

Determinants of FDI Flows to Transition Economies: Evidence from Moldova

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ABSTRACT:

This paper investigates the determinants of FDI flow in Moldova and analyzes the potential of the country to attract foreign capital given the main findings on the determinants. The paper establishes that in the case of Moldova, high investment risk is largely responsible for the low level of FDI. Furthermore, the paper finds that the current package of laws adopted as a part of EU-Moldova Action Plan harmonized the legal framework, and implementation must replace the formalism of currently adopted strategies.

Moreover, the poor government effectiveness, controversial legal framework and deficient infrastructure contributed significantly to the low levels of FDI into the country. The analysis enabled the identification of important determinants that reflect the risk of the investment climate; these factors could be addressed with greater political will and commitment in improving the country's position in international rankings, on which foreign investors rely extensively.

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List of Abbreviations

- BNM -Banca Nationala a Moldovei (National Bank of Moldova)
- BPO -Barometer of Public Opinion
- CIS -Common Wealth of Independent States
- CPRM -Communist Party of Republic of Moldova

EIU -Economic Intelligence Unit
EU -European Union
FDI -Foreign Direct Investment
fSU -former Soviet Union
GCI -Global Competitiveness Index
GDP -Gross Domestic Product
GNP -Gross National Income
ILO -International Labor Organization
IMF -International Monetary Fund
KKZ -Kaufmann, Kraay and Zoido-Lobaton Index
ORI -Operation Risk Index
R&D -Research and Development
M&As -Mergers and Acquisitions
RTAs -Regional Trade Agreements
TNC -Transnational Corporation
WEF -World Economic Forum

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CHAPTER 1: INTRODUCTION

As a large number of studies revealed, FDI flows depend considerably on previous accumulated capital stock which is “path dependent” (Gari & Josefson 2004, p.2), hence low levels of foreign capital is likely to further deter the potential of increased investments in the Moldovan economy. Thereby, to break this cycle it is significantly important to study the country specific factors that succeeded so far to ensure a continuous flow of investments into the country but also the factors that posed a noticeable threat to foreign investors. To give a better understanding and investigate for FDI determinants in Moldova, I employ the data provided by Economic Intelligence Unit regarding the country Risk Rating Indicators, data obtained from National Bank of Moldova (BNM), the World Bank indicators on Doing Business and data from the Heritage Foundation 2008, the Index of Economic Freedom.

The empirical evidence that reveals the positive relationship between foreign investment and economic growth in transition countries is insufficient in the literature of FDI. Although, the results reveal that FDI does not exert an independent influence on the economic growth in host countries (Carkovic & Levine 2002 cited in Lyrودي et al 2004). However, it can be implied that the intervention of foreign companies usually brings innovative and new technology which is adopted by incumbent industries, offers employees training, managerial skills and know-how, the introduction of new processes, etc. (Lyrودي et al 2004, p. 98). Moreover, studies (Voinea 2003) that analyze the impact of technological transfer by the multinational companies to the host countries demonstrate that it takes longer for highly

developed states to generate new technology and expertise than it is for developing countries to adopt them.

Nevertheless, FDI must not be considered as a panacea for a miraculous economic growth and for all problems that transition countries face. Moreover, many researches signal countries about the risks of “state capture” and immense political and economic clout that multinational companies may exercise in host countries. FDI may also cause current account deficits or force small emerging domestic entrepreneurs out of business (Blazic & Dizdarevic 2006, p. 10). The loss of “cultural capital” due to the homogenization of tastes, interference or even replacement of local products by international brands, is another negative outcome of the extension of multinational firms which is closely related to globalization (Shahid 2001). Loss of national sovereignty and pressure from international organizations and MNCs makes countries more cautious in framing their own policies. However, many scholars support a limited flow of FDI across the borders (Rodrik 2008). In the absence of opened borders and free flight of capital, countries seem to be protected against external economic turbulences and thus, capable of saving their national resources (Shahid 2001). As a result, countries can manage better their economies which makes them, consequently, more secure against imported inflation or other internationally imported economic problems. However, policy makers have a daunting task in trying to balance economic stability with economic growth in such an interlinked world.

In the analysis presented in this paper, I will focus on the determinants of FDI in Moldova, while identifying the impact posed by the risk factors on foreign investors.

The CIS countries were chosen since there is little empirical literature that focuses specifically on this region. Recent studies (Hunya & Schwarzhappel 2008, Parletun 2008, Tondel 2001, Resmini 1999, Popa 2007, etc.) pooled the countries from CIS and compared them to other Central East European countries which are at a startling different level of economic development. Current study focuses only on the CIS as a group of countries that share common history and economic trends such as common trade agreements and previous economic interdependency. Moreover, the CIS are not expected to adhere in the near future to the EU, thereby, to receive a boost from European Union accession reforms. Thus, the CIS must embark on comprehensive competition reforms, openness to international trade, enable a hospitable environment for new entrants on the market that will, consequently, drive up standards and improve economic environment and productivity. Thereby, attracting foreign capital stands at the core of advised economic reforms for transition economies. Moreover, based on Michael Porter's definition of stages of economic development¹ (cited in WEF), six out of ten CIS countries² included in the ranking are still in the first stage of economic development, with Azerbaijan, Ukraine and Kazakhstan being in transition from one to the second, and only Russia being considered a "second stage development country" (WEF, GCI 2007). The CIS region also received low levels of FDI during their transition period due to low competitiveness and uncertain political and economic environment. The Moldovan case is of particular interest as there is no empirical research that focuses solely on

¹ According to Michael Porter's definition of economic development stages, the 1st stage is factor-driven, where countries compete based on their factor endowments, such as unskilled labor and natural resources; the 2nd stage is efficiency-driven as wages raise and the countries start to compete by developing more efficient production and improving product quality; as countries keep the wages high and the businesses compete with each other by producing high value-added products, countries enter the 3rd stage which is efficiency-driven (for more details see: GCI: Measuring the Productive Potential of Nations, WEF).

² Belarus is not included in the ranking.

FDI determinants. Moreover, due to its proximity to the European Union, the country may benefit from potential foreign investors that operate across the border, although solely the status as a EU neighboring country is not enough to assure certain flows of FDI. The existing literature on Moldova studies the impact of FDI on the economic growth (Doltu 2007 & Popa 2007) and touches little upon factors that seem to attract or deter FDI into the country. Moreover, Moldova is a less successful story from the CIS region in attracting foreign businesses into its economy. Contrary to the main determinants cited in the FDI literature, use the importance of the risk perception as a separate indicator, rather than as a significant and complex variable which plays a crucial role for foreign investors in the conditions when almost all CIS countries offer a “level field” for investment³. Being susceptible to almost all kinds of risks, foreign companies specialized in high-tech or financial services often decide to relocate their business because of high uncertainty in their domestic country (Baniak et al 2002, p. 17). Moreover, establishing the causality between FDI and the level of risk investment in Moldova, will pressure to speed up the process of convergence in terms of business climate improvement in the country (Selowski & Martin 1997 cited in Benassy Quere et al 2007, p. 2). Assuming that investors are risk-averse, the main hypothesis to be discussed in the present paper is that *high-risk rating deters foreign investors to operate in Moldova which displays an uncertain investment milieu*.

The paper is organized as follows. In the chapter 2, I review the relevant literature on the main determinants of FDI in the transition. In chapter 3, I give brief overview of the FDI determinants in the CIS countries, while discussing in detail the evolution of

³ Personal communication with the Head of the TCS, TATA, Hungary 21.07.2008.

FDI flows in Moldova. In chapter 4, employing the analytical frameworks from World Bank (WB), Economic Intelligence Unit (EIU), World Economic Forum (WEF) I assess the impact of risk indicators on the potential foreign investors in Moldova. In chapter 5, I sum up the most important obtained results of the study.

CHAPETR 2: LITERATURE REVIEW ON FDI DETERMINANTS

2.1. *FDI Determinants in Transition countries*

The chapter will review the most cited FDI determinants in the transition countries by underlining the complexity and importance of the macroeconomic, socio-political, legal, and infrastructural factors. Moreover, factors that reflect the country risk perception are also equally important for investors who analyze international rankings as a first point of reference in the conditions of information asymmetry.

The literature on FDI determinants, while extensive, is inconclusive about the exact mix of factors that trigger and/or preclude FDI flows. The difference in results stems from various factors including the use of data samples, country specific conditions, the time spans considered by researchers and so on. Moreover, the determinants that seem to attract or deter FDI flows in developed countries vary considerably from those in developing or transition economies (Broadman & Recanatini 1999, Shahid 2001, Resmini 1999, Brahmbhatt 1998, etc.).

Brahmbhatt (1998, p. 18) defines FDI as “the establishment and operation of a business in one country that is substantially controlled by residents of another [...]”. Thus, the main determinant that draws foreign investors to establish a business in a host country is the investment climate, which by its peculiarities promises higher returns than in the home country and thereby attracts foreign businesses (Broadman & Recanatini 1999). However, there is still little consensus among economists upon the main determinants of FDI which guarantee, draw, and ensure a stable flow of foreign businesses in the host economies. The most quoted gains of a free

circulation of capital across borders are an augmented level of “stock skills”, access to the world market, and increased level of technology that speeds up the process of growth and development (Shahid 2001). For instance,

“by increasing the presence and role of foreign banks, the host country can import best practices, inject more competition into the banking sector, and supplement its own regulatory oversight with that conducted by regulators in the home countries of the investing banks” (World Bank 1999 cited in Shahid 2001, p. 48).

Policy makers that rely substantially on attracting FDI in their country believe that the application of tax exemptions to foster inward investment will diversify the base of exports and increase the quality of products and services, by exposing the hosting economies to a more competitive international market (Broadman & Recanatini 1999). Studies on the determinants of FDI and the location of multinational corporations (MNCs), have found that besides tax reductions, other factors such as a large market size, quality labor force, equipment and infrastructure, the enforcement of property rights⁴, and clear regulations are other significant factors considered by foreign investors (see Markusen 1995; 2002, Nunnenkamp 2001, Blonigen 2005, Hemmelgarn 2006).

While the above reveal the importance of FDI determinants in specific sectors, other authors advise for a more comprehensive intervention in order to enhance the attractiveness of the investment climate. For instance, Shahid (2001) advocates simultaneous political interventions to redress the problems that currently hinder foreign investors from initiating businesses outside the domestic market. Incremental policies are not likely to produce substantial results and thus there is an increased

⁴ Other authors found that although the enforcement of property rights has a positive sign, it does not seem to be statistically significant indicator (Javorcik and Spatareanu 2004, p. 10).

need for concerted actions, which must target as many sectors as possible (Growth Report, World Bank 2008). Nevertheless, there are determinants that are country specific and cannot be changed easily. Dunning (1977, 1981 cited in Resmini 1999, p.6) proposed the *OLI* paradigm for studying the FDI determinants. According to this framework, a foreign company will decide to locate its operations abroad only if the comparative ownership advantage is fulfilled (*O*), the location factor (*L*) is met simultaneously and the extent to which the firm can exploit internally (*I*) all available opportunities.

Based on the above review, the FDI determinants can be grouped in several categories. The first one encompasses *socio-political indicators*, where the population size, share of urban population, and political stability are considered crucial elements for an attractive investment climate. For instance, Javorcik and Spatareanu (2004, p.19) estimate that one percent increase in population augments the FDI stock by 1.8 percent. Political stability⁵, can have a deterring effect or can be irrelevant depending on the type of foreign companies that are located in the host countries (see Bandelj 2002, see also section 4.2.2).

Second, the *macroeconomic indicators* refer to economic growth rates, GDP per capita (Javorcik and Spatareanu 2004, Nonnemberg & Cardoso de Mendonca 2002), level of exchange rates (Nakamura & Oyama 2004, cited in Hasan, 2004), level and persistence of inflationary trends (Nonnemberg & Cardoso de Mendonca 2002), quality of the labor force and human capital, infrastructural facilities like

⁵ The concept pioneered by Tumman & Emmert, (2004, cited in Kolstad & Villanger, 2008) measures the volatility of the country based on the frequency of riots and perceptions about the probability that the current government will be intimidated by violent means or constitutional measures.

transportation and communication, power supply, accommodation, and growth of exports (Hasan, 2004). The country's debt level, market size (Resmini 1999, Dunning 1993 cited in Resmini 1999) and a declared open trade regime (Nair-Reichert & Weinhold 2001 cited in Nonnemberg & Cardoso de Mendonca 2002) are also extremely significant determinants, which draw investors' attention when deciding to invest in a specific region (Resmini 1999; te Velde and Nair, 2006; Kolstad & Villanger, 2008).

Third, indicators that refer to *institutional infrastructure* are equally important and form the so-called "infrastructural fitness" (Wilhelm, 1998 cited in Hasan, 2004), which mirrors the composition of governmental organs, educational system, as the enforcement of property rights (*Index of Strength of Property Rights*⁶ used in *Global Competitiveness*⁷ reports) and socio-cultural set-ups. Regulatory policies and provisions covered in the national legal framework may attract or, at the same, deter investors from initiating any investment projects. Overregulation or "red tape", unfriendly business policies, low business climate index, price controls and state controlled central banks are most likely to affect significantly one's country investment appeal. Practices such as "behind the border barriers" and "costs of surprise" (Brahmbhatt 1998), which although are not initially stipulated in the

⁶ The International Property Rights Index gauges the significance of physical and intellectual property rights and their protection for economic wellbeing using data from 70 countries around the globe, representing 95 percent of world GDP (for more information see http://www.undp.org/legalempowerment/pdf/PRA_Interior_LowRes.pdf).

⁷ The Global Competitiveness Index is an analytical framework used by the World Economic Forum (WEF), which measures the competitiveness of 125 countries. It assesses the factors which are considered crucial for driving productivity and economic growth such as institutions, infrastructure, macroeconomy, health and primary education, higher education and training, market efficiency, technological readiness, business sophistication and innovation (for more details see: <http://www.competitiveness.lk/gcr.htm>).

agreement contracts, may pop up later and exert significant pressure on foreign investors. Therefore, foreign investors will seek to investigate in detail any record of such controversial practices.

Fourth, foreign direct incentives indicators (Lewis, 1999 cited in Hasan, 2004) are the determinants on which political actors have a large room of maneuver and may exert direct intervention by hindering or attracting foreign investors. Officials may apply high corporate taxes on the operations of foreign investors or offer favorable package of incentives. The impact of corporate taxes was confirmed in studies carried out by Hines (1996 cited in Javorcik and Spatareanu 2004), Devereux, and Griffith (1998 cited in Javorcik and Spatareanu 2004). The main tax incentives include tax exemptions, reductions of corporate taxes in specific sectors that benefit of a preferential regime and incentives for companies that provide R&D services or use domestic raw materials. The level of local value-added, level of technology used in the local industry, and companies, which fulfill the local content may thereby benefit from extended tariff protection (Lewis, 1999 cited in Hasan, 2004).

Fifth, Risk Rating is also a significant proxy for FDI which is often employed in the literature on determinants. For instance, Nonnemberg & Cardoso de Mendonca (2002, p. 9) used a group of 38 developing countries between the years of 1975 to 2000 and found that low risk ratings is negatively correlated with FDI volume and it is a highly significant variable. Other studies consider important the cultural proximity which may play a significant role in the location of MNCs as it reduces the costs of entering a foreign market (Resmini 1999, p.12). For instance, Bandelj (2002, p.23) estimates that relational characteristics (such as political alliances, networks, and

cultural ties) and investor's country controls 81 percent of the variance in cross-national FDI flows in the Central and East European countries. Chunlai (1997, cited in Gari & Josefsson 2008, p. 17) in his study analyzed thirty-free developing countries over 8 years between 1987-1994 and found geographical position, specifically remoteness, measured by the relative distance to the centre of world market, to influence negatively the FDI flow in the these countries, however, the remoteness effect seem to weaken over time.

2.2. *FDI Determinants in the Commonwealth of the Independent States (CIS)*

This section provides the reader with an overview of the FDI determinants to CIS and with the sectorial distribution of FDI flows into the region. The Commonwealth of Independent States⁸ was chosen because they share the same historical and economic past, and was formerly centrally planned states. The study sample is relevant in terms of FDI flows since this pool of countries were characterized by small FDI flows during the transition period and have been accompanied by negative economic growth rates for 6 years consecutively during 1991-1997 (Tondel 2001, p. 12). Whereas, compared with the Baltic States and Central East European countries (CEE), the average of economic growth was 5 and 3.5 percent respectively for the same period (Tondel 2001, p. 12). Previous studies followed the trend of an "inappropriate pooling of wealthy and poor countries in empirical FDI studies" (Blonigen & Wang 2004 cited in Gari & Josefsson 2004, p. 8). Thereby, the data

⁸ The Common Wealth of Independent States comprise Moldova, Ukraine, Russia, Belarus, Kazakhstan, Georgia, Kirgizstan, Uzbekistan, Armenia, Tajikistan, and Azerbaijan.

collected has been analyzed in the framework of European Union accession and ignored the FDI trends and impact on the CIS countries.

The FDI flows to the CIS countries increased over the past years from \$26.8 billion in 2004 to \$46.3 billion in 2008 and will continue to increase to an estimated \$49.1 billion to 2011 (World Investment Prospects to 2011, EIU, p. 57). However, the FDI share in the GDP of the CIS will decrease from 3.5 in 2004 to 1.8 by 2011 (World Investment Prospects to 2011, EIU, p. 57). Despite the promising growth in the volume of FDI in the region, foreign investments, according to the *Economic Intelligence Unit* (EIU 2007), will be offset by regional political risks, unfavorable business environment and susceptibility to macroeconomic fluctuations.

At the beginning of the transition period, the main motivator of foreign companies to invest in CIS was the size of the local market (Meyer 1995 cited in Reilajan et al 2001; Tolden 2001, p.38). Elteto (1999 cited in Reilajan et al 2001, p. 7) has found that the major types of FDI in the region are efficiency-seeking, market-seeking, and resource-seeking FDI. This means that enterprises that develop operations in this area are more concerned with the risk and stability of the region which is not the case with the resource seeking FDI. The main flow of FDI into the CIS countries was in the form of cross-border Mergers & Acquisitions (M&As) and the acquisition of other private companies (EIU 2007, p. 61). During the year of 2007, FDI flows into the region registered buoyant increase mainly in the primary sector and services, which almost doubled from the level reached in 2005 (EIU 2007, Foreign Direct Investment and the Challenge of Political Risk, p.53).

The researches that studied the FDI determinants to the CIS region (Doltu 2007, Popa 2007, Resmini 1998, Parletun 2007) emphasized the institutional shortcomings of the region in attracting foreign capital. Abed and Davoodi (2002 cited in Hellman et al 2002, p. 7) found that corruption is negatively correlated with FDI flows in the region. However, the impact of structural reforms that the states undertake proves to have a larger impact on the FDI volume. Resmini (1999, p.19) finds the following variables particularly relevant for CIS: GDP per capita, population, ORI (Operation Risk Indicators), new markets, lower production cost, higher profit rates (Reiljan et al 2001), the degree of openness of the economy, and of manufacturing concentration. Geographical proximity and wage differential, determinants which are believed to be significant for the region, play a minor role in attracting the foreign capital (Reiljan et al 2001. The FDI in the region depends considerably on the level of economic progress achieved by each country in the transition process (Reiljan et al 2001, p.6). The study conducted by Kinoshita & Campos (2002, p. 15) shows that concentration economies or agglomeration effect is by far the most significant driver for FDI in the CIS when compared with non-CIS countries. The “concentration economies” can be explained by the “herding effect” which means that foreign investors when confronted with information asymmetry decide to locate their operations in regions where they can benefit from positive externalities, such as qualified labor, local information, and reduced investment risk (Kinoshita & Campos 2002, p. 15). The authors also signal that small volume of investments in the CIS countries is associated with the lack of skilled labor force and deficient legal system (Kinoshita & Campos 2002, p. 16).

The next section focuses on the evolution of the main investment trends in the case of Moldova and identifies the main FDI determinants that are more likely to exert an influence on foreign investors.

CHAPTER 3: THE FDI DETERMINANTS IN THE REPUBLIC OF MOLDOVA

3.1. *General FDI Trends in Moldova*

Since it became an independent state in 1991, Moldova tried a large range of “economic cocktails” to restructure its economic sectors, to open its economy to foreign investors and further integrate in the world market. Despite all economic reforms and endeavors undertaken so far, the future and economic prosperity of Moldova still depends considerably on the economic linkages with developed countries. The chapter analyzes trends of FDI in Moldova by following the character and historical path of foreign capital into the region. The information aims to shed light on the most significant FDI factors that proved to exert a considerable influence on investors’ choice to locate or not to locate their operations in Moldova.

Although there are no “clear cut” findings in the literature which reveals the positive impact of FDI on the economic growth in transition countries, foreign capital is indeed an ingredient for stimulating competition, augmenting national capital, and engineering production (Kinoshita & Campos 2002, Popa 2007). Moldova stepped into the transition stage without any significant stocks of FDI and started to augment foreign capital in 1995 when the Russian oil company Lukoil entered the Moldovan market (Popa 2007, p. 13). The relationship of economic development and FDI in Moldova has not been readily observed, although some research suggests that, starting in 2002-2003 economic growth was affected with foreign capital flows, when the volume of foreign investments was somewhat larger and capable to push outward the economic growth (Doltu 2007). Moldova is still a relatively unattractive

country for foreign investors when compared to most other countries in the CIS, being the eighth out of eleven CIS countries based on the FDI flows (Popa 2007, p. 10). Foreign investors emerged on the Moldovan market at the beginning of 1990s and were strategic “assets-seeking”, when large array of previously state owned enterprises started to be privatized. However, the accretion of the global fixed capital in Moldova was only 21.7 % of the GDP in 2004 (Doltu 2007, p.76) and the FDI represented 6.6 percent of GDP in 2006 (MIEPO 2008). Doltu (2007) mentions that although Moldova reached in this period quite a reasonable level of economic growth, the existing resources were not directed towards the improvement of the investment climate. This signifies the fact that the attraction of foreign inventors into the country was not a priority for the governing party (the Communist Party, which has been in power since 2001), thereby, the government embarked only recently on substantial investment projects after Moldovan economy started to reflect large dependency on foreign markets and weakness of its undiversified economic sectors. It is worth mentioning that until 2001, the country did not have a national long-term investment strategy.

The structure of the Moldovan economic sectors goes back to the former Soviet Union time, when its main specialization was agriculture and food industry. Moldovan industries were oriented towards producing mostly raw materials, which were afterwards exported to other republics of the former Soviet Union that further processed the products into final goods. Thereby, the Moldovan economy developed a complete dependence upon other countries from the Union, which has great economic repercussions until today.

During the socialist period, Moldova also specialized in the production of cars and tractors, which resembles the same dependency pattern. Large volumes of raw material, labor force and energy resources were imported mainly from Russia, as the main provider, and Ukraine as a secondary provider. As Doltu (2007) effectively points out, after the collapse of the former Soviet Union, when Russia raised significantly its tariffs for energy resources and stopped importing Moldovan products, the result was a collapse of the Moldovan economic sectors (Doltu, 2007), which were completely dependent on the 'synergetic activities' of former Soviet republics. Therefore, after becoming an independent state and being forced to cope with aggressive external shocks, Moldova started to rely on foreign investments to improve its economic environment and to broaden and diversify its export base. The sectors contracted to foreign investors were closely scrutinized, as it was quite challenging to reconcile national priorities with the interests of foreign investors, with the latter being viewed as pursuing profit maximization rather than relevant investments in sectors that needed the most restructuring intervention. For instance, foreign companies invested mainly in retailing, manufacturing, transport, and energy sector but deterred from investing in agriculture or agricultural machine industry which reduced significantly the proportion of agricultural sector in GDP (Popa 2007, p. 17).

Another significant determinant which may negatively affect the willingness of foreign direct investors to locate their business in Moldova, is the small share of Moldovan exports. Although, the volume of exports is increasing (+26.4 percent), imports are still swelling at an accelerated pace (+37.8 percent) (Economic Reality 2008). The small proportion of exports reflects great dependence on foreign markets, low

competitiveness and high vulnerability, which consequently implies that the country displays a considerable investment risk (EIU, Moldova Risk Rating 2008). Moreover, the current trade deficit is around 50% of the GDP (EIU, Moldova May Report 2008). The government is trying to cover it with large flow of stable remittances, fickle foreign grants and borrowings (EIU, Moldova May Report 2008).

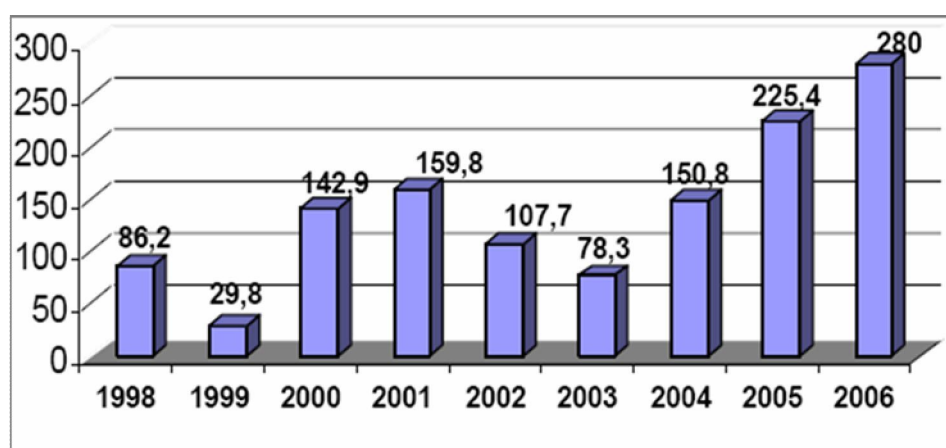
The volatility of government politics, suspicious attitude towards foreign businessmen, controversial treatment of investors, deficient competition policies all hinder Moldova's competition on the global market. Still, the main drawback is poor institutional infrastructure. The road and railroad infrastructure is underdeveloped, and the present one is badly maintained. For instance, in Chisinau, which is the hub of foreign investments, only 15% of the city's roads repair needs were completed in 2007. The streets in Chisinau are used very often as parking areas, which reduces the traffic capacity, by around 30% (Roscovan et al.2007).

3.2. Current FDI Trends in Moldova

The *2006-2015 Foreign Direct Investment and Export Development Vision and Strategy* covers significant measures deemed necessary to improve the investment environment and redress present economic situation in Moldova. The main criticism raised against the current strategy (Doltu 2007) is that it does not provide sufficient incentives to investors, who may be interested to invest in the main national economic sectors.

According to the current strategy, the main steps that will be taken to improve and promote the country image, simplify the regulatory framework and decrease the number of procedures needed to register a business. Up until now, the administrative hindrances were a major constraint which deterred considerably foreign investors from establishing businesses in the country. Although there are substantial changes in the legislation which regulate investment market, much remains to be improved.

Figure 1: *The dynamic of Foreign Direct Investments in the Republic of Moldova (1998-2006, millions of US dollars)*



Source: Doltu 2007, p.75

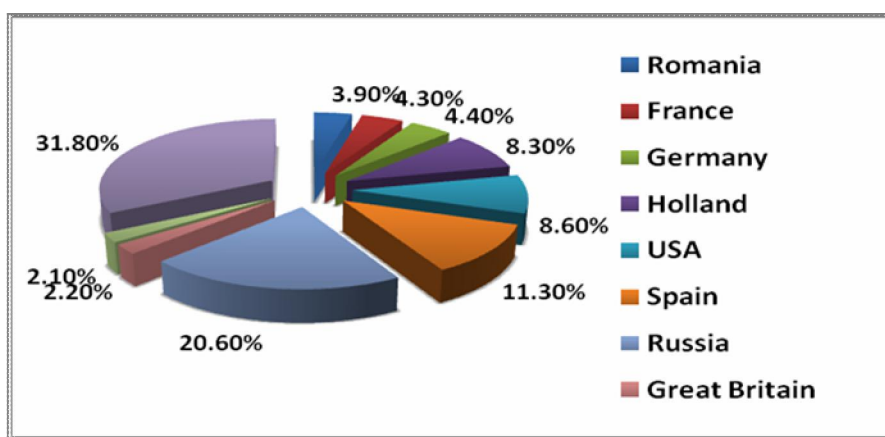
(http://www.cnaa.acad.md/files/theses/2007/7197/constantin_doltu_abstract.pdf)

During the last ten years, the volume of foreign investments has increased significantly compared to the proportions reached in 1998 (see Figure 1), when Moldova started to rely substantially on foreign investments. However, the graph above indicates considerable fluctuations in the flow of investments volumes in the economy which lacks a clear trend until the year of 2004. The FDI flows were

irregular over the last years that could potentially reflect the lack of a national strategy but there could be also other international factors that affect this trend.

Presently, there are forty-two foreign investors in Moldova, and the volume of foreign capital is steadily increasing, although there is a lot to be done regarding the improvement of the investment milieu. Currently, the main foreign investors in Moldova remain to be Holland with 31.80%, the biggest and most steady investor in Moldova since 1994 and Russia with 20.60% of shares (see Figure 2).

Figure 2: *The largest investors in Moldova (1994-2006)*



Source: Doltu 2007

(http://www.cnaa.acad.md/files/theses/2007/7197/constantin_doltu_abstract.pdf)

However, there are key objectives that have not been privatized yet, such as Moldtelecom, Tutun CTC and Alfa which missed the first wave of privatization that could contribute substantially to the development and restructuring of these companies (Popa 2007, p. 16). However, current government embarked on a large scale of privatization plans which include key companies that are still state-owned⁹.

⁹ There is still no intention to privatize the energetic sector (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008, p. 18).

The plans could be engineered by IMF visits in Chisinau, or that after the 2009 elections the CPRM will not be able anymore “to decide the fate of these assets” (EIU, Moldova Country Report, June 2008, p. 13). In June 2008 decided to privatize 40 companies via Moldovan Stock Exchange which include tobacco companies, small banks and pharmaceutical firms (EIU, Moldova Country Report, June 2008, p. 13). There are also other 10 companies on the privatization waiting list.

Table 1: *The largest Foreign Investors in Moldova (2008)*

Company	Country of origin	Domain of Activity
Societe Generale	France	Banking sector
Lukoil Europe Ltd	Russia	Petroleum products
Union Fenosa	Spain	Energy distribution
Lafarge	France	Construction materials
France Telecom MI	France	Telecommunications
Veneto Bank	Italy	Banking sector
METRO Group A.G.	Germany	Retailing
Danube Logistics	Holland	Logistics
Mabanaft A.G.	Germany	Petroleum products
WNISEF	USA	Banking sector, Food industry and glass production
KNAUF	Germany	Construction

Source: Moldovan Investment, Export and Promotion Organization (MIEPO), Investment Guide 2008
http://miepo.md/index.php?option=com_investors&Itemid=98

Moreover, the Government is planning finally to privatize the fixed-line company Moldtelecom, the Tobacco company Tutun CTC and the Unic department store in Chisinau¹⁰ (EIU, Moldova Country Report, June 2008, p. 13). Worth mentioning is the number of greenfield¹¹ investment projects that decreased from 14 in 2005 to 6 in 2006 (Chamber of State Registry cited in Popa 2007, p. 16).

¹⁰ Although the government announced the privatization of the above mentioned companies, it did not specify how much of the 100 percent state-owned enterprises will be offered to interested investors (for more information see: EIU, Moldova Country Report, June 2008, p. 13)

¹¹ Greenfield investments are the projects where all vertical processes are initiated in the host countries contrary, for instance, to the outsourcing where only specific processes are relocated in the host economy.

CHAPTER 4: MOLDOVA INVESTMENT CLIMATE RISK RATING

4.1. *Moldova's Position on International Rankings*

Towers Perrin, a global professional firm, carried out a study which involved a cross country-industry group of 1.452 senior executives of medium size and large companies around the world to see how senior executives of big companies perceive risk and opportunities when faced with market distortion, geopolitical conflicts, labor force risks or rising prices of energy (Towers Perrin Risk and Opportunity 2008). Although conducted before the credit crunch, the findings of the survey revealed that corporate leaders do not fear risks that can emerge on a host market, but they rather perceive them as potential opportunities which must be exploited in a timely manner (Towers Perrin Risk and Opportunity 2008). However, they do express greater concern about business forces from the host countries that cannot be controlled directly by foreign companies. Thereby, risks that are country specific are more likely to deter foreign investors even if the region may display an investment potential.

The most risk susceptible investments are those in high tech sector which imply greater financial commitments (Resmini 1999, p. 21), therefore is not surprising that foreign investors choose to invest in countries that rank on the top of risk ratings and usually choose to postpone investment projects in transition countries until the level of investment risk becomes acceptable for them (Lankes et al 1998 cited in Reiljan et al 2001, p. 6). International experience shows that in conditions of information asymmetry and international circulation of capital it is very important to have objective information about the business opportunities that each country might offer

in terms of governance quality, balance of payments, the structure of imports and exports, the level of bureaucracy, labor cost, infrastructure, and inflation level (Towers Perrin Risk and Opportunity 2008). Studies that considered the impact of country's low risk ratings on the FDI flows show that one percent change in ORI (Operation Risk Index) leads to 3.4 percent change in FDI stock (Garibaldi et al 2001 cited in Nonnemberg & Cardoso de Mendonca 2002, Resmini 1999, p. 19).

Moreover, Moldova currently compares unfavourably in terms of the recognized international indices that compare countries on their environment for attracting foreign direct investors. For example, the World Forum County Growth Competitiveness Index ranks Moldova 109th out of 131 countries where the lowest indices that drag down the score is innvation (131) and innovation (124) score the lowest (World Economic Forum, 2007).

To complicate matters more, corruption is still deeply rooted into the society's fabric, despite aggressive campaigns but symbolic law enforcements practices. Numerous studies which have been conducted (e.g. Benassy-Quere et al 2005), proved the substantial risk of corruption on foreign direct investors particularly on FDI flows to transition countries of Eastern Europe and Former Soviet Union (Hellman et al 2002, p.2). Wei (1997 cited in Hellman et al 2002, p. 7) finds a negative relationship between corruption and FDI in a data set of bilateral investment flows. The practice of paying bribes for solving bureaucratic problems in a timely manner will take some time to be completely erased from peoples' mentality. Moldovan businesses spend on average more than 2% of their revenues on side payments (International Finance Corporation, 2004). Moreover, based on *Doing Business* indicators, Moldova slipped

from the 90th place in 2007 to 92nd in 2008. In order to complete license work, on which Moldova scores the lowest (see Table 2) a new investor needs to fill in 30 applications, and has to spend approximately 292 days to get all the licenses required for registration (Doing Business 2008).

Table 2: *Moldova's Doing Business Ranking 2008*

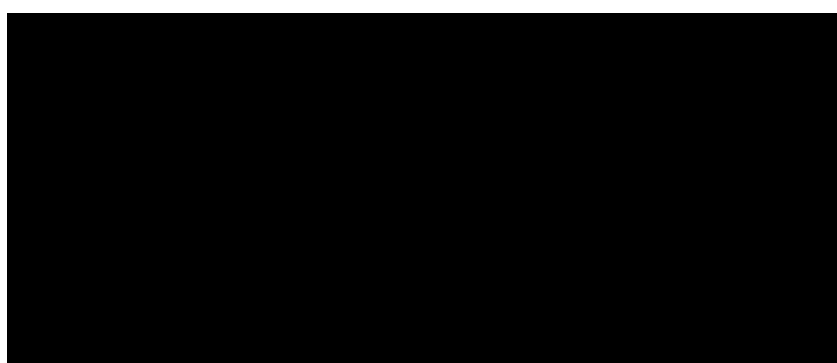
Rank	Doing Business 2008
Ease of Doing Business	92
Starting a Business	81
Dealing with licenses	153
Employing Workers	93
Registering Property	46
Getting Credit	97
Protecting Investors	98
Paying Taxes	111
Trading Across Borders	122
Enforcing contracts	17
Closing a Business	82

Source: Doing Business 2008, World Bank
<http://www.doingbusiness.org/ExploreEconomies/?economyid=129>

Paying taxes is another indicator where Moldova performs poorly. There are 49 fees to be paid which takes about 218 hours to complete and decreases the investor's profit by about 44% (Doing Business 2008). However, Moldova performs high on *enforcing contracts* (see Table 1), and it ranks on this indicator higher than Bulgaria, Czech Republic, Hungary, Poland and Slovakia (Doing Business 2008). These indicators are extremely important, as the national markets have decreased in importance due to regional and international integration. Thereby, the difference of costs among regions and the ease of doing business became among the most important factors which shape investors' decisions to locate their operations in transitional regions (Partlettun 2008, p. 7).

The FDI flow into the CIS region reflects interesting trends that varied significantly over the time. For instance, Georgia, which mirrors some of Moldova's political and economic features, but still ranks lower than Moldova in terms of risk perception rating, seems to receive larger volumes of FDI for the last 2 years and almost doubled the volumes received by Moldova in 2006 (see Figure 3).

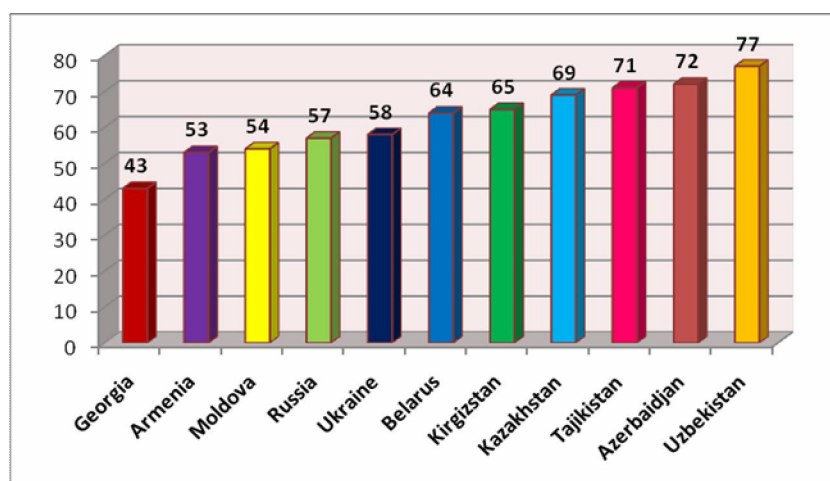
Figure 3: *FDI Flows as Gross Fixed Capital Formation in Moldova and Georgia (GFCF 1990-2006)*



Source: UNCTAD 2007, (<http://www.unctad.org/wir>)

However, Georgia rates the last on the risk perception ranking from the 11 CIS countries and ranks higher than Moldova only on security, political and macroeconomic risk which, in the case of Georgia seems to have a greater significance for investors (see Figure 4). The prospect of Georgia's accession to NATO exerts a signaling effect on investors and reflects political credibility and a much more secure environment. Although Georgia's accession to the Membership Action Plan (MAC), the last stage to become a full member, was stalled at NATO's summit in Bucharest in April 2008, the possibility of adherence gives a considerable boost to Georgia's international image (EIU, Georgia Country Report, 2008).

Figure 4: CIS Risk Ratings 2008



Source: EIU 2008

Employing the EIU data on Business Risk Rating, I will provide an evaluation of the main investment determinants that are likely to attract or deter foreign investors in Moldova.

Table 3: Moldova Risk Ratings (2008)

Risk ratings	Current Rating	Current Score	Previous Rating	Previous Score
Overall assessment	C	54	C	54
Security risk	B	36	B	36
Political stability risk	C	55	C	55
Government effectiveness risk	D	75	D	75
Legal & regulatory risk	D	70	D	70
Macroeconomic risk	B	40	B	40
Foreign trade & payments risk	B	39	B	39
Tax policy risk	B	38	B	38
Labor market risk	C	54	C	54

Financial risk	D	67	D	67
Infrastructure risk	D	69	D	69

Source: Economist Intelligence Unit, Risk Ratings: Moldova Country Briefing, April 28, 2008.¹²

4.1. Moldova's Ranking on Investment Climate Risk

4.1.1. Security Risk

The study conducted by Benassy-Quere et al (2005, p. 27) shed light on the impact of security risk on the flow of foreign capital in the host countries. Moreover, there are findings in the literature that prove that FDI inflows into a country may relieve social unrest due to the benefits of having foreign production of food and consumer goods (Piatkin 1993 cited in Tondel 2001, p. 20). Based on the Economic Intelligence Unit (Risk Ratings 2008) the security risk is low in Moldova (see Table 3). However, the Transnistrian conflict was always perceived as an eminent threat by foreign investors since the conflict resolution issue came usually on international media attention. The EU contributed significantly to the settlement of Transnistrian conflict, through the 5+2 talks (which comprises OSCE, Russia and Ukraine, and as observers, the EU and the US). After a protracted pause in negotiations, on 11 April 2008, the Moldovan President met for the first time in the last six years with Smirnov, the president of the Transnistrian breakaway region. The Moscow negotiation

¹² Economic Intelligence Unit gauges the business climate on a scale from A (no risk) to E (most risky) and from 0 (perfect business environment quite similar to industrialized economies) to 100 (unacceptable business conditions for foreign-owned enterprises). The data was kindly provided by Aidan Manktelow from EIU.

leaders pressurized the meeting and it is perceived as a “huge boost” for the ruling party, as the 2009 elections are approaching (Moldova Country Report, May 2008, EIU).

The risk of terrorist attacks is very low (EIU Risk Ratings 2008). However, the threat of organized crime is still a serious problem, since over 30% of domestic businesses that is almost double the CIS regional average, expressed their concern about organized crime (Moldova Risk Ratings, EIU 2008). Businesspersons complain about paying “protection fees” for their economic activities, a practice very much engrained in the region (Moldova Risk Ratings, EIU 2008).

Corruption is still the most difficult to fight. On 3 April 2008, the European Commission issued the second public progress report regarding the implementation of the EU-Moldova Action Plan, which highlighted significant improvements in almost all sectors covered by the agreement. However, there is great concern regarding the effectiveness of the judicial system, transparency in the business and investment climate, and the implementation of labor standards such as trade union’s rights and labor disputes stipulated in International Labor Organization (ILO) Decent Work Country Programme that Moldova signed in (Commission of the European Communities, Moldova Progress Report 2008, p. 5). The most significant achievement for alleviating the security risk was the amendment of the legislation which permits economic operators from Transnistria to register their business in Moldova. Registering their business temporarily or permanently based on Moldovan laws and regulations will allow them to benefit from international and EU trade preferences.

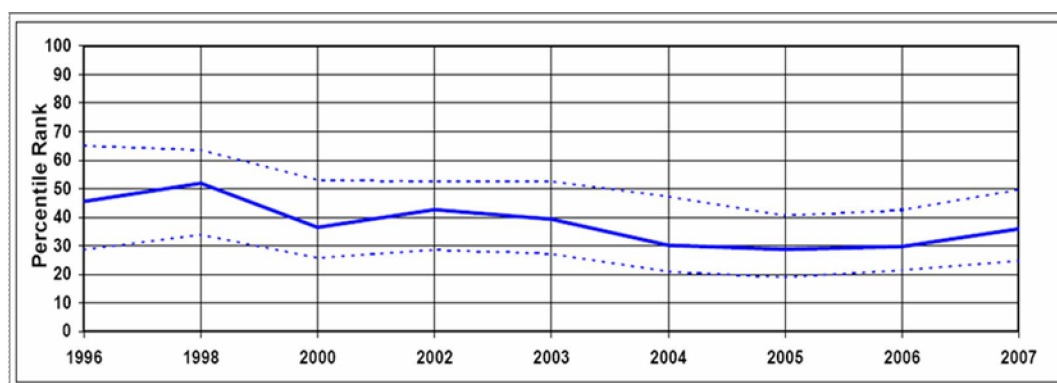
4.1.2. Political Stability Risk

The impact of political stability was extensively debated in the literature on FDI determinants and often produced mixed results with Bollen & Jones (1982 cited in Bandelj 2002) showing weaker effect of political stability on FDI and Bennet & Green (1972 cited in Bandelj 2002, p. 6) finding contrary results. Bandelj's study (2002, p. 21), which analyzes FDI determinants from a relational perspective, suggests that political stability has the biggest impact on FDI among all included variables. However, its strength is weakened when other relational predictors such as migration, trade and cultural ties, are added to the model; therefore, political stability does not have a uniform effect in all countries from the region. However, most of foreign investors are concerned with risk minimization; thereby political instability is likely to act as a deterrent for their investments¹³ (Tondel 2001, Brunetti & Weder 1997; Sing & Jun 1995 cited in Tondel 2001, p. 19).

As far as Moldova is concerned, political stability has lowered considerably in the last 10 years (see Figure 5). It was significantly weak during the period of 2004-2006 and only in 2007, it started to improve slightly, but still low compared to the pinnacle achieved in 1998.

¹³ The Head of the TCS, TATA Hungary confirmed that because of current political instability in Hungary, the company would not increase the number of employees. He also mentioned that the company would rather open new branches in Romania, Kazakhstan, Ukraine and Kirgizstan which have at least lower operations costs (Personal communication, 21.07.2008).

Figure 5: *Political Stability and Absence of Violence in Moldova*¹⁴ (1996-2007)



Source: Worldwide Governance Indicators, 1996-2007, World Bank

(<http://info.worldbank.org/governance/wgi/pdf/c138.pdf>)

The current ruling party has bolstered its popularity since 2005 with a slight increase from 45% to 46% based on Barometer of Public Opinion (BPO) compared with 70% in 2001 (Moldova Country Report, May 2008, EIU). However, the risk of political instability remains quite high (EIU Risk Ratings: Moldova Country Briefing 2008). The Communist Party of Republic of Moldova (CPRM) improved its position due to the replacement of the prime minister with a new more reformist one in March 2008. Moreover, PCRPM won the majority of seats in the autonomous region of Gagauz Yeri after it failed to obtain a meaningful number of seats in local elections last year. Positive evaluations of the European Union-Moldova Action Plan received from the European Commission strengthened the political effectiveness of the party.

The leading party embarked on controversial policies which are supposed to target directly the opposition. For instance, the changes made in the Electoral Code raised

¹⁴ The dotted lines in the graph show the minimum and maximum of the variation in the political stability indicator.

the electoral threshold from 4% to 6% and prohibits electoral blocs. Moreover, they enacted legislation which bars officials that possess multiple citizenship from holding public offices (Moldova Country Report, May 2008 EIU). This may cause social upheavals such as street demonstrations that happened in the spring of 2001. However, I would argue conversely to the EIU opinion, that the existence of strongly pro-Romanian and pro-Russian minorities does not pose any real confrontation risk as the previous street manifestations were mainly composed of pro-Romanian dissenters and boycotted the PCRM. Current discrimination policies targeted at the opposition parties strains political cooperation which was streamlined so far towards European integration.

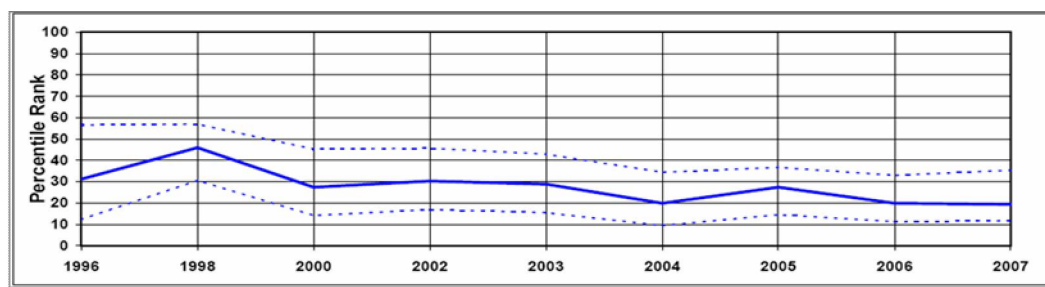
4.1.3. Government Effectiveness Risk

Kaufmann et al (1999 cited in Javorcik and Spatareanu 2004, p.9) have confirmed the impact of governance quality on FDI flows in the host country, specifically on small business enterprises which have a weaker bargaining power than bigger companies (Lskavyan & Spatareanu 2007, p. 6). The measure compiled by the authors is known as the KKZ Index (Kaufmann, Kraay and Zoido-Lobaton) which is considered a more refined and sophisticated version of Transparency International Perceptions Corruption Index. The study of Javorcik and Spatareanu (2004, p.10) also proves that better governance is more likely to attract more investing companies into the country, moreover, better institutional quality “could have as much substantial impact as suddenly becoming a neighbor of a large source country” (Benassy-Quere et al 2005, p. 4).

The impact exerted by reasonable governance infrastructure on FDI is substantial as Benassy-Quere et al (2005, p. 19), argue that governance institutions seem to exert an independent effect apart from the GDP per capita which is so much encouraging for developing countries with low rates of economic growth. It unleashes the risk of uncertainty of additional costs to FDI as policy reversals, poor enforcement of property rights and weak governance performance in general (Benassy-Quere et al 2005, p. 8).

Moldova scores the lowest on government effectiveness (see Table 3) and starting from the year of 2006 it plummeted; the drop was significant when compared with the level of government effectiveness reached in 1998 (see Figure 6). Political efficiency is rather low (EIU Risk Ratings: Moldova Country Briefing 2008) and local authorities still encounter difficulties in identifying and linking local needs with national policy objectives. Moreover, the relationship between resources and policy objectives is clearly lacking.

Figure 6: *Government Effectiveness in Moldova (1996-2007)*



Source: Worldwide Governance Indicators, 1996-2007, World Bank, (<http://info.worldbank.org/governance/wgi/pdf/c138.pdf>)

There is still substantial shortage of qualified personnel which weakens considerably the administrative capacity. Although, there is significant concern about cutting the number of public servants, there is already an approved increase in public wages up to 23 percent in order to keep qualified workers. Worth mentioning is that current public sector wage is the highest in the CIS region.

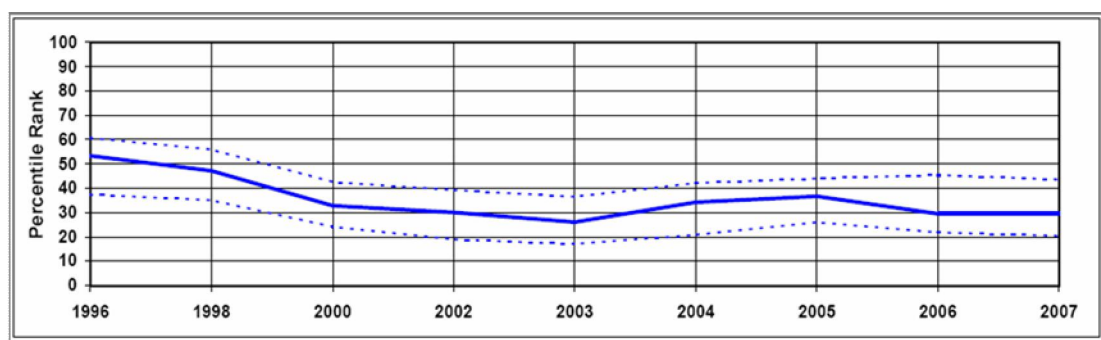
The business environment has improved but the red tape is still considerable. Vested economic interests hamper any reforming attempt as they are very well represented in both the ruling party and the opposition. The judiciary is captured and restrained by influential politicians who affect its credibility and institutional effectiveness. Public officials do not show any sign of accountability, moreover government has been currently vehemently criticized for discriminating Roma minorities and for curbing on free speech (EIU Risk Ratings: Moldova Country Briefing 2008).

4.1.4. Legal & Regulatory Risk

The performance of judicial system stands at the core of investment climate. Foreign investors need the guarantee of a fair judiciary which is free of political clout and arbitrariness. The better perceived judicial system is the higher volume of foreign capital it will be able attract (Kinoshita & Campos 2002, p. 13). As a current progress report issued by European Commission states, the Moldovan national legislative bodies perform very poorly. Major objections raised by the report targeted legislative reforms, which are implemented very slowly; moreover, current legislation on local governments is not implemented properly. The performance of judicial system in 2007 dropped and equals the rank reached in 2000 (see Figure 7). There is no comprehensive law covering all legal forms of business activities (Implementation of

the European Neighborhood Policy, Progress Report Moldova 2008, p. 10). Limitations on land acquisitions and heavy bureaucracy remain the dominant hindrances to inward investment. For instance, although the Law nr. 81-XV from March 18 2004¹⁵, regarding the investments in the activity of the entrepreneur, offers the same treatment of local and foreign investors, it still restricts the acquisition of agricultural and forestry land by foreigners which hampers considerably foreign investments in agricultural sector. Current provision contradicts with Annex 1B from GATT, Article XVI; Article 1 from Commission Directive 88/361/EEC; but also with p. 2.4.2., paragraph 1 from EU-Moldova Action Plan which calls for “the abolishment of all discriminatory acts towards foreign investors” (Popa 2007, p. 36). However, the issue of whether to permit land acquisition to foreign investors or not is heatedly debated in many countries and the fears associated with it doom large¹⁶.

Figure 7: *Rule of Law in Moldova (1996-2007)*



Source: Worldwide Governance Indicators, 1996-2007, World Bank

(<http://info.worldbank.org/governance/wgi/pdf/c138.pdf>)

¹⁵ The Law no. 81-XV from March 18 2004 is the main document that regulates the activity of foreign investors in Moldova.

¹⁶ In Moldova exists the risk of selling the agricultural land to foreign investors too cheaply. Currently, the price of ha of agricultural land is 550-650 EUR, whereas the price for a ha of agricultural land in Greece was 3500 EUR and 7000 EUR in Germany in 2003-2005 (For more information see Economic Reality, Nr. 1, March 2008).

A worrying move is a current law adopted by the government which instituted a working group to monitor the flow of strategic foreign investments and of all activities associated with them which can be interpreted as a direct control on foreign direct investments exerted by the state (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008). In the domain of services, although Moldova continues to implement the IMF's Financial Sector Assessment Program (FSAP), it does not fully comply by all regulations (Implementation of the European Neighborhood Policy, Progress Report Moldova 2008, p. 10).

There was never a solid political commitment for an independent judiciary. The CPRM that took over the legislature in 2001 attempted to reform radically the judiciary by undertaking mass replacements of judges but without having a strategic vision for such kind of restructuring. In the short run, there is a need of an outcome framework that will assess the effectiveness of present judicial branch. On the long run, however, a new generation of excellent prepared judges is needed to carry out and harness an independent judiciary from political interferences.

Significant measures were undertaken "on paper" such as Guillotine II initiated by the president Vladimir Voronin, which aimed at curbing bureaucratic procedures and red tape. The problem now is lack of implementation. Private entrepreneurs also complain that they have to complete about 350 of different taxation forms annually (Regulatory assessment survey cited in Munteanu 2005, p.9) and that the practice of giving bribes is in its zenith, therefore not "complying" with the "game rules" will result in a closed business. Consequently, people do not trust the state authorities and they perceive them as undermining businesses rather than supporting and

stimulating them. Thereby, there is a “simultaneous problem” of judiciary where “poorly functioning legal system engenders corruption and corruption, at the same time, hampers legal system from operating properly” (Broadman & Recanatini 1999, p. 18).

Despite all comprehensive measures undertaken to attract FDI, the ruling party is losing its credibility vis-a-vis foreign investors. For instance, the PCRM has cancelled a privatization agreement with a German investor based on non-fulfillment of investment commitments like what and has not yet paid back the loss incurred by the investor (EIU Risk Ratings: Moldova Country Briefing 2008). These practices of mistreatment have long-term implications and erode government credibility and commitment to protect foreign investors that choose to invest in Moldova. For instance, a study conducted by La Porta et al (1998 cited in Benassy-Quere et al 2005, p. 8) show that risk of contract repudiation by government and of expropriation of the companies or assets to have an extremely significant importance for foreign investors¹⁷. Protectionism trends displayed by the ruling party are not new and have been observed in other privatization incidents¹⁸. A case in point was the cancelation of the agreement with an Italian shoe-making firm, “GEOX”. The state feared the migration risk of workers from the state-owned enterprise “Zorile” to the Italian firm (Popa 2007, p. 12).

¹⁷ An American firm Europharm was expropriated in 2002. When the litigation was “solved”, the Moldovan state obtained the ownership of the factory without to pay the company the invested expenses (Popa 2007. P.28).

¹⁸ A relevant case is the litigation of Bimer Company which was forced to appeal to ECHR after the Supreme Court of Moldova ruled out the company’s complaint raised against a new law which stipulated the closure of all duty free shops at Moldovan customs points. As a result, the ECHR condemned Moldova to pay 52.000 of Euros (for details see Popa 2007, p. 28).

Despite all judicial shortcomings, worth noting are current improvements in the legislative framework. In the domain of company law, the legislation on limited liability companies keeps the same minimum amount of registered capital societies at the level of 5 400 Lei (Implementation of the European Neighborhood Policy, Progress Report Moldova 2008, p.10). Supreme capacities of Council of Magistracy were strengthened and a Department of Judicial Administration was established which has started its work on January 2008 (Implementation of the European Neighborhood Policy, Progress Report Moldova 2008). A National Institute of Justice was created which started its operations in November 2007 and law introduced a judicial inspection system in July 2007. The effectiveness of these institutions stands in their full implementation in accordance with European Union-Moldova Action Plan objectives. Although, the Customs Services adopted the Arusha Declaration regarding the implementation of the Ethics Code, foreign investors still regard the corruption high.

4.1.5. Macroeconomic Risk

The macroeconomic picture reveals the overall competitiveness of the country. Thereby, the decision to invest in transition countries is influenced considerably by sound macroeconomic management which transmits clear signals of government commitment and credibility (Kinoshita & Campos 2002, p. 7). For instance, low inflation rates and small budget deficit reflect the prospects of economic growth in the host countries and thereby they represent significant elements in gauging one host country's investment risk (Kinoshita & Campos 2002, p. 7). Schneider and Frey (1985 cited in Parletun 2008, p. 5) estimated the flow of FDI in 80 less developed

countries and found that the higher the real GNP and the lower the balance of payments deficit is, the higher is the potential that the country will attract foreign capital into the country.

For Moldova, the economic outlook for 2008-2009 looks promising. It will keep the same growth rate of 6 percent in real GDP and with a budget deficit of only 0.5 percent. The monetary and fiscal policies look sound. The budget revenue will suffer a setback due to zero corporate tax but it will be offset by stable public consumption which boosts the VAT revenue. Moldova will receive food aid due to previous summer draught which affected significantly the economy. Remittances sent home by Moldovan Diaspora will offset the current budget deficit which is 50 percent of GDP. According to a World Bank report, remittances to Moldova in 2007 amounted to 36.2 per cent of GDP (World Bank 2008). The volume of remittances increased more than six times during 2000-2006 (Moldova Hooked on Remittances, Business Week Business Week News 2008). Moreover, as a proportion of population, Moldova has the largest segment of its citizens working abroad (Moldova leads the World in Cash Remittances, The Tiraspol Times 2008).

4.1.6. Foreign Trade & Payments Risk

Regional integration through Regional Trade Agreements (RTAs) is considered to have a major impact on FDI due to the countries' efforts to integrate in the European Union through the Free Trade Zones (FTZs) (Blazic & Dizdarevic 2006, p. 6). Although, the authors argue about different effects of FDI on the host market due to regional integration or other types of regional agreements, overall there is a positive

impact on host productivity in specific industrial sectors (Blazic & Dizdarevic 2006, p. 6). Banga (2003 cited in Gari & Josefsson 2008, p. 17) studied the effects of investment agreements and government policies on FDI flows in developing countries. The study showed that bilateral investment treaties with developed countries and different regional treaties are significantly important for FDI location. Equally significant are the results obtained by Bevan and Estrin (2000) which show that exclusion and gloomy prospects to European Union accession of poorly developed transition countries further limits their potential for attracting FDI.

The risk of trade embargo is high as the Russian ban in 2006 demonstrated (EIU Risk Ratings: Moldova Country Briefing 2008). Although, the wine export on the Russian market resumed it is far below historical levels. Moldova used to export more than 80% of its wine to Russia and after wine resumption of the wine exports; Moldovan firms lost their market shares and have been forced to redirect their production on Western European markets. However, the wine export increased significantly from US\$15m in 2007 to US\$44m in January-March 2008 due to trading on new European markets (Economic Intelligence Unit, Country Report May 2008). Presently, wine exports on Russian market amount to 24% while wine exports to Ukraine and Belarus are 30% and 25% respectively (Economic Intelligence Unit, Country Report May 2008).

From March 2008 Moldova benefits from a preferential trade scheme, the European Union General System of Preferences, "GSP+ treatment", which opened a wider door for its competitive exports (EIU Risk Ratings: Moldova Country Briefing 2008). Moldova and Ukraine continue to implement the agreement on the New Customs regime which is based on Joint Declaration of Moldovan and Ukrainian Prime

Minister of December 2005 (Implementation of the European Neighborhood Policy in 2007, Progress Report-Moldova, Commission of the European Communities, p.6).

The regulations on foreign investors are more lax now and Moldova has liberalized current-account operations and foreign investors can repatriate funds freely but the capital account has been only partly liberalized (Economic Intelligence Unit, Country Report May 2008).

4.1.7. Tax Policy Risk

The transparency of the tax system seems to have a greater impact than tax incentives as such (Tondel 2001, p. 31). For instance, a survey conducted by Lankes & Stern (1998 cited in Tondel 2001, p. 31) reveals that high tax regulations are considered the most severe obstacle by 80% of the enterprises engaged in business worldwide and specifically in CIS region. Although tax policies and tax incentives are not considered important factors for foreign capital flows by some authors (Lankes & Stern 1998), they do exert an enormous influence as most of the countries from the region converge and compete using similar policies (Blazic & Dizdarevic 2006, p. 3). The impact of tax policy efficiency on FDI was confirmed by Globerman and Shapiro's results on bilateral FDI (1999 cited in Benassy-Quere 2005, p.22, Blomstrom & Kokko 2003 cited in Blazic & Dizdarevic 2006, p. 7). The findings indicate that higher values of tax system and government effectiveness in origin country reduce outward investment, whereas higher scores in the host country attract inward investments. Moreover, the transparency and predictability of the tax system seem to be more relevant and crucial for multinational companies than

specific tax schemes incentives (OECD 2003 cited in Blazic & Dizdarevic 2006, p. 23).

As the EU-Moldova Action Plan required it, the government adopted the 2006-2010 Fiscal Service Development Strategy, and started the implementation of the fiscal performance indicators to streamline and introduce discipline into the sector. However, current tax exemptions are not expected to boost foreign capital into the country. The problem is the high rate of other high “hidden taxes” such as social state contributions, VAT and other local taxes which must be paid by the foreign entrepreneurs. Moreover, the VAT reimbursements to economic agents is still a problem especially for non-residents, as Moldova applies VAT on exported goods (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008). Although the fiscal reforms undertaken were considered to level the field for domestic and foreign investors, in the case of fiscal amnesty in 2007 and other regulations¹⁹, it favored only the local state-owned enterprises without considering the companies of the foreign investors. There are significant improvements regarding the curbing of bribery related to tax collection (EIU, Moldova Risk Rating 2008).

4.1.8. Labor Market Risk

The results of a study conducted by Javorcik and Spatareanu (2004, p.1) as well as some theoretical models (Haaland et al 2003 cited in Javorcik 2004) show that greater flexibility of labor market regulations are associated with larger flows of FDI

¹⁹ Due to a lack of universal definition of “state subsidy” in the national legislation which is compatible with the EU legal framework for competition policy, there is high concern among foreign investors in regarding the free competition as the government subsidizes only state-owned enterprises and municipal companies.

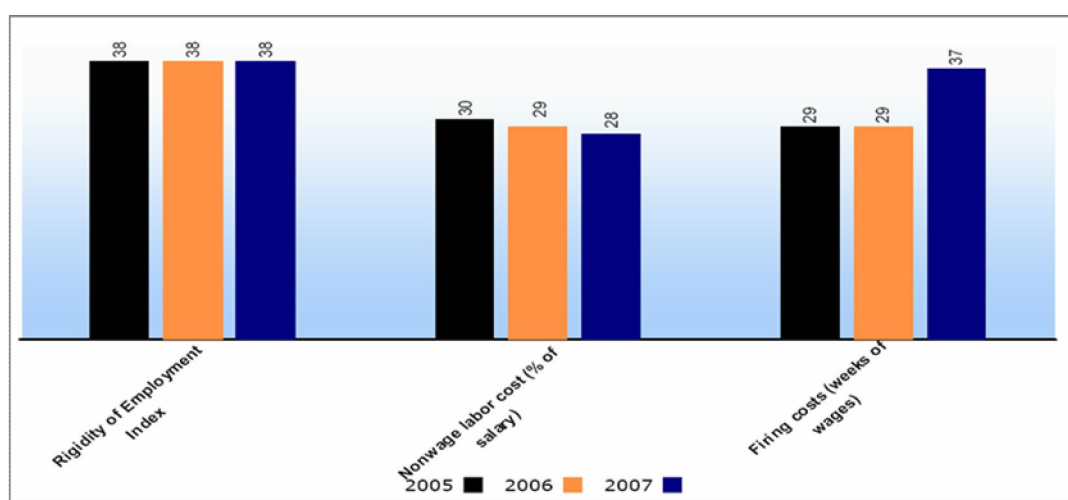
especially in transition countries, moreover as the flexibility increases from inflexible to flexible the volume of FDI soars by between 14 and 18 percent.²⁰ Moreover, London and Ross (1995 cited in Bandelj 2002, p.7) based on their theory of global capitalism state that developed countries prefer lower labor control and cost of the developing markets. The findings are useful for the Moldovan case (due to its status of a transition country and of larger potential to attract FDI in the service sectors) as the study reveals that labor flexibility has a larger impact on FDI in service sectors than in the manufacturing.

In some cities in Moldova such as Chisinau and Balti, migration raised wages and created labor shortages. Moreover, labor regulations are far more rigid than the European and regional standards (EIU Moldova Risk Rating 2008). The employment terms lack flexibility, which did not change for the last years (see Figure 8), and although Moldova signed the ILO Decent Work Country Programme in 2006, it still needs to amend the legislation regarding labor disputes and implement the regulations appropriately on the free association and collective bargaining (Commission of European Communities, Moldova Progress Report 2008). The two syndical organizations, the Confederation of Syndicates and the Confederation of Free Syndicalists “Solidarity”, merged but their real independency vis a vis the government still needs to be proved. Although, an elaborate legal framework is in place, the Labor Code is irregularly applied. The non-salary cost of employing a worker are significantly high and dismissing a redundant worker seems at times impossible (The Heritage Foundation, The Index of Economic Freedom 2008). The numbers of days Moldovan workers loose on strikes is high above the CIS average

²⁰ A study (unpublished) conducted by Dewit, Gorg and Monagna (2003) also researched the impact of labor regulation on the FDI flows in the OECD countries and revealed that inflexible labor regulations hampers the location of FDI in the host countries.

(0.4 days per year per business) and current regulation which requires employers to provide employees with insurance certificates and return them if the workers are fired, make foreign investors question the profitability of the Moldovan business environment (EIU, Moldova Risk Ratings 2008).

Figure 8: *Employing workers indicators in Moldova (2005-2008)*



Source: Doing Business, Moldova country report, World Bank

(<http://www.doi.gov/oia/procurement/reports/2008%20World%20Bank%20EoDB%20Rankings.pdf>)

4.1.9. Financial Risk

A transparent financial sector is pivotal for establishing a sound credibility of the system. Thereby, predictable credit market regulations and soundness of commercial banks exert enormous influence on FDI (Benassy-Quere et al 2005, p.25). For instance, results obtained by Alfaro et al (2002 cited in Lyrودي et al 2004,

p. 100) show that insufficiently developed financial markets reduce the effect of FDI spillovers. Moreover, a great bulk of literature finds a statistically positive relationship between a sound financial system and FDI flows in transition countries (e.g. King & Levine 1993 cited in Tondel 2001, p. 11). Major investors complain about illiquid local markets which represents a hindrance to finance investments in Moldova with more than 70 percent of resources needed coming from savings and other retained earnings (EIU Moldova Risk rating 2008). There are 15 commercial banks with only two foreign branches (The Heritage Foundation, The Index of Economic Freedom 2008). Thereby, the financial sector still lacks foreign investors who have greater possibility to access the world market; moreover, capital markets are not fully developed whereas the stock market it is in its infancy (EIU Moldova Risk rating 2008).

4.1.10. Infrastructure Risk

A high quality infrastructure reduces the effect of distance and has a bigger potential to integrate low developed regions into the national economy (WEF, GCI 2007, p. 4). The quality of infrastructure in the host countries is a prerequisite for attracting FDI regardless of its type (Kinoshita & Campos 2002, p. 7). For instance, the results obtained by Kinoshita & Campos (2002, p. 12) reveal that a sufficient infrastructure along with market size and availability of skilled workers, are the most important FDI drivers for CIS countries.

As far as Moldova is concerned, the road and railroad infrastructure is badly maintained due to insufficient financial resources and to a non-transparent founding

system (EU-Moldova Action Plan, Implementation Screening, Expert Group 2008). For instance, in Chisinau, which is the hub for foreign investments, only 15% of the city's repair needs are being implemented in 2007. The streets in Chisinau are used very often as parking arrears and this reduces the traffic capacity by 30% (Roscovan et al.2007). Almost all freight is done via railways and passenger traffic (the former accounts for roughly 30% of freight and 80% of passengers), which is significantly hindered by underinvestment and slow reforms which depend financially on fickle foreign grants (EIU 2008). All international flights are concentrated in Chisinau airport, which serves over 20 international destinations (EIU 2008). Current progress has been achieved in improving aeronautics security and in replacing a number of old aircrafts. The government adopted the 2007-2012 Development Strategy for Civil Aviation but the strategy does not discuss the resources for financing the major objectives (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008, p. 18).

Mobile telephone network has also extended rapidly. The Moldtelecom, the fixed-line company, remains state-owned while all privatization attempts have been stalled. Internet use, which is technically monopolized by the Telecom (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008, p. 19), is limited in rural areas, albeit growing rapidly in urban areas (EIU 2008). The National Agency for Telecommunications and Informatics regulations is still highly state dependant (EU-Moldova Action Plan: Implementation Screening, Expert Group 2008, p. 19). Municipal infrastructure reform is necessary while water provision is still sub-standard (EIU 2008).

CHAPTER 5: CONCLUSION

The paper has enabled the identification of factors which affect FDI flow in Moldova and to analyzed the potential of the country to attract foreign capital given the results. Although, Moldova made substantial steps to restructure and innovate its policies in order to integrate in the world economy. The investment in research and innovation is almost insignificant since only 0.35 percent of GDP is allocated for this area. Moldova's position on international rankings is very low without any significant changes over the years. Moldova ranks the lowest on the investment freedom, being the 89th out of 162 countries having its business environment 30 percent free according to the Index of Economic Freedom (The Heritage Foundation, Index of Economic Freedom 2008). Based on risk rating indicators (EIU 2008), it the highest investment risk having only Armenia and Georgia under at the bottom on the ranking. Security risk remains to be high due to organized crime and corruption, which is very high, compared to the region average. Political stability, although has improved in the last 10 years, is still lower than in 1998. The government effectiveness is the riskiest indicator as the level of government performance in 2008 mirrors the level reached in 1998 with no significant improvements. Lack of political will and shortage of qualified personnel weakens considerably the administrative capacity. The business environment is still characterized by red tape, corruption, vested interests, and weak judiciary.

The judicial system is the second riskiest indicator as the judiciary is still highly state-dependant. Moreover, current restrictions imposed on foreign investors, such as impossibility of acquiring agricultural and forestry land will further deter important investments in agricultural sector.

Regarding the risk of foreign trade and payments, in Moldova foreign investors can repatriate funds freely but the capital account has been only partly liberalized. The tax policy is still highly unpredictable with “hidden taxes” and other state contributions and local taxes. The non-salary cost of employing a worker is significantly higher than the average in the CIS region and dismissing a redundant worker is almost impossible. The financial sector still lacks foreign investors moreover; capital markets are not fully developed whereas the stock market it is in its infancy. Badly maintained road and railroad infrastructure is likely to exert a negative impact on foreign investors.

The whole package of reforms that was undertaken was either too late or started under the pressure of international advisers and economic considerations²¹ (Bokros 2007). There was a continuous resistance to open traditional sectors to foreign investors. However, Moldova looks more cosmopolitan nowadays with services devolved to international companies, which brought high quality services for reasonable prices. Here can be mentioned Spanish energy distribution company, which revitalized the system completely. There is still a lot to be done which cannot be achieved without political will and commitment which will improve Moldova’s score on the international rankings on which foreign investors rely extensively²².

²¹ Personal communication with Prof. Lajos Bokros.

²² Personal communication with the Head of TCS, TATA, Hungary, 21.07.2008.

APPENDICES:

Appendix 1: *FDI flows into Eastern Europe*

Eastern Europe	1996	1997	1998	1999	2000	2001	2002	2003
Inflows (US\$bn)	16.8	24.1	26.7	29.1	29.5	30.0	36.0	35.1
%of world total	4.2	4.9	3.7	2.6	2.1	3.5	5.8	6.2
% change, year on year	1.2	43.1	10.8	5.6	1.5	1.5	20.3	-2.9
%of GDP	1.8	2.6	3.2	4.0	3.7	3.4	3.6	2.9
	2004	2005	2006	2007	2008	2009	2010	2011
Inflows (US\$bn)	66.8	77.1	105.9	104.0	94.3	94.1	94.8	96.9
%of world total	9.2	7.9	7.9	7.1	6.7	6.4	6.2	6.0
%change, year on year	90.8	15.4	37.2	-1.8	-9.3	-0.3	0.8	2.3
%of GDP	4.4	4.1	4.7	3.8	3.0	2.8	2.6	2.4
CIS	1996	1997	1998	1999	2000	2001	2002	2003
Inflows (US\$bn)	5.3	9.0	6.8	6.9	5.4	7.2	9.1	15.8
%of world total	31.6	37.5	25.4	23.7	18.4	24.1	25.3	45.2

%change, year on year	32.4	69.9	-24.9	-2.7	-21.3	32.9	26.6	73.5
%of GDP	1.1	1.7	1.8	2.4	1.5	1.8	2/0	2.8
	2004	2005	2006	2007	2008	2009	2010	2011
Inflows (US\$bn)	26.8	26.1	42.2	52.0	46.3	48.0	48.0	49.1
%of world total	40.1	33.8	39.9	50.0	49.0	51.0	50.6	50.6
%change, year on year	69.4	-2.9	62.1	23.1	-11.0	3.7	0.0	2.3
%of GDP	3.5	2.6	3.3	3.4	2.6	2.4	2.1	1.9

Source: World Investment Prospect, Economic Intelligence Unit
http://a330.g.akamai.net/7/330/25828/20070829185216/graphics.eiu.com/upload/WIP_2007_WEB.pdf

Appendix 2: Numbers of Reforms of Doing Business 2008

Rank	✓ Positive Reform ✗ Negative Reform Economy	Starting a Business	Dealing with Licenses	Employing Workers	Registering Property	Getting Credit	Protecting Investors	Paying Taxes	Trading Across Borders	Enforcing Contracts	Closing a Business	Total number of reforms
1	Egypt	✓	✓		✓	✓			✓			5
2	Croatia	✓			✓	✓					✓	4
3	Ghana	✓			✓	✓			✓	✓		5
4	Macedonia, FYR	✓	✓					✓				3
5	Colombia						✓	✓	✓			3
6	Georgia	✓	✓		✓	✓	✓				✓	6
7	Saudi Arabia	✓				✓			✓			3
8	Kenya	✓	✓		✓	✓						4
9	China		✓			✓					✓	3
10	Bulgaria		✓					✓		✓		3
	Moldova	✓		✗				✓		✓		2
	Czech Republic	✓	✓	✓								3
	Hungary	✓			✓			✗			✓	2
	Poland				✓					✓		2
	Slovakia											0

Note: Economies are ranked on the number and impact of reforms, Doing Business selects the economies that reformed in 3 or more of the Doing Business topics. Second, it ranks these economies on the increase in rank in Ease of Doing Business from the previous year. The larger the improvement, the higher the ranking as a country reformer.

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