6. FOREIGN DIRECT INVESTMENTS TO ESTONIA WITHIN THE CONTEXT OF ECONOMIC GLOBALIZATION AND REGIONAL INTEGRATION

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Introduction

In the last decade foreign direct investment flows have increased rapidly in the world. Most of the FDI inflows are targeted to the developed countries (78% in 1999), about a fifth of the flows go to the developing countries, and the Central and Eastern European transition economies are the host countries for only 2% of the world's FDIs. The changes have been brought about by both globalization of the world economy and the rising level of regional integration.

Several authors have concluded that the most globalized are small nations for whom openness allows access to goods, services and capital that cannot be produced at home (Measuring ..., 2001, p. 59). Because of this, a thorough analysis of these processes is extremely important for Estonia. As regional integration is one possible way for making a country more open to foreign trade and foreign capital flows, the topicality of the subject from Estonia's viewpoint keeps increasing, since a number of the Central and Eastern European transition countries, including Estonia, are in the middle of the process of integration into the European Union now.

Both globalization and economic integration induce several changes into the investment climate and through this have an impact on FDI flows. The extent and consequences of globalization processes are naturally wider than those of regional integration processes. Because of this, the first part of the present chapter attempts to point out major ways for regulating the global economy in order to increase the impact of foreign trade, credits and foreign investments on economic growth and welfare within the context of globalization. The results are analyzed from the viewpoint of the global economy, not presenting the results for Estonia separately. The last part of the chapter concentrates on discussing the possible changes in attractiveness of the investment climate for different types of foreign investors in the Central and Eastern European transition countries within the context of European integration. The transition countries differ quite significantly, therefore the case of Estonia is used as an illustrative example.

The nature of globalization

Globalization is a relatively new and popular term. The sociologist Anthony Giddens first used it in the late 1980s and early 1990s (Wood, 2001, p. 12). In economics and business, the emergence of the term can be associated with the globalization of trademarks Coca-Cola and BMW. Later the term was used to characterize complexity of economic relations. Recently it has become linked with those views which tend to see the disadvantages rather than advantages of growing economic dependency between countries (von Weizsäcker, 1999, p. 47).

When analyzing the nature of globalization, different levels of aggregation can be distinguished — the entire world, a specific country, a specific industry, a specific company, or even a specific line of business or functional activity within the company (Govindarajan *et al.*, 2000, p. 275). Differences in understanding the nature of globalization can be illustrated by its different definitions. For example, Anderson (2001, p. 13) has suggested that "globalization could be defined simply as the decline in costs of doing business internationally". At the same time, Wood (2001, p. 12) has found two definitions of globalization worth using. The first one, states that globalization is "international economic integration". The second one was proposed by Tom Friedman and suggests that "it is the inexorable integration of markets, nation-states, and technologies to a degree never witnessed before — in a way that is enabling individuals, corporations and nation-states to reach around the world farther, faster, deeper, and cheaper than ever before".

Ali (2001, p. i) has pointed out that in the social sciences various schools of thought have evolved to explain and analyze globalization. The views of the scholars suggest that globalization takes place through world trade expansion, world market expansion, world domination, global manufacturing/marketing, global capitalism, or global integration.

Govindarajan and Gupta have noted that globalization is becoming increasingly feasible and increasingly desirable. These trends can be explained by the following (2000, pp. 277–279):

- an increasing number of countries with liberalized investment and foreign trade policies (the latter is the result of economic and political integration and emergence of regional blocks),
- introduction of new technologies that help to lower communication and transportation costs,
- due to the higher growth rates, the economic centre of gravity tends to shift from the developed to developing countries,
- increase in competition because of the liberalization of foreign trade and investment policies.

Globalization may be seen as improvement and development of closer economic, political, cultural, or environmental contacts and interdependence between countries and regions (Measuring ..., 2001, p. 56). This process brings together different people, organizations and institutions that all have different values, but nevertheless have to co-operate with one another. In order to facilitate contacts between various cultures and religions and make them mutually beneficial, it is necessary to develop standards and rules. Globalization creates several problems because the development of rules proceeds slowly, failing to catch up with the spread of globalization processes. Therefore globalization processes involve a lot of conflicts and discrepancies, which generate contradictory expectations (see Modelski *et al*., 1999). It is assumed that not only may globalization follow different paths, but those paths may even contradict one another (see, for example, Kapstein, 1998).

The current organization of the global economy, which to a certain extent has managed to regulate and balance the economic relations between the great industrial powers, was mainly built up after the Second World War. Despite occasional "trade wars", peace has been achieved in the world. However, tensions and (local) conflicts have not yet disappeared. More and more often do they tend to break out in the developing or transition countries. Many of those tensions, which occasionally culminate in armed conflicts, accumulate their energy from the uneven economic development of countries, their polarization into the rich and the poor. Here lies a whole load of problems urgently needing to be dealt with in order to stabilize the global economy. Free movement of goods, services and capital in the equal conditions of competition form a normal basis for economic development of all regions. Those processes depend on the creativity and efforts of all participants. A market-led economy needs more regulation than a command economy and that is why the global economy needs to be regulated in order to secure the harmony of processes. Moreover, the global economy requires more regulation than any single nation.

Usually two dialectically related sides of economic globalization are distinguished between:

- movement towards wider openness of national economic regions,
- securing equal conditions of competition to producers all over the world.

The solution to the above-mentioned set of problems would lead to elimination of many international conflicts and causes of economic pressures. The crises and conflicts in recent history have often been caused by unfair balance between economic interests. However, a new round of negotiations organized by the WTO, which was supposed to administer globalization, was stopped. The reason for this is that the contradictions between openness and justice have not been duly taken into consideration.

Globalization of the world economy

6.2.1. International trade as a basis for economic globalization

Exchange of goods and services between countries is the simplest and most frequently used form of international economic co-operation. Despite the rapid growth of capital flows, trade will continue to be the basis for globalization in the future, too. Trade leads companies to search for the best market that would supply them with necessary raw materials and semi-manufactured products, but also with machinery and technology. It is via trade that enterprises look for markets where they can sell their products and services. International trade connects manufacturers whose capital belongs to various capital owners from all corners of the world, therefore it can be seen as a global production basis. Roughly, economic globalization can be described through quantitative and qualitative development of international trade. The quantitative side shows growth in volume and relations between various sectors, while the qualitative aspect of world trade involves free market access and equal trade conditions as well as transparency.

The volume of international trade has increased relatively fast in recent years. Countries or groups of countries integrating into the world economy can be characterized through the growth of the volume of their exports and changes in competitiveness. The importance of particular countries or, rather, particular groups of countries in world exports keeps changing. The figures showing world export dynamics and structure by industrial, developing and transition countries are presented in Table 6.1. The total world export volume was 2028 billion USD in 1980, and 5458 billion USD in 1999 (2.7–fold growth). The industrial countries' export growth has been particularly fast — in 1999, the figure was 3752 billion USD, which is 2.9 times bigger than in 1980 (at that time it was 1280 billion USD). During the decade in question the industrial countries' share in world exports went up from 63 to 69%. At the same time, the developing countries' exports have not yet reached a growth rate similar to that of the industrial countries. During the period indicated, the developing countries' exports grew from 591 billion USD to 1494 billion USD (2.5 times). Especially slow has been the transformation countries' export growth — in 1980, it was 157 billion USD, and had reached 212 billion USD by 1999 (that means only 1.4–fold growth). Compared with 1980, the importance of the developing and transformation countries in world exports has also decreased, from 29% to 27% and from 8% to 4%, respectively. (World Merchandise Exports ..., 2000) Neither foreign investments nor foreign loans and developmental assistance have been able to improve the export competitiveness of the developing countries in the world market. They are gradually being pushed into the background. One reason for the transition countries' poor performance has certainly been economic recession. Also, the overassessment of mutual trade volumes in 1980 and particularly the overvalued "transfer rouble" used in statistical reports have had their impacts on development.

Table 6.1

Changes in world exports by region, 1980–1999

	Exports (billion USD)		**Share in total exports (%)**		**Growth (times)**
	1980	**1999**	**1980**	**1999**	
World	2028	5458	100	100	2.7
Developed countries	1280	3752	63	69	2.9
Developing countries	591	1494	29	27	2.5
Transformation countries	157	212	8	4	1.4

Source: World Merchandise Exports ..., 2000.

Similar developments have occurred in imports (see Table 6.2). When in 1980 the world's imports totalled 2067 billion USD, then in 1999, the respective figure was 5723 billion USD (2.8–fold growth). As in the case of exports, the industrial countries' importance is also biggest with regard to imports (in 1980 it was 68% and in 1999 71%). The developing countries' imports have grown relatively fast — if in 1980 the indicator was 503 billion USD, then by 1998 it had already risen 2.9 times, reaching 1461 billion USD (the share in total imports 24% and 25%, respectively).

During the same period, the industrial countries' imports grew from 1410 billion to 4051 billion USD. Import growth has been slowest in the transition economies, with 154 billion USD in 1980 and 211 billion USD in 1998 (1.4–fold growth). (World Merchandise Imports ..., 2000)

To a certain extent the given figures should be approached critically, as the calculations are approximations only. The estimation of import volume exceeded that of export volume in1980 by 39 billion USD and in 1999 by 265 billion USD. Import figures are statistically more distinct than export figures. Since the inaccuracies do not exceed 5%, at the level of

Table 6.2

Changes in world imports by region, 1980–1999

	Imports (billion USD)		Share in total imports (%)		Growth (times)
	1980	1999	1980	1999	
World	2067	5723	100	100	2.8
Developed countries	1410	4051	68	71	2.9
Developing countries	503	1461	24	25	2.9
Transformation countries	154	211	8	4	1.4

Source: World Merchandise Imports ..., 2000.

of all indicators, they would not significantly affect the results of trade dynamics and structure analysis. Although the data are somewhat inaccurate, it is nevertheless possible to draw conclusions about the changes in trade balance and the tendencies that prevailed in the 20 years long period. The conclusion would be that the industrial countries' trade balance deficit decreased, the developing countries' trade balance surplus fell back to balance and the transformation countries' trade balance remained in balance. This confirms the view that the competitiveness of the developing countries decreased in the past decades.

It is clear that in the past decades trade has been the major generator of growth in the world economy. Already in the 1990s the growth rate of world trade constantly exceeded production growth. Between 1991 and 1998, yearly production growth indicators fluctuated between 1.8 and 4.3%, while the annual trade growth (goods and services) of the same period was between 3.3 and 9.9%. It is interesting to note that the production growth rates of the developing countries have always been above average (3.3–6.8%), whereas those of the developed countries have been below average (1.2–3.2%). The growth rate of foreign trade is also higher in the developing countries than in the developed ones, the exports of the former having grown 2.2–13.1% yearly (3.2–10.3% in the developed countries) and imports 7.2–11.5% (1.7–9.7% in the developing countries) (IMF Annual Report 1999, p. 14).

The developed countries' actual average growth rate of GNP in 1981–1990 was 3.1% and was forecast to be 2.3% in 1991–2000. The developing countries' actual GNP growth rate in 1981–1990 was 4.2%, and in the period 1991–2000 was expected to be 5.4% (World Economic Outlook, 1999, p. 140, 145). However, despite their faster growth rate, their low initial level of development and increasingly intensive outflow of earnings does not leave the developing countries any chance to reduce their backwardness. While the industrial countries will benefit most from economic globalization, the less developed ones are losing their positions. Therefore, it can be said that international trade in its present form does not improve the integration and balance between the world's developmental levels.

6.2.2. Flows of foreign direct investments to the developing countries

Although trade relations between countries are the basis for economic globalization, they should still be viewed as prerequisite conditions for unification of the world economy. In the process where values are created, trade forms the surface layer. If different countries' capital (especially in production) gets interlaced, this is a great step forward.

Foreign direct investments into the developing countries seem to be more in the interests of their economic development. Here investors take the responsibility for the effectiveness of their investments. The total amount of foreign direct investments into the developing countries has increased almost 15 times in the recent past, from 14 billion USD in 1986 to 208 in 1999. The share of the developing countries as recipients of direct foreign investments has also grown — in 1999 direct investments into the developing countries accounted for 24% of foreign investments in the whole world (in 1986 their share was 17%). At the same time, foreign direct investments made by the developing countries themselves have also grown considerably. While in 1986 their companies' foreign investments only amounted to 2 billion USD (2.3% of the global volume), then in 1999 their direct investments already reached 65 billion USD (8.2% of the global volume of investments). Hence the growth rate of foreign direct investments made by the developing countries has been several times higher than that of foreign investments made into the developing countries. (WIR, 1992, p. 14; WIR, 2000, p. 283, 289) However, the importance of the developing countries with regard to foreign direct investments has decreased during the last decade. In 1996 investments made into the developing countries formed 37.7% of the total volume of the world's investments, while investments made by the developing countries formed 15.5%. The reasons for the setback could be found in the financial crisis of many developing countries. In conclusion we can say that the role of foreign direct investments in the developing economies has been comparatively stable and in the next few years no further growth can be expected.

Direct investments vary greatly. Export-oriented investments that combine modern technologies, foreign know-how and local resources are most keenly expected in the developing countries — in this case factor costs are covered and interests on investments are earned in foreign markets. Unfortunately, in the developing countries foreign investments have mostly a market- or resources-seeking nature and are not aimed at servicing foreign markets. Due to limited local markets, reinvestment of the earned profit is not meaningful and in the future this kind of direct investment will become a source of capital outflow from the developing countries. This mostly threatens investments in monopolistic infrastructure enterprises (like telecommunications and energy supply), but also banking.

6.2.3. Flows of foreign credit capital and official development assistance to the developing countries

Credit capital movements between countries have an important role in the integration and globalization process of the world economy. International economic institutions (IMF, World Bank) have fought for liberalization of capital movement for many years. The recent financial crises in Asia and other parts of the world have generated critical views of the short-term credit or the so-called “hot money”. The latter has gone out of control and has had a destructive impact on the world economy. Policies of long-term financing of the developing countries should also be critically revised.

Global socio-economic disparity has grown due to mistakes made in international crediting of the developing countries over the past years. Proceeding from simplified theories of economic growth, it was believed that the main reason for retardation of development is shortage of capital. Large-scale inflow of foreign credit into the developing countries did not encourage internal saving and made possible investing in inefficient (economically or socially unsuitable) projects. All this resulted in a very rapid growth of the external debt of the developing countries, which considerably exceeded their economic growth. The debt burden of these countries grew from $ 609.5 billion in 1980 to $ 2316.6 in 1997 (i.e. approximately four times), at the same time their GNP grew from $ 2900.9 billion to $ 6635.4 (a little more than twice). At the beginning of the 1980s, the developing countries had reached a debt crisis which even today remains unsolved. Foreign credits to the developing countries, which once served as supporters of their economic growth, have for some time been inhibiting development.

The developing countries are compelled to contribute more and more funds on debt servicing — in 1997, for example, these payments reached $ 305.2 billion, i.e. approximately 5% of

GNP. Inefficient use of foreign credits has its roots in the fact that nearly 80% of long-term loans have been bound to the recipient country's guarantee (Global Development ..., 1999). This means that neither the creditor nor the actual user of the loan is held liable for the economic feasibility of the financed project.

Many developing countries face complicated economic problems that need urgent solution, but these countries are not capable to cope with them alone. Frequently the question is not about securing developmental capabilities, but how to relieve hunger and satisfy primary needs. In this case there is a need for the industrial countries' developmental assistance in order to protect the world against destructive crises or dangerous tendencies. The industrial countries' volume of developmental assistance reached its peak in 1991, being $ 70 billion and forming 0.50% of the industrial countries' GNP (Kapstein, 1999). According to the United Nations Development Program data, the developed industrial countries provided official development assistance approximately to the amount of $ 48 billion in 1997 (whereas, according to the same sources, the developing countries have confirmed receipt of assistance in the amount of approximately $ 34 billion). The nominal amount of development assistance has stabilized over the past decades, but its share of the gross national product (GNP) of donor countries decreased from 0.33 per cent in 1986/87 to 0.22 in 1997. Only less than a quarter of development assistance is provided within the framework of multilateral programmes (UNDP Human Development ..., 1999, pp. 192–196) which might be considered more balanced and neutral than bilateral aid. This means that donor states have lost their belief in the economic purposefulness and efficiency of development assistance and are withdrawing it. The actual value and influence of economic assistance will apparently decrease in the coming years. Reduction of development assistance would be justified if the differences between the developed and developing countries were decreasing. Unfortunately, this has not been achieved and there are tendencies that even refer to a contrary process. On the other hand, re-establishment of development assistance would presuppose its purposeful and efficient use. (Kapstein, 1999)

6.3. Impact of globalization on differences in development levels of the developed and developing countries

Rapid development of technical science and technology as well as a higher educational level have created conditions for an increase in factor productivity, more effective use of resources and energy. Most interstate barriers to free movement of capital, technologies and know-how have been removed. All this allows one to expect a constant decrease of disparities in the levels of development of different regions and countries. In reality, we are witnessing a rather contrary process — in 35 years (1960–1995) the gap between the levels of development of the rich and poor countries has enlarged by 2.5 times. The split on the basis of per capita income between the countries with the richest fifth of the world's people and those with the poorest fifth increased from 30 : 1 in 1960 to 60 : 1 in 1990, and to 74 : 1 in 1995 (UNDP Human Development ..., 1999, pp. 104–105). UNCTAD's evaluation clearly indicates that for most of the world globalization has not brought in its wake a rise in living standards (Whitley, 1999).

Regardless of transfers of capital and technologies from industrial states to countries with less developed economies, no remarkable change for the better can be observed or expected in these countries. Besides poverty and lack of development, many developing countries are staggering under the pressure of very large foreign debts, which leaves no hope for a considerable improvement in welfare within upcoming decades. Such a situation creates domestic and foreign policy tensions both in the developing as well as the industrial countries, including migration from poorer countries to richer ones. Besides, prospects for development are undermined by the outflow of more active and better-qualified labour force. However, tensions are also growing in the labour market and social system of industrial states. In today's globalizing and merging world notable differences in the development of countries and regions are becoming a common problem and their reduction requires joint efforts.

Regardless of the efforts of the United Nations Organization (UNO), the World Bank (WB), the International Monetary Fund (IMF) and other international institutions, differences in the countries' levels of development have been constantly growing over the past decades. The reasons for this should be looked for in the foundations of the global economic system. Without a radical reform of the operation of the global economy, it would be impossible to surmount the division of the world into very different countries and regions by their level of welfare and eradicate the tensions and deformities arising from them. Measures taken to tackle the poverty-related problems and lack of development have not yielded expected results because of being disintegrated, contradictory, insufficient and inefficient.

While looking for solutions to reduce development disparities between countries and regions one should find answers to the following questions:

- why has the influence of large-scale aid transfers, foreign credits and direct investments on the developing economies and societies been so modest?
- why has the share of the developing countries in global production and trade not increased sufficiently enough, regardless of the rapid growth of population and the improved supply of capital?
- why have the disparities in standards of living between the developing and industrial countries increased, instead of decreasing?

When trying to find answers to these questions one shouldn't overlook the fact that several reasons are rooted in the internal situation of the developing economies and societies:

- the structure and qualifications of the people,
- the structure and level of development of public institutions,
- the nature of economic and social policies,
- the existence and level of development of the technical infrastructure, etc.

No doubt, it is necessary to try to improve the internal structure and functioning capability of the developing and transition countries' society and economy. However, in this attempt one should not simply take over the institutional solutions of the developed countries, i.e. their legal system, economic policy, etc. Modern technical science and technology, monetary system and consumer protection, social security and environmental protection should proceed from the cultural tradition of a particular society for their successful operation.

However, a considerable number of reasons for the backwardness of the developing countries lie in shortcomings of the operation of the global economy itself. While high-sounding declarations speak about the openness, liberalism and equality of the global economy, in reality the balancing of protectionism between the industrial countries and foreign trade discrimination of the developing countries is taking place. As a result of negotiations held from the position of economic strength, the developing countries are forced to open up their markets more than the industrial countries do. The industrial countries close their markets by trade barriers to those goods in the production of which the developing countries have a competitive edge. This will deprive the developing countries of the possibility to make their own living and accumulate resources for development. According to the United Nations Development Program data, the developing countries lose 500 billion USD yearly because of various trade barriers established by the industrial countries, which is ten times more than the total amount of the official development assistance. It has been estimated that the trade barriers set up by the industrial countries affect half of the export potential of the Central and East European transition countries. Limited access to markets caused by trade policy protectionism can therefore be viewed as one of the major reasons for the low effectiveness of foreign credits implementation and one-sided flows of foreign direct investments.

The European Union has achieved notable success at shaping a common liberally regulated economic area in mutual relations between its member states. At the same time, the EU is a stronghold of trade policy protectionism with respect to other countries outside the Union. Carefully protecting their less competitive branches of economy, i.e. people's workplaces and incomes, the developing countries are forced to accept asymmetrical unbalanced trade conditions.

The World Trade Organization (WTO) declares as its aim to promote fair and unbiased competition, desiring to establish concrete trade rules that would regulate the functioning of a liberal and open trade system. In actual fact, the WTO represents an organization that regulates protectionism (balances protectionist conditions between the great powers). At the admission of new members they do not even try to ensure equal conditions of competition for the enterprises of both parties, but rather try to grant possibly more favourable conditions to the enterprises of the "old" WTO members in order to penetrate the markets of new members. All this results in trade policy discrimination, which distorts the conditions of competition and inhibits the economic development of the developing countries. Under unequal conditions of competition the developing countries have practically no hope to get over their backwardness in the level of development and welfare through their own measures.

The developing and transition countries will have an opportunity to shape their development purposefully, to occupy an appropriate position in the global economy, which corresponds to the existing conditions of competition, and actually do something about their economic backlog only if they can enjoy equal competition conditions of economic policy in interstate economic relations. Ending the discrimination in international trade, balancing the relations between huge multinational enterprises and economically least developed countries, drafting joint development programmes in environmental protection, energy and water supply and solving other key problems of the global economy are the inevitable preconditions for shaping a more harmonious and stable global society.

It is certainly impossible for the industrial countries to give up the protection of their markets in a short time. That would mean bankruptcy for many companies and millions of people would lose their job. From a socio-economical standpoint these means are not acceptable and in the conditions of democratic policy they would be unrealistic. It would be necessary to develop a programme that would gradually open markets. The programme should consider mechanisms of solving social problems that are likely to occur and how to compensate the developing countries losses caused by protectionism.

The requirement of equal competitive conditions can have several meanings also for the developing countries, where competitiveness of prices is often achieved through techniques that are considered unacceptable by civilized societies. The developing countries' enterprises have a low level of productivity. Due to low productivity the wage level of these countries is also low. In addition to the wage level, the competitiveness of the developing countries' production in the world market considerably depends on social, environmental and other duties imposed on enterprises (May, 1998, p. 62). Even a slightly stricter implementation of the requirements whose aim is to help avoid "social and wage dumping" or unification of environmental standards would inevitably decrease the competitiveness of the production originating from the developing and transition countries.

The prerequisite for solving the problem of unequal conditions of competition, caused by differences in wages, social and other costs, is the ability to find such compromise criteria for assessing the implementation of the main principles of social, environmental and consumer protection that would equalize the level of competitive pressure on enterprises of different countries rather than the requirement of equalizing the absolute level of competition conditions. Instead of the requirement that the developing countries should reach the same level of social security, health care, environmental protection, etc. with the industrial countries (which is unattainable for them), one should agree upon reaching the share of those expenditures in GNP equal to the (average) share of the industrial countries. This would mean a major breakthrough in the policy of the developed countries with respect to the developing ones. At the moment the industrial countries' commercial policy (export subsidies and restrictions on imports) has been mainly aimed at the creation of better than average competition conditions for their own enterprises. At the same time, the developing and transition countries should bear in mind that competitiveness, achieved at the cost of improper working conditions that might put people's life and health in danger, together with an inhuman social environment, is not acceptable in a civilized society.

6.4. Analysis of the impact of regional integration on foreign direct investment flows

Like globalization, regional integration too induces various changes into the investment climate which do not always increase the host country's attractiveness to foreign investors. Therefore, several scientists (for example, Barrell *et al*., 1997, Blomström *et al*., 1997, Brenton *et al.*, 1998, Pain *et al*., 1997) have studied the impact of regional integration on FDI flows and have, in view of differences in the potential impact of integration, pointed out that the following aspects should be taken into consideration:

- the impact of regional integration on FDI flows is different in case of regional block member countries and other countries;
- differences in the impact of regional integration on FDI flows may derive from the fact that foreign investors have different motives;
- there are significant differences in the analyses of the impact of regional integration on FDI flows, depending on how foreign trade and FDIs have been considered — whether they are substitutes or complements;
- differences in the impact of regional integration on FDI flows may also derive from the discrepancies in the existence and levels of tariff- and non-tariff barriers to foreign trade;
- the impact of regional integration depends on the geographical location of a country (whether it is located in the middle or in the periphery of a regional block).

Market-seeking foreign investors are mostly interested in servicing the local market. In this case, the impact of integration on FDI flows from the other member states of the regional block depends on the nature of a commodity involved (a physical good or a service) and on the level of transportation costs. Pain and Lansbury (1997, p. 90) have suggested that in the case of services or goods with high transportation costs, no significant change in FDI inflows is to be expected. In their paper they additionally pointed out that the need to differentiate between and adapt goods and services is another argument supporting this opinion.

When analyzing the impact of regional integration on FDI inflows to those sectors where the transportation costs of goods are low, a very important aspect that should not be overlooked is the nature of foreign trade and FDIs. If these are substitutes, lifting of trade barriers between countries would increase the amount of foreign trade and decrease FDI flows. In the case when trade and investments are complements, liberalization of foreign trade would stimulate foreign investments (Blomström *et al.*, 1997, p. 3; Brenton *et al.*, 1998, p. 24).

The results of the research by Brenton, Di Mauro and Lücke (1998, p. 23) indicated that as a consequence of regional integration, economic activities tend to concentrate on the member countries of the regional block where the demand is the highest. In this case horizontal FDIs are replaced by foreign trade to exploit the advantages stemming from economies of scale. This principle in selecting the host country for foreign investments is valid both in the case of investments from the member countries of the regional block and from other countries (Pain *et al.*, 1997, p. 89). Several authors have attempted to examine the validity of this approach in their empirical analysis. For example, Barrell and Pain got contradictory results, suggesting that despite relative cost advantages and a flexible labour market, only few manufacturers in Great Britain have decided to increase manufacturing in the home country (and to exploit economies of scale in this way) and service the whole European market by export (Barrell *et al.*, 1997, p. 70). As a result, there were no significant changes in the FDI flows.

The impact of regional integration on the FDI flows from the third countries is somewhat different from that described above. Namely, the tariff and non-tariff barriers that the regional bloc introduces to imports from the third countries may favour FDIs as the entry mode for the member countries' markets (Barrell *et al.*, 1997, p. 67) and as a result, an increase in FDI inflows is to be expected. However, the impact of transportation and other costs and the size of the target market(s) have to be taken into consideration in this case as well. For example, if an enterprise from a third country already has a manufacturing unit in one of the member countries and it is possible to service the markets of new member countries with production from this unit, no increase in FDI flows is expected. Instead of that, manufacturing units in some countries may be closed down as a result of concentration of activities for exploiting the advantages of economies of scale.

Since Estonia has so far had liberal foreign trade and foreign investment policy, **market-seeking investors** have mainly been interested in entering the local market; avoiding tariff- and/or non-tariff barriers has not been their reason for investing here. At the same time, it is not reasonable to assume that protection of the local market would have increased FDI inflows to Estonia since the size and purchasing power of the local market is too small to look attractive to such investors. After integration into the European Union an increase in FDI flows from the third countries to Estonia is expected due to the introduction of tariff- and non-tariff barriers. Additional investments can also be expected because of the differences in growth rates of economies — GDP growth in the Central and Eastern European transition countries exceeds that of the European Union's present member countries.

Enterprises from the present EU member countries have so far been the main investors to Estonia. Most of them already possess manufacturing plants in the EU and because of that no significant changes in FDI inflows are expected after removal of the tariffs and other barriers to foreign trade.

When analyzing the attractiveness of a host country, **efficiency-seeking foreign investors** take into account production and transportation costs as well as availability of qualified labour. In the case of services and goods with high transportation costs, the analysis of the impact of regional integration on FDI flows does not differ significantly from the approach presented above. In the case of goods with low transportation costs, an additional dimension, viz., the existence of cost advantages in the regional block member country, has to be taken into account (see, for example, Pain *et al.*, 1997, p. 90). The results of several empirical analyses have shown that the bigger a change in the investment climate and the stronger the locational advantages of a host country, the more likely is an increase in FDI inflows both from the regional block's other member countries and from the third countries after regional integration (Blomström *et al.*, 1997, p. 25).

If the production of an enterprise is targeted to the regional block's member countries' markets and the foreign investment's host country has no cost advantages, a decrease in FDIs will follow as a consequence of regional integration due to the fact that foreign investors relocate their activities to the member country (or member countries) that have cost advantages. If a new member country of a regional block has cost advantages, FDI flows to this particular country may increase after removal of tariff- and non-tariff barriers to foreign trade. (Barrell *et al.*, 1997, p. 67)

Pain and Lansbury (1997, pp. 89–90) have suggested that assembling plants that make intensive use of labour will concentrate in the periphery of the regional block after integration, since the level of labour costs in these areas is lower. At the same time, more capital-intensive activities are relocated to the core countries of a regional block. In order to decrease uncertainty, some regional blocks have imposed restrictions on relocation of economic activities after the integration. For example, the European Commission may prohibit regional aid to the projects that relocate investments from less to more favourable regions. However, the European Commission has mainly concentrated on regulating manufacturing industries and has not thus far paid much attention to the service sector (Foreign Direct Investment ..., 1998, p. 8).

If the target market of a particular production of a company with foreign participation is a third country, the impact of regional integration on the FDI inflows from the third and regional block's other member countries depends on the existence and level of tariff- and non-tariff barriers that are implemented by the third country for the production from the regional block. If there was a free trade agreement between the FDI host country and the third country before integration but the third country has introduced barriers for the regional block, a new member state may lose the cost advantage(s) and thus a decrease in FDI inflow is to be expected. (see Blomström *et* *al.*, 1997, p. 5) In the opposite case, an increase in FDI inflows to a new member country may be expected.

It is complicated to estimate the impact of the integration into the European Union on **efficiency-seeking foreign investors**. The flows of this type of foreign investments may increase due to the smaller political risk and instability. In addition to that, Estonia has several cost advantages compared to the present member states of the European Union. However, since Estonia is located in the periphery of the EU, transportation costs are higher than in the case of the other integrating transition countries that also have cost advantages. Likewise will its relative lack of (qualified) labour decrease the competitiveness of Estonia as a potential host country for foreign direct investments.

In the case of **natural-resources-seeking foreign investors** there are no significant differences in the impact of regional integration on the FDIs between the member countries of the regional block and third countries. If a particular resource is scarce, no significant change in FDI inflows is to be expected. Changes are possible in specific cases — for example, the regional block may prohibit foreign investment to the enterprises that are extracting and/or making extensive use of specific natural resources.

In the case when natural resources are not scarce, the impact of regional integration on FDIs depends both on the relative price of a resource and transportation costs. If natural resources are exported to the third countries, potential changes in barriers to foreign trade have to be taken into consideration in the same way as in the case of efficiency-seeking foreign investors.

No significant changes are expected in **strategic-assets-seeking foreign direct investment** inflows after regional integration. An increase in FDI flows from third countries is possible if access to the regional aid or grants (for example, for enhancing research and development) given by the regional block is made possible in that way.

No significant changes are expected in **natural-resources-seeking and strategic-assets-seeking** foreign investments after integration into the European Union. Since the share of foreign direct investments from third countries is very small in Estonia, the grants that are provided by different EU funds will not significantly affect foreign investors' decisions. Increase in these types of FDIs from the present member states of the European Union is expected only if the grants are linked with regional aid programmes.

A few possible changes in FDI inflows that will take place during the economic integration are presented in Table 6.3. Previous empirical research on the impact of regional integration on FDI inflows has been somewhat ambiguous. Barrell and Pain (1997) have suggested that an increase in FDI inflows in several European countries is a consequence of EU member status and access to the EU market. Pain and Lasbury (1997) pointed out that the Internal Market Program has had a positive and significant impact on FDI flows between the European Union member states both in the case of manufacturing and service sector. Results of an analysis carried out by Brenton, Di Mauro and Lücke (1998) have shown an increase in FDI flows in ten European Union member countries after the Single European Act was introduced. They also pointed out that a decrease in FDI flows to the present member states of the European Union is not probable as a result of integrating Central and Eastern European transition countries to the EU. At the same time, the results of the analysis suggested that EU member status has no significant impact on FDI flows from third countries.

Table 6.3

Potential changes in FDI inflows to a new member country of a regional block

<table>
<tr><th></th><th>Regional block member country</th><th>Third country</th></tr>
<tr><td rowspan="3">Market-seeking FDIs</td><td>• service or good with high transportation costs — no change in FDIs</td><td>• increase in tariffs — increase in FDIs</td></tr>
<tr><td>• low transportation costs and foreign trade and FDI are substitutes — decrease in FDIs</td><td>• existing manufacturing unit in a regional block — decrease in FDIs</td></tr>
<tr><td>• low transportation costs and foreign trade and FDI are complements — increase in FDIs is likely</td><td></td></tr>
<tr><td rowspan="5">Efficiency-seeking FDIs</td><td colspan="2">• service or good with high transportation costs — no change in FDIs</td></tr>
<tr><td colspan="2">• low transportation costs, cost advantage; the target market is the regional block — increase in FDIs</td></tr>
<tr><td colspan="2">• low transportation costs, no cost advantage; the target market is the regional block — decrease in FDIs</td></tr>
<tr><td colspan="2">• low transportation costs, the target market is a third country and its tariffs are higher — decrease in FDIs</td></tr>
<tr><td colspan="2">• low transportation costs, the target market is a third country and its tariffs are lower, cost advantage — increase in FDIs</td></tr>
</table>

<table>
<tr><th></th><th>Regional block member country</th><th>Third country</th></tr>
<tr><td rowspan="2">Resources-seeking FDIs</td><td colspan="2">• scarce resources and no restrictions — no change in FDIs</td></tr>
<tr><td colspan="2">• other resources — depends on transportation costs and the price of a resource (see efficiency-seeking FDIs)</td></tr>
<tr><td>Strategic-assets-seeking FDIs</td><td colspan="2">• no significant changes in FDIs</td></tr>
</table>

Sources (modified and adapted by the author): Barrell *et al.*, 1997: 67, 70; Blomström *et al.*, 1997: 3, 5, 25; Brenton *et al.*, 1998: 23–24; Foreign Direct Investment …, 1998: 8; Pain *et al.*, 1997: 89–90.

Conclusions

In the past few decades economic globalization has developed rapidly and flows of capital and goods that move between countries have increased. The globalization process has also involved the developing countries. The foreign direct investments made by the developing countries have shown a particularly rapid growth rate. At the same time, the inflow of foreign direct investments to the developing countries has also increased remarkably. The growth rate of foreign loans exceeds the production and trade growth in the developing countries, but the result of this are the increasing debt burden and debt servicing costs. Altogether, the developing countries' importance in world trade has decreased, although it was expected to increase.

The industrial countries' international relations generate national development. At the same time, the effect of globalization on the developing countries is not positive as foreign investments and inflow of direct investments and loans to them have not yielded the expected results. The developmental assistance is not efficient and its share in the donor countries' GNP is decreasing. The contrast between the industrial and the developing countries' levels of development has deepened remarkably during the past decades. The reason for this is the industrial countries' market protection policy, which prohibits entry of competitive products to their market. Unfair trade and competition caused by subsidies have an equally important role. On the other hand, the developing countries achieve relative cost advantage by way of implementing "labour cost, social and ecodumping", which is against the standards of a civilized society.

The current organization of the global economy, mainly formed in the 1940s and 1950s, does not meet the requirements of the constantly globalizing and merging world. The organization of the global economy needs a rapid and radical change towards greater openness of markets and equality of competition conditions for countries at different levels of development. It is a complex and complicated task, which mostly calls for a change in the nature of interstate relations — egoistic self-interests should be confined within the borders of one's own country, whereas beyond them a spirit of global solidarity aimed at finding balanced solutions should rule. This is something that would help move towards not only the welfare of billions of people in the developing and transition countries, but also towards stability and peace throughout the globe.

One possible way to increase openness of countries to foreign trade and foreign capital flows is regional integration. An analysis of possible changes in FDI inflows to Estonia was carried out in the last part of this chapter. On the basis of the results of the analysis, it can be expected that the inflow of market-seeking foreign direct investments to Estonia will not change considerably after the country's integration into the European Union. At the same time, the impact of the integration on efficiency-seeking foreign investments is ambiguous. In the case of natural-resources-seeking and strategic-assets-seeking foreign investments, Estonia's accession to the European Union is not likely to significantly increase the inflows of these types of foreign investments to Estonia.

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