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The Case of Romania

I. Introduction

The collapse of communism in Eastern Europe has left significant economic challenges in its wake. The first challenge facing these newly liberated states is the removal of the centralized economic system that allocates resources by command and sets prices without reference to market forces. The second challenge is more long-term in nature and involves the recapitalization of the national industrial base. It is finding the solution to these short- and long-run problems that represents the challenges and opportunities present in the transitional economies of Eastern Europe. Such solutions are required to assure that economic growth and development proceed.

The replacement of centralized economic planning with a system of free prices and private ownership of capital is essentially an internal political process. The speed and extent of the dismantling of the structure of government subsidies and the state operation of enterprises must be determined by the resilience of the population. Consequently, the focus of this study will be upon the process of industrial recapitalization in these emerging market economies. More specifically, we will examine the determinants of foreign direct investment, which

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represent a critical component in the revitalization of industry in Eastern Europe.

Presently, the rate of capital inflows into the former Soviet bloc is inadequate for meaningful industrial recapitalization. Although foreign investment has increased relative to previous years, the high degree of political uncertainty remains a deterrent to many Western investors. East European governments have attempted to allay these fears through a nearly complete deregulation of the legal framework that controls direct foreign investment. As shown in Table 1, most of the former centrally planned economies now allow 100 percent foreign ownership and the repatriation of profits. Some of these countries also have instituted significant tax deductions and tax holidays.

Romania, the focus of this study, represents one of the most dramatic cases of transition to a market-based economy.¹ Having been both the poorest and the most authoritarian among the Soviet bloc nations, Romania will face the greatest challenges in converting to a market-driven economy. To date, the transition strategy of the Romanian government has emphasized four elements: lifting price controls, privatization, institutional reform, and incentives for foreign investment. Attracting foreign capital is of tremendous importance to Romania, yet the government's principal focus has been only on tax incentives. The objective of this study is to examine the determinants of foreign direct investment and thereby assist in the design of policies that will stimulate Western investment in Romania. Although politically unique, this period of economic transition is not so different from that experienced by many Third World nations, especially those of Latin America. Indeed, we use the pattern and nature of foreign direct investment in Latin America to develop a descriptive relationship of foreign investment that will be of use for Romania and, more generally, for all of Eastern Europe.

The choice of Latin American economies as our sample for analysis is determined by the relatively large number of observations from an approximately homogeneous group of countries. Much like the East European countries under consideration in this paper, many of the Latin American countries in the sample have experienced periods of state intervention and economic regulation interrupted by periods of economic liberalization. The longer-run trend in these countries has been toward increasingly free markets, consistent with the current state of the East European economies. Moreover, the general level of

Table 1

Western Joint Ventures (JVs) in Eastern Europe

	Total JVs with Western partners	Total JVs with U.S. partners	Major sectors	Legal conditions
Albania	9	0	NA	<ul style="list-style-type: none"> —Passed first foreign investment law on 7/31/90 —Allows JVs, does not allow 100% foreign ownership —100% repatriation of domestic and foreign profits —100% foreign ownership allowed —New law passed 5/17/91
Bulgaria	100	21	Food processing Footwear Chemicals Electronics	<ul style="list-style-type: none"> —Repatriation for all profits pending under internal convertibility and future BIT —Allows for 100% ownership —JVs have lower tax rate —100% foreign ownership allowed —No government licenses required —100% repatriation of domestic and foreign profits
Czech and Slovak Republics	1,000+	40	Casino Light industry Retail sales	<ul style="list-style-type: none"> —100% foreign ownership allowed —No government licenses required —100% repatriation of domestic and foreign profits
Hungary	5,000	300	Consumer goods Services Manufacturing Tourism	<ul style="list-style-type: none"> —100% foreign ownership allowed —100% repatriation of export earnings —Access to foreign exchange —Amendments to joint-venture law pending —100% foreign ownership allowed —100% repatriation of hard currency/some soft —Two to five year tax holiday —100% foreign ownership allowed —Repatriation of profits and invested capital guaranteed
Poland	2,442	177	Food processing Construction Tourism	<ul style="list-style-type: none"> —100% foreign ownership allowed —100% repatriation of export earnings —Access to foreign exchange —Amendments to joint-venture law pending —100% foreign ownership allowed —100% repatriation of hard currency/some soft —Two to five year tax holiday —100% foreign ownership allowed —Repatriation of profits and invested capital guaranteed
Romania	1,000+	50+	Data processing Chemical production Services (trading)	<ul style="list-style-type: none"> —100% foreign ownership allowed —100% repatriation of hard currency/some soft —Two to five year tax holiday —100% foreign ownership allowed —Repatriation of profits and invested capital guaranteed
Yugoslavia	1,000+	42	Food processing Electronics Tourism	<ul style="list-style-type: none"> —100% foreign ownership allowed —100% repatriation of hard currency/some soft —Two to five year tax holiday —100% foreign ownership allowed —Repatriation of profits and invested capital guaranteed

Source: Eastern Europe Business Information Center. Revised July 18, 1991.

income and standard of living in most Latin American countries is similar to that prevailing in Eastern Europe. The similarities between these two groups of countries are also evident in terms of the level of industrial development and national productivity levels.

II. Theoretical Discussion

A number of studies have examined the nature and level of foreign direct investment. In this section we will construct a model for foreign direct investment using variables suggested in the literature. The results of this analysis will allow us better to understand the nature of foreign investment in an emerging market such as Romania.

Imports. According to Mundell (1957), foreign direct investment should flow into those countries that are importing goods from abroad. Because of market imperfections, such as tariffs and quotas, foreign firms will find it attractive to produce locally in order to satisfy domestic demand. This classic concept of "import substitution" has long been a theory used to explain international capital flows.

Helmberger and Schmitz (1970) as well as Dunning and Norman (1983) contend that foreign direct investment creates vertically integrated production units and therefore increases the amount of trade. Hymer (1970, 1972), Kindelberger (1970), Vernon (1966), and Caves (1971) argue that, given the oligopolistic structure of markets and international integration, imports and the level of foreign direct investment are complementary. Thus, the hypothesized relationship between imports and foreign direct investment is positive.

Exports. As the level of a nation's exports increases, its economy becomes more internationally integrated. This has the effect of altering local labor markets and driving domestic wages toward world levels. This, in turn, makes foreign investment less profitable as the advantage of lower wages evaporates. Based upon these observations, one might hypothesize a negative relationship between exports and foreign direct investment.

There is, however, an alternative possibility. A nation may have higher exports because of some unique access to foreign markets. If, for instance, a country characterized by low wages had access to a trading group, one might expect that country to attract significant levels of foreign direct investment as countries external to the trading group attempted to sell within the group. This targeting of the low-wage

country by nations outside the trading group could lead to a positive relationship between the level of exports and foreign direct investment.

Infrastructure. Vernon (1966) has suggested that for production to migrate abroad, the host nation must provide an adequate infrastructure. Munteanu (1991) has also described the essential dilemma of the foreign investor, that is, the multinational corporation desires to operate within a developed nation that has a reliable infrastructure because such an infrastructure will result in a more efficient distribution system. Moreover, as noted previously, a less-developed nation likely means lower wages with a correspondingly greater profit potential. Based on these observations, *ceteris paribus*, we hypothesize a positive relationship between foreign direct investment and the level of development of the country's infrastructure.

Gross domestic product (GDP). Gross domestic product captures the productive capacity of an economy. It reflects both the size of the domestic market and the purchasing power of citizens. A positive relationship between this variable and foreign direct investment would be consistent with Kindleberger (1970), who contends that foreign investment requires a sufficiently large host-country market to accommodate the increase in local supply.

Population. Population is a measure of the potential market size of the host country. A smaller population will reduce the projected profit from foreign investment as potentially low wages will be more rapidly driven to world levels. Culem (1988) reports a positive impact of population on foreign investment within developed countries. The model to be specified might enter this variable as a direct measure of population, in which case we would expect a positive relationship between population and foreign direct investment. Alternatively, the influence of population may enter the model as a per capita measure of imports, exports, or GDP.

Political risk. The existence of political risk should have a depressing effect on the attractiveness of foreign direct investment. Aharoni (1966, 1973) notes that, although managers attempt to avoid risk in their investment decisions, many dimensions of risk are difficult to measure. Thus, the political risk associated with foreign direct investment has a high subjective content. Lucas (1990) considers political risk to be one of the major reasons why capital does not flow from wealthy to poor nations as freely as predicted by neoclassical theorists. We hypothesize a negative relationship between this variable and

foreign direct investment, suggesting an inverse relationship between political risk and the level of foreign direct investment.

III. Empirical Methodology

A. Model Specification

Based upon the immediately preceding discussion, we specify our model of foreign direct investment as follows:

$$\text{FORINV}_{j,t} = \beta + \beta_1 \text{IMP}_{j,t-1} + \beta_2 \text{EXP}_{j,t-1} + \beta_3 \text{GDP}_{j,t-1} + \beta_4 \text{VEH}_{j,t} + \beta_5 \text{RISK}_{j,t},$$

where:

$\text{FORINV}_{j,t}$ = net dollar amount of foreign direct investment in country j at time t ;

$\text{IMP}_{j,t-1}$ = dollar amount of imports in country j at time $t-1$ standardized by the country's population at time $t-1$;

$\text{EXP}_{j,t-1}$ = dollar amount of exports for country j at time $t-1$ standardized by the country's population at time $t-1$;

$\text{GDP}_{j,t-1}$ = dollar value of country j 's gross domestic product at time $t-1$ standardized by the country's population at time $t-1$;

$\text{VEH}_{j,t}$ = number of commercial vehicles used in country j at time t standardized by the country's population at time t ; and

$\text{RISK}_{j,t}$ = the natural log of a published political-rights index for country j at time t .

Further elaboration regarding the specification of each of the variables presented above is required. Four of the five independent variables are specified in a per capita format. These variables are imports, exports, GDP, and commercial vehicles (our measure of the level of infrastructure development). Further, three of these variables, imports, exports, and GDP, are lagged one year because of the possible problems of reaction time as well as a possible problem of endogeneity.² Capital inflows are not likely to reflect the influence of changes in these variables instantaneously. In terms of the possible endogeneity problem, large foreign investment flows could have an impact on the reported levels of imports, exports, or GDP.

Because infrastructure involves so many different components of a nation's economy, there are a number of possible proxies for its

measurement. We elect to use the number of registered commercial vehicles to represent the extent of infrastructure development. As vehicle registration increases, so do the miles of paved roads, fuel stations, and other such measures of infrastructure. Such increases, in turn, should have a favorable influence on commodity distribution and communication networks.

The RISK variable captures the degree of democracy of the political system rather than the political risk of the nation.³ This index, calculated by Freedom House of New York, was selected over other indices, such as International Business Communication's International Country Risk Guide or the Political Risk Index produced by the Economist Intelligence Unit, because of its availability over a longer time period. Variables reflecting the corporate tax regime and exchange rates are not included in the model's specification for two reasons. The first concerns the extremely limited data available on corporate tax structures for our sample of developing nations. Second, for many of these nations the exchange rate is set by government authority on an administrative basis and does not reflect the true market valuation of its currency.

B. Sample and Data Description

As discussed above, our sample consists of eleven Latin American countries: Argentina, Bolivia, Brazil, Chile, Colombia, Ecuador, Mexico, Paraguay, Peru, Uruguay, and Venezuela. Our sources of data include the International Monetary Fund's *International Statistics* (1963–88), the United Nations' *Statistical Yearbook*, and the Gastil Freedom Index published by Freedom House (Gastil 1978). Our period of analysis extends from 1963 to 1985, but because of incomplete data not all countries are included for every year.

IV. Empirical Results

The results of our regression analysis are contained in Table 2. The results are consistent with previous findings regarding the importance of international trade as a determinant of foreign direct investment. The estimated coefficient of the previous period's imports (IMP) is positive and significant, indicating that the volume of investment inflows is directly related to the volume of foreign imports.⁴ Culem

Table 2

Determinants of Foreign Direct Investment

$$\text{FORINV}_{j,t} = \beta + \beta_1 \text{IMP}_{j,t-1} + \beta_2 \text{EXP}_{j,t-1} + \beta_3 \text{GDP}_{j,t-1} + \beta_4 \text{VEH}_{j,t} + \beta_5 \text{RISK}_{j,t}$$

Variable	Coefficient	Probability value
INTERCEPT	139.659	0.9596
IMP	12.332	0.0352
EXP	-31.513	0.0001
GDP	7.701	0.0001
VEH	2,643.767	0.0001
RISK	10.755	0.9929

Adjusted R² = 0.3836
F = 155.933

(1988) and Harvey (1989–90) have recently provided evidence consistent with this result. The negative and significant estimated coefficient of the previous period's exports (EXP) indicates that the smaller the volume of exports from the developing country, the more likely it is that the country will receive foreign direct investment. This finding is consistent with our expectations, indicating that the policies and strategies of multinational corporations are strongly oriented toward cost reduction: that is, multinational corporations invest in countries with the largest potential for increases in exports. This is also consistent with neoclassical theories, e.g., Heckscher and Ohlin (1991), which predict that capital will flow to countries with the highest marginal productivity of capital. In countries with a relatively low level of exports, the factors of production are not fully competing for price equalization on the international market. Therefore, there are benefits to be exploited as a result of the lower prices of the factors of production. Investing in such a country, however, should increase the level of exports and ultimately drive up the price of the factors of production.

The estimated coefficient of the previous period's gross domestic product is positive and significant as hypothesized. As the less developed countries of the sample become more wealthy, they represent a potentially more profitable market and thus should attract larger amounts of foreign direct investment.

As expected, we found a positive and significant estimated relationship between the number of commercial vehicles in use (VEH) and the level of foreign direct investment. It is important to note that this variable proxies the level of infrastructure development in these

economies. Adequate infrastructure permits the minimization of transportation and distribution costs as well as the penetration of new markets.

The political-rights variable (RISK) has a positive estimated coefficient that is not significantly different from zero. If one were to attribute information to this point estimate, it would suggest that foreign investors prefer to invest in countries dominated by restrictive political systems. That is, it may be that foreign investors are risk averse and prefer to invest in nations with a high degree of social stability. Though historically dictators do not long endure, their regimes are usually of sufficient duration to be considered a reasonable investment horizon. The truth is that investment in a free but poor country with significant social problems may be viewed as more risky than one in a totalitarian regime.⁵ However, it must be emphasized that this discussion is based upon a positive point estimate, not a significant estimated coefficient.

IV. Application of Findings to Romania

A. Relevance to Romania

Because the transition to a market economy in Romania has only recently begun, it is impossible to examine the relationship between foreign direct investment, trade, and infrastructure using current Romanian data. The time series of the required data is not currently sufficiently developed. Yet it is not unreasonable to believe that our empirical findings using a sample of other developing nations are applicable to Romania. We base this contention on three critical considerations.

The first consideration that validates these results for Romania involves the nature of state economic planning. In our sample of countries, the central government had long been the primary economic agent. In Romania, the state economic sector had been strong for decades, and government intervention in the economy had been extensive. Second, political instability and/or social unrest are common phenomena in many of the countries investigated. The experience of most former communist countries has been similar since their independence from the Soviet bloc. Third, Romania, like the nations in our sample, is a developing country. Moreover, the countries in our sample include a wide variation in their level of development, so there should be no particular bias. Given the relevance of these findings for Romania,

let us now consider the present state of foreign direct investment in the Romanian economy.

B. Current Foreign Investment in Romania

From March 1990 through September 1991, the number of investment projects involving foreign capital in Romania increased sharply from about a dozen firms to more than 5,900. The total foreign capital invested by these firms was \$245 million, an average of \$41,600 per project. Table 3 provides a detailed national breakdown of foreign investment in Romania by total capital committed and the number of joint ventures.

Although the amount of foreign investment in Romania has recorded tremendous increases since the democratic revolution of 1989, its absolute level continues to be relatively modest compared to the requirements for the Romanian economy. Estimates for the modernization of Romania's energy sector alone approximate \$1 billion. Thus, given Romania's need for foreign capital and the limited amounts currently being received, it is critical that both Romanian officials and international investors understand the determinants that make foreign investment attractive. The following discussion will expand upon those factors and illustrate how they might apply to Romania.

C. Determinants of Investment in Romania

In a recent study, Munteanu (1991) evaluates the political and economic determinants that supposedly shape foreign investment decisions in Eastern Europe. He argues that in the case of Romania overall economic and financial risks are perceived to be higher and more important than the political risk for businesses. The behavior of foreign firms in Romania appears to support such a belief, as major investors seem to be attempting to avoid uncertainty by entering into joint ventures with the state. Foreign investors will obviously minimize the risks associated with an emerging market economy if their joint ventures are with the government. The extent to which foreign firms are willing to invest in an evolving economy may depend upon the extent to which the state is willing to share its monopoly. When domestic output declines, as is presently true in Romania, the absolute size of the state monopoly correspondingly shrinks. Therefore, the part to be shared becomes

Table 3

Joint Ventures in Romania (March 1990–September 1991)

Country	Total capital invested (\$000)	Country	Number of joint ventures
United States	31,746	Germany	918
Germany	27,323	Italy	624
Italy	26,209	Syria	541
England	21,804	Turkey	536
France	16,435	United States	367
Netherlands	16,372	Lebanon	315
Switzerland	11,692	France	315
Spain	11,223	Israel	252
Turkey	8,361	Hungary	188
Austria	7,940	Austria	187
Dominican Republic	7,553	Greece	170
Syria	6,775	Jordan	156
Israel	6,495	Iraq	130
Canada	6,021	England	109
Lebanon	5,925	Switzerland	106
Ireland	5,122	Netherlands	102
Egypt	4,105	Iran	101
Greece	3,457	Sweden	87
Soviet Union	2,107	Canada	84
Hungary	2,052	Belgium	81
Cyprus	1,993	Yugoslavia	78
Yugoslavia	1,826	Egypt	53
Sweden	1,693	China	49
Iraq	1,396	Australia	44
Iran	1,323	Cyprus	37
Jordan	1,089	Spain	26
Belgium	995	United Arab Emirates	25
Australia	782	Liechtenstein	23
Hong Kong	744	Soviet Union	22
Moldovan Republic	618	Denmark	22
Korea	583	Moldovan Republic	21
United Arab Emirates	550	Sudan	17
India	309	Libya	17
Cameroon	292	Kuwait	14
Singapore	284	Bulgaria	13
Liechtenstein	282	Yemen	12
Libya	220	Poland	12
Norway	209	India	11
China	182	Norway	10
Japan	162	Ireland	9
Panama	143	Tunisia	8
Tunisia	108	Singapore	8
Yemen	108	Panama	8
Bulgaria	103	Pakistan	8
Denmark	103	Japan	8
Finland	95	Korea	7

Table 3 (cont.)

Country	Total capital invested (\$000)	Country	Number of joint ventures
Luxembourg	91	Finland	6
Sudan	88	Algeria	6
San Marino	87	Qatar	4
Kuwait	79	Luxembourg	4

Source: Romanian Agency for Development 1991.

smaller, reducing the probability of attracting large foreign investors. Maintaining a monopolistic environment and eliminating investment restrictions combine to provide attractive investment opportunities but may deter the emergence of free competition in the future. There is a clear trade-off. If the dismantling of the state monopoly proceeds rapidly, significant long-run investment opportunities are created. Alternatively, the political and economic instability arising from an excessively rapid dismantling of state monopolies may discourage more immediate foreign investment.

The levels of both imports and exports are shown above to be important issues relative to foreign direct investment. In order to reduce its dependence on foreign markets, Romania pursued an import-substitution-oriented strategy of development until 1989. This type of inward-oriented policy allows economic growth only through increases in domestic demand and output.⁶ While drastically reducing imports, the Romanian government imposed draconian measures to increase exports in order to reduce its foreign debt. At the beginning of 1989 the foreign debt was retired, but the economy was weak with both a stagnant technological base and low productivity. Presently, Romania does not have a coherent trade policy. Export subsidies have been reduced, while some import restrictions have been lifted. Yet the government continues to impose other restrictions on exports. Our empirical results suggest that countries that have the potential to increase exports and are relatively dependent on imports are more likely to be the targets of foreign direct investment. In the case of Romania, an export-promotion strategy is preferred to an import-substitution strategy because it imposes low barriers to international trade and signals that the country is willing to become more internationally integrated. Moreover, the United Nations' *World Development Report* (United Nations 1985) finds that export-oriented developing countries achieve higher growth performances than those pursuing import substitution.

Physical infrastructure is another critical determinant of foreign direct investment. Romania is an example of the importance of infrastructure in determining the level of economic growth. Romania's economy presently suffers from inadequate and obsolete highway, communications, and distribution systems. Many of the shortages of 1990 and 1991 were caused by the failure of the distribution and communication facilities, not by the lack of supply. It is reasonable to believe the empirical conclusion that multinational corporations prefer to invest in countries with a higher level of infrastructure development. Hence modernization of the Romanian infrastructure is essential for the expansion of foreign investment. Until now, the state has not appeared eager to undertake massive public investment in this sector. The reasons are simple. Tax revenues are not sufficient to support such long-term expenditures, and the benefits of such investments are long-term in nature. Yet the costs of failing to make such expenditures will be felt by the economy for many years into the future. Rather than allocating scarce capital for the maintenance and operation of inefficient state-owned facilities, Romania needs to increase its spending on infrastructure development.

V. Conclusion

The object of this study has been to examine the determinants of foreign direct investment in emerging market economies. We have then applied these findings to Romania in an effort to direct public discussion and policy initiatives into meaningful channels. A successful program of foreign investment will permit the modernization of the Romanian economy and perhaps ultimately ensure the survival of its recently enacted democratic reforms.

Our findings indicate that a country's participation in international trade has a positive influence on its capital inflows. Greater levels both of imports and of export potential enhance a nation's attractiveness for foreign direct investment. This suggests that Romania should abandon the vestiges of its former policy of attempting to produce locally for import substitution and move toward a greater export orientation.

We also discover that the degree of infrastructure development has an overwhelming impact on the process of foreign investment. The existence of adequate distribution and communication networks

encourages capital investment by multinational corporations. Romania needs to increase its public funding for infrastructure-related projects in order to maximize its return from invested capital.

As with all the newly liberated East European countries, Romania will continue to experience tremendous social changes. These changes need to be accompanied by political stability in order to produce an attractive investment environment for multinational corporations. The requirements of balancing democratic change and political stability are a challenge to all emerging market economies of Eastern Europe. It is important to realize that efforts to retard the implementation of democratic changes in order to preserve political and economic stability may ultimately result in a failed conversion to a market economy.

Notes

1. Although the former Soviet-bloc nations all had centralized economic planning, there is currently a diversity among them. Czechoslovakia, Hungary, and Poland are more developed than Bulgaria or Romania. Attempts to reform the communist economic system were made in Hungary and Poland earlier than in any other communist nation. Czechoslovakia, Romania, and Bulgaria began their reforms only after 1989.

2. In our estimation of the model, we also used lags of two and three years. The results obtained were qualitatively identical to those reported for a one-year lag, and thus they are not presented separately in this study.

3. The possible values of this index range from 2 to 14. A free country in which the citizens enjoy political rights and civil liberties would have an index equal to 2, whereas a country experiencing a total dictatorship would have an index equal to 14.

4. Industrial-organization-based explanations of foreign direct investment, such as Caves (1971), Vernon (1966), and Kojima (1978), further inquire whether the foreign investment was a substitute for imports, was generated by market imperfections and protectionism, or was a complementary alternative for multinational corporations to minimize production costs.

5. Because of the qualitative nature of the political-risk variable, we also estimated our regression analysis excluding this variable. The results were not significantly changed. The estimated coefficients of the remaining variables retained both their sign and their significance.

6. Romania was not the only developing country to use an import-substitution type of trade policy. Outside the communist bloc, other developing countries, such as Argentina, Bolivia, Peru, Ethiopia, and Bangladesh, pursued import-substitution strategies as well. The alternative to import substitution is export promotion. In this case, the economy is outward focused and, therefore, significantly dependent on international markets.

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