capital by facilitating the exchange of goods and services, identifying and monitoring high expected return projects as well as facilitate the adoption of new technology to enhance economic development based on the intensive use of technology and knowledge. In order for domestic investment and foreign capital inflows to have an effect on economic development, the efficient financial system is necessary to provide better mobilization of savings and capital accumulation. Hence, development of an efficient and effective financial sector is identified as a key factor enhancing economic growth (King and Levine, 1993).

During transition of FSU economies from centrally – planned, where financial sector acted as an instrument to carry out the plan by administrative arrangements, to market – oriented financial institutions based on capitalistic principles, financial system development level received primary importance in facilitating this process. Evolutionary strategies and reforms of financial sector over the past two decades have demonstrated remarkable achievements in developing fully functioning and efficient banking sector. However, significant growth of foreign capital inflows, recent improvement in economic development require better understanding to what extent the role of financial sector development contributes to FDI – economic growth relationship in FSU.

The lack of the evidence on domestic financial system development, FDI and economic growth relationship in specific environment of transition economies is partly due to the fact that current literature on FDI has concentrated on determinants of FDI, investment climate and consequences of such inflows as well as the availability of the data for earlier transition period limits the time frame to conduct reliable results. To achieve better comprehension of the potential implications and withstand the risks associated with FDI in Former Soviet Union republics, research should also address the consequences of development of financial sector using lengthy time series and advanced econometric techniques. No existing study has investigated whether the level of domestic financial sector development plays an important role in linking FDI and economic growth in these countries in the context of an econometric framework that controls the determinants of economic growth. The focus of this research is to test whether there is the evidence that factor of financial development is a link between FDI and economic growth.

1.6 Objectives of Study

1.6.1 General Objective

The general objective of the study is to investigate effect of Foreign Direct Investment on economic growth in selected transition economies.

1.6.2 Specific Objectives

i. The first objective is to investigate the nature of relationship between FDI and export. Specifically, the aim is to test whether they are substitutes or complements.
ii. The second objective of this thesis is to investigate whether financial sector development level has any effect in mediating a positive effect of FDI on growth.

1.7 Significance of Study

The FSU region has seen a marked increase in FDI inflows in recent years. The number of theoretical and empirical investigations has pointed out several channels through which FDI may positively or negatively affect economic growth. Existing literature on FDI has concentrated on determinants of FDI, investment climate and consequences of such inflows. Most of the cross – sectional empirical studies are not region specific (Alfaro et al., 2004; Hermes and Lensink, 2003). The contribution of this thesis is to indicate whether FDI and exports are positively or negatively correlated in FSU countries with transition economies. Moreover, there are no studies that examined the role of financial sector development in enhancing the contributions of FDI on economic growth in Former Soviet Union republics. This study hopes to fill this gap in the literature. The econometric findings of this research can be associated with the predominant institutional frame, and hence motivate academic and policy discussions. Range findings can have important implications in stimulating the economic growth in this region.

1.8 Limitations of Study

To test the effect of the effect of FDI on exports this study employs a nominal exchange rate variable to capture domestic price conditions relative to foreign price. Despite that obtained results give a preliminary picture on FDI-export relationship, real effective exchange rate indicator is also important to interpret country's price competitiveness. In our analysis the data of this variable is limited for almost all economies of Former Soviet Union.

To test the role of financial development level in FDI-growth relationship the value of credits issued by financial intermediaries to the private sector is used as a proxy for financial market development, since this variable is the most preferred measure as it reflects more precisely the efficiency of the banking sector in credit provision. However, literature suggests several variables to measure financial development that concentrate on the size and efficiency of other financial institutions (eg., liquid liabilities, black market premium, quasi money to GDP). This study focuses on banking sector rather than stock market because the data for domestic stock markets for the selected countries is extremely limited, not accurate and insufficient to be included in the regression analysis.

1.9 Organization of Chapters

The structure of this study is organized as follow: Chapter II reviews theoretical development of main FDI theory, economic growth theories and trade theories. This is followed by overview of empirical discussions of the effects of FDI on economic growth on macroeconomic and microeconomic level, as well as provides the review of recent literature on the impact of FDI on exports and the role of development of financial intermediaries in FDI – growth relationship. Chapter III focuses on the description of the research methodology, in terms of specification of the models and employed estimation process, as well as adopted dataset and selected variables of interest for estimations. Chapter IV includes presentation of the research results for the tested hypotheses in the research. First section focuses on the description of the obtained econometric results for investigation of the relationship between FDI and exports; second section provides interpretations of estimation results for testing the possible role of domestic financial development in FDI – growth relationship. Chapter V is the conclusion chapter that addresses a review of the main findings, emphasizes on the contributions and suggestions for future research areas that are arise from this research study.

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APPENDIX

LIST OF THE COUNTRIES

Model 1: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Moldova, Russian Federation and Ukraine.

Model 2: Armenia, Azerbaijan, Belarus, Estonia, Georgia, Kazakhstan, Kyrgyz Republic, Latvia, Lithuania, Russian Federation, Tajikistan and Ukraine.