

INCREASING OF CAPITAL FLOWS TO THE REPUBLIC OF LATVIA: ILLUSTRATION OF AN INVESTMENT PROJECT PORTFOLIO

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Abstract

Small open economies, such as the Republic of Latvia, are dependent on financial and capital flows to the economies to ensure their development. Due to the existing financial and economic crisis, capital flows to Latvia have significantly decreased in some times even reversed. In such circumstances, new ways of attracting investment flows to the country must be sought.

Aim: the aim of this paper is to illustrate the possibilities of attracting financing, including exemplifying an alternative way of attracting financing for business projects in the private and public sector, by joining them in a project portfolio, undertaking an initial due diligence, and presenting them to international investors in a structured and cost-efficient manner.

Materials and methods: analysis of existing literature on achievements of other countries in the domain of investment attraction and use of investment project portfolio, analysis of available information on countries, focus group method, expert interview method.

Main results and conclusions: fostering of investment to the country is necessary, especially in the wake of global economic and financial crisis. Although investment is being promoted already, more can be done in this domain. The paper illustrates the possibility of institution of investment project portfolio, which would show the demand for investment that is currently unknown and which would enable investment promotion actors promote investment to Latvia proactively.

Key words: *investment, FDI, investment promotion, investment project, investment project portfolio.*

Introduction

Development of a country can take place based on internal development stimulus or its development can be fostered by external development momentum. Internal development can be grounded in inter alia abundance of production resources, abundance of workforce, its knowledge and skills, geographic position, historic heritage etc. External support, in turn, can take the form of investment into a country, thereby fostering its development. There are various types of investment, among which foreign direct investment (FDI) deserves special attention due to a number of its positive characteristics such as the positive spillover effects, transfer of knowledge and know-how, increasing of other capital flows to the country and others. For small and open economies, such as Latvia, investment flows play an important role in the development of their national economies.

Over the last years, Latvia has suffered economically and financially from the global economic and financial crisis. Since FDI is one of the profound ways of levelling up the development of the national economy of a country, the situation with attraction of FDI to Latvia needs to be examined. It is necessary to understand the current situation with FDI in Latvia, the plans of increasing FDI flows to Latvia, and the possibilities to improve the existing situation. Comparison with other countries in this regard is viewed as important, since it might disclose effective and efficient means of working with investment, with particular emphasis on FDI.

Methods employed for writing of this paper are as follows. Analysis of existing literature and analysis of experience of other countries in promoting investment has been performed. Moreover, institution of investment project portfolio and investment attraction in general has been discussed in a focus group comprised of high level experts and managers at the Riga International School of Economics and Business Administration. The issue of investment project portfolio has also been discussed with a number of high level managers both in public and private sector. Representatives of the focus group and the high level managers have positively recognised the project portfolio idea and have come up with a number of useful suggestions that have been employed in the course of writing of this publication.

This paper is organized as follows. The next part describes the importance of FDI in a national economy. The third part describes the situation with foreign investment in Latvia, the fourth part sheds light on the investment promotion plan of Latvia, and the fifth part shows some examples of investment attraction in other countries. The sixth part explains a novelty in investment attraction, a project portfolio. The last part concludes the paper and provides suggestions for further research.

Importance of FDI

Importance of FDI in development of national economy can hardly be overestimated. Empirical work on the role of FDI in host countries seems to suggest that FDI is an important source of capital, complements domestic private investment, is usually associated with new job opportunities, in most of the cases is related to the enhancement of technology transfer and overall boosts economic growth in host countries (Chowdhury et al, 2003). According to Borensztein et al (1995), FDI is an important vehicle for the transfer of technology, and there are strong complementary effects between FDI and human capital on the growth rate of income. As stated by Lim (2001), FDI contribution to growth comes through its role as a conduit for transferring advanced technology from the industrialized to the developing economies. Knowledge diffusion (often referred to as externalities or efficiency “spillovers”) can lead to improvements in productivity and efficiency in local firms in several ways, firstly, a spillover can occur when a local firm improves its productivity by copying the same technology used by multinational affiliates, and secondly, when local firms are forced to use existing technology and resources more efficiently, or to search for more efficient technologies, because entry of multinational affiliate has increased competitive pressure in the local market. In addition, spillovers can occur when an affiliate demonstrates new techniques to and trains local workers, who later accept employment in local firms or start their own firms. FDI appears to have “crowding-in” effect on domestic investment (Lim, 2001), having two potential effects on domestic investment: by competing in products and financial markets, multinational corporations may displace domestic firms, however FDI may also facilitate the expansion of domestic firms through complementarity in production and productivity spillovers. Available studies find the latter effect to be dominating (Borensztein et al, 1995).

The attraction of FDI to the host country happens mostly by creating favourable investment climate and exploiting appropriate investment promotion.

Moran (1998) states, that important determinant of FDI caused spillovers magnitude is the type of host investment climate. Liberal investment climate would tend to generate stronger spillovers because it is more likely to attract more dynamic FDI that have a number of attractive qualities in that they are large, enjoy economies of scale, exhibit best management practices, are at the cutting edge technologically, and highly efficient. On the other hand, a restrictive investment climate with conditions such as mandatory joint partnership, licensing, or domestic content requirements tend to attract FDI that are likely to be less efficient and exhibit older technology, as well as experience slower rates of new technology transfer and lags in the utilization of advanced management systems.

Purpose of investment promotion is to reduce the costs of FDI by providing information on the host country, helping foreign investors cut through bureaucratic procedures, and offering fiscal or other incentives to international investors. Investment promotion activities lead to higher FDI inflows to developing countries (Harding et al, 2007).

Investment promotion includes several components (Wint et al, 2000):

- * National image building: aims to build a perception of the country as an attractive location for foreign direct investment;
- * Investment generation: involves identifying potential investors, developing a strategy to contact them and starting a dialogue with the purpose of having them commit to an investment project;

- * Investor servicing: assisting committed investors in analyzing business opportunities, establishing a business and maintaining it;
- * Policy advocacy: initiatives aiming to improve the quality of the investment climate and identifying the views of private sector in this area.

Opinions differ regarding what is most important for effective FDI attraction – investment climate or investment promotion. As stated by Harding et al (2007), on the one hand, investment promotion may be more important in the developing world where information is more difficult to access. On the other hand, it is possible that investment promotion may be ineffective due to deficiencies of the business environment, or even unnecessary, if low labour costs alone are powerful enough to attract foreign investors. The data suggests that investment promotion efforts are more effective in developing countries with a good business climate. This is consistent with the view that marketing a country works only if there is a “good product” to sell. We share the view that investment climate and investment promotion are inter-dependant composites of a successful FDI attraction strategy.

Investment promotion in a country is usually performed by investment promotion agency (IPA) or by number of small interrelated agencies and institutions. IPAs are potentially key institutions for delivering increased levels of welfare through the attraction of FDI (UNCTAD, 2008). IPAs’ fundamental purpose is to act in the national interest by helping to bring into the country needed capital, technology, advanced managerial skills, and access to international markets. IPAs are therefore expected to develop mechanisms designed to attract foreign investors and to facilitate their setting-up business in the country (FIAS, 1999).

Necessity of FDI attraction to Latvia

The economic situation in Latvia has worsened since the beginning of the global financial and economic crisis that broke out in 2008. The GDP decrease in 2009 amounted to 18% year-on-year (Central Statistical Bureau of Latvia - CSB). The 1st quarter of 2010 witnessed 13.8% decrease of GDP compared to the same period in 2009 (Bank of Latvia, 2010). In the meanwhile, the registered unemployment kept rising and stood at 16.2% in May 2010 (Bank of Latvia, 2010). State budget deficit saw significant increases from 0.3% of GDP in 2007 to 4.1% of GDP in 2008, to 9% of GDP in 2009. Although state budget income in 2009 was lower than both in 2007 and 2008, the state budget expenditure in 2009 was above its 2007 levels, though lower than in 2008. The government debt level in 2009 kept rising and according to the May 2010 ECB Convergence Report (p. 43), the government debt is expected to reach 48.5% of GDP in 2010 (European Central Bank, 2010).

Aforementioned macroeconomic indicators show the general outcomes of the global financial and economic crisis. The said crisis has also had its impact on the investment flows to Latvia. Year 2009 was the first year since Latvia joined the European Union in 2004 when it witnessed drop in total accumulated investment in the country. Although the drop was around 2.4% (CSB), it still showed the change in trend. Total accumulated FDI, in turn, remained almost at the level of 2008 with less than half a percent increase in 2009 over 2008. The whole picture of total accumulated investment can be seen in Graph 1.

However, a completely different graph can be created when comparing incoming/outgoing FDI over years since Latvia joined the European Union. In year 2009 the incoming FDI was LVL 36.3 million, which is 94% less than in 2008 when it stood at LVL 604.4 million, and incoming FDI in 2008 was already 49.2% lower than in 2007. Graph number 2 depicts the trend for years 2004-2009 as a percentage of GDP.

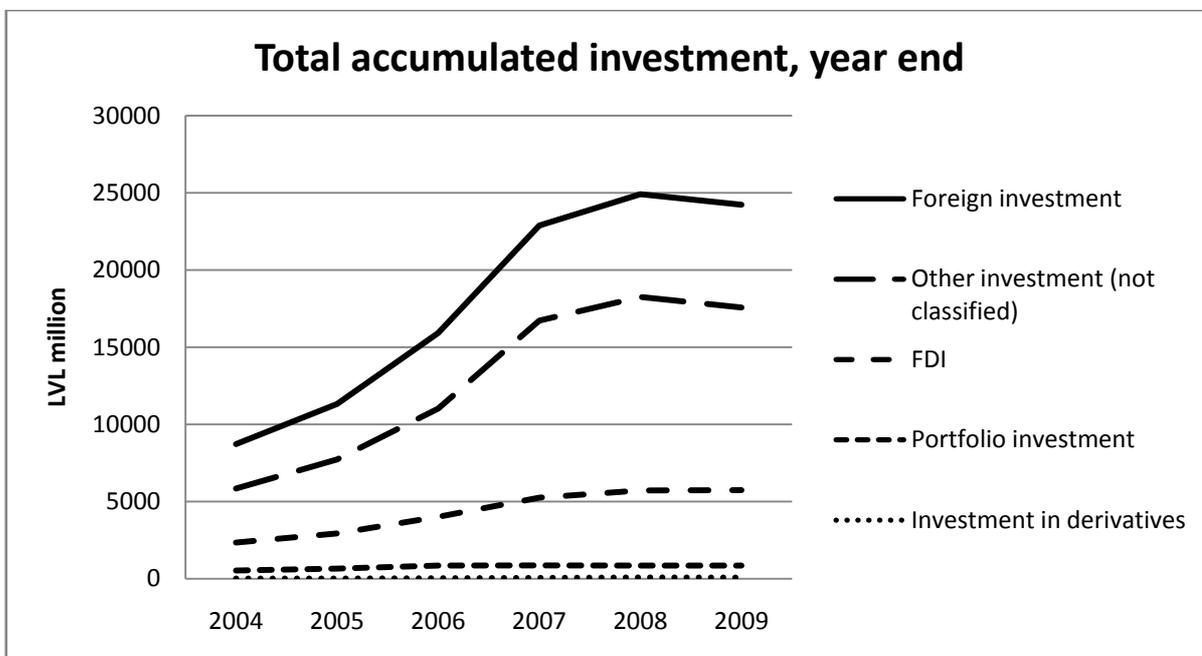


Figure 1: Total accumulated investment in Latvia, by types of investment, year-end, mill. of LVL (source: CSB).

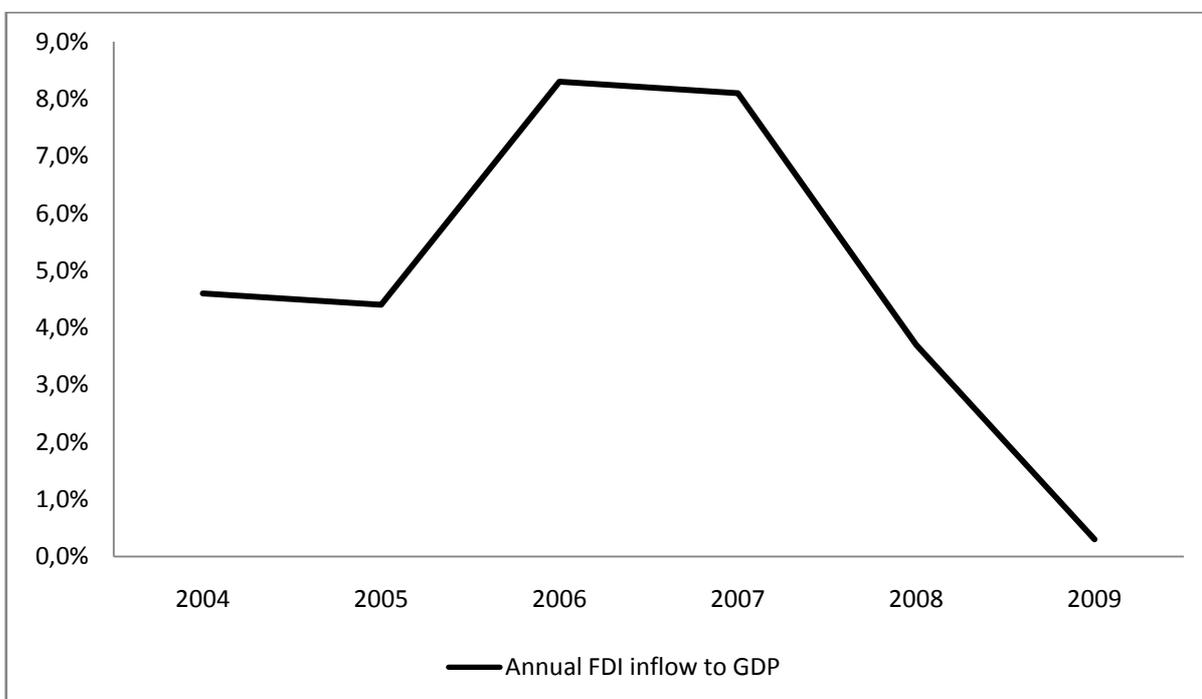


Figure 2: Annual FDI inflow to Latvia, as percentage of GDP (source: CSB).

As was seen in the previous part of this paper, FDI is a major catalyst to growth. Hence, the fact that FDI inflow to Latvia has almost been put to halt in 2009 is arguably compromising the future growth prospects of Latvia. The aforementioned facts call for action to promote investments and FDI in particular to Latvia.

Investment attraction plan of Latvia

Problems with investment attraction have been also recognized by the Government of Latvia, and some of them have been laid out in the Plan of fostering of exports of products and services made in Latvia and attracting investment for the years 2010-2011, which has been adopted by the Government of Latvia on March 31, 2010. The goals of the plan are to

foster the competitiveness of exporters by providing export support activities as well as fostering attraction of FDI.

The aforementioned plan foresees specific activities for fostering of attraction of FDI (p. 24-27). Almost all of these activities are to be carried out by the Investment and Development Agency of Latvia (IDAL). The activities foreseen are:

- * responding to potential investors' requests, organizing of visits of foreign investors to Latvia, technical support for investors that want to start doing business in Latvia;
- * integrated marketing campaign for attracting of investment in specific sectors, participations in exhibitions and conferences, incl. within the scope of methodology of Polaris system;
- * preliminary research for potentially significant investment projects;
- * formulation of active investment attraction methodology;
- * provision of support for innovative business ideas and high value-added entrepreneurship, thereby creating new businesses capable of exporting;
- * organization of or participation in investment or trade promotion seminars;
- * proactive involvement of representations of Latvia abroad in FDI promotion.

The plan does also contain some other measures that can stipulate FDI attraction indirectly by having implicit positive impact on the business environment in Latvia. The activities foreseen above, however, do not substantially differ from the activities that are and have been carried out by the IDAL. Moreover, the necessary budget for these activities, according to the plan, for 2010 is LVL 146,087 and LVL 141,000 for 2011. Not only the budget is slightly lower for 2011 than for 2010, but the budget as such is very low compared to the activities foreseen. Hence, the plan does not seem to provide for a real solution for increasing of FDI flows to Latvia.

Country experiences

As a result of worsening economic situation, almost all countries had to accept and implement some actions and programs aimed at increasing economic stability of the country. The new methods and strategies for attracting FDI were also considered, IPAs often being the main body responsible for development, implementation and supervision of more intensive investment attraction strategies. The main steps made towards increase and maintenance of FDI flows to the particular countries can be mainly divided in two groups:

- * short term oriented activities, aimed at creation of even more positive image of a country as a place to invest comparing to the rivals, thus increasing FDI flows to the particular country in the nearest future and this way softening the negative impact of the crisis to the national economy;
- * long term strategies, aimed at development of certain investment attraction instruments or specific industries, that may be considered as crisis resilient, thus way increasing FDI flows in the long and medium run, and protecting national economy in case of possible future crises.

The aforementioned groups of activities will be supported by some examples.

As one of the immediate measures that can be undertaken to increase competitiveness of a country is provision of more timely and accurate information to the potential investors. This is the classic element of investment promotion, which can be used both if there are changes in the investment environment of the country, or if the environment is unchanged and just to better promote existing investment opportunities and look more competitive than the rivals with less intensive investment promotion. Active investment promotion techniques as a response to crisis were undertaken by Turkey (Erdilek, 2009) and Ukraine (InvestUkraine, 2009). Even if provision of timely and accurate information to investors does not automatically make country very attractive to possible investors, positive signals are being sent that increase the likelihood of attracting investments to the particular country.

Another example of immediate investment attraction activities is immediate involvement in development of actual and projects important for everyday use, such as road and railway infrastructure, modernization and construction of facilities and other infrastructure that is of everyday importance. It might seem obvious that in times of scarce financial resources the development of infrastructure projects might be stopped or slowed down till better times, but the example of Armenia (Armenian Ministry of Economy, 2009) shows that the crisis might be a triggering factor to raise efforts to attract foreign financing for development of practical and needed state infrastructure, this way increasing total FDI flows to the country and employment. Poland also is expecting to maintain high level of FDI by involving foreign investors in development of country infrastructure that is still not so good as compared to European developed countries (Brownell, 2010a).

Increasing responsiveness and availability of the government to potential investors is of crucial importance for successful investment attraction, and if countries were not maximally hospitable and approachable, so the crisis was the right moment to re-evaluate the proximity of the government to investors. The government of Rwanda, for example, has significantly reduced bureaucratic procedures, enforced anti-corruption legislation and changed the way of „doing business” in governmental sector, treating investors as clients are treated in private sector, and providing high quality services to them in terms of fast service delivery (Brownell, 2010b). As a result of aforementioned activities and due to impressive improvements of investment environment, Rwanda rose 76 places in the World Bank’s ‘Doing Business 2010’ report, from 143rd in the world to 67th; rose 144 points from 171st to 27th in terms of protecting investors; and was named as the world’s biggest reformer across all indicators.

New investment attraction technique that can be considered as immediate, but also with lasting effect, is change in the way investors are approached. In the period of crisis many countries have realized that it might be not enough just to provide information to interested investors, but it might be worth to search for investors themselves, offering interesting investment opportunities and specific projects to carefully selected potential investors. The situation changed from principle „investors search for countries” to principle „countries search for investors”. Although usage of aforementioned technique has not witnessed dramatic increase in FDI flows, still it can contribute to the investment promotion by successful combination of it with other investment attraction techniques. Some countries that have changed the way foreign investors are approached are Moldova (OECD, 2009a) and Ukraine (InvestUkraine, 2009).

Regarding the long-term oriented investment attraction tools, as one of the main and general proposals made by OECD to the countries where investment attraction policy is still in development phase, was definition of country specific investment promotion strategy, based on core competences and available resources of the country. Creation of common strategy is a cornerstone for successful development of the investment policy of the country in a centralized, structured and clearly defined way.

The experience of economic downturn showed that less hit by the crisis were those countries or regions where crisis resilient industries are more developed. As an example, Navarre started to recover from crisis much faster than any other region of Spain, Navarre’s GDP rose 0.5% in the third quarter of 2009, compared with a decline of 0.3% for Spain. Renewable energy is one area in which Navarre can be considered to being a world leader. Navarre is also a leader in medicine and medical research, and agribusiness and wine is also vital to its economy. As future plans to maintain high competitiveness in terms of good place to invest is development of manufacturing in high value added industries, as well as development of green energy industry (Stewart, 2010). Rwanda, for example, set up the ten year plan to develop such sectors as tourism, ICT, business services, agro-business and infrastructure, as well as use country’s natural resources and produce energy (Brownell, 2010b).

Another way how to use the scarce resources of the country effectively is undertaking sector approach and concentrating on core competences of the country. Czech Republic has proved to be a successful example in implementing cluster approach (Peterkova, 2009), and this approach has gained much attention in the crisis period. Sector specific approach helps to understand few core competences of the country, and to concentrate the scarce investment promotional resources on those sectors, that are likely to bring the most benefit to the development of the economy. The sector approach is already widely used in Poland (Mezynska, 2009), but such countries as Moldova (OECD, 2009a) and Ukraine (OECD, 2009b) are just on the implementation stage of this approach. At the same time, concentration on few core competences of the country should not mean „putting all eggs in one basket”, but must be well diversified and go in line with aforementioned development of crisis resilient industries.

Development of free economic zones and industrial parks is considered as long term investment attraction strategy, aimed at creation of convenient infrastructure and investors' supportive environment. Creation of free economic zones enables possibilities to develop some particular regions of the country, increasing employment by creation of more job places. Concentration of particular type of enterprises in one place also means convenience in term of infrastructure, supply services, and possibilities to develop common R&D. Good example of free economic zones and industrial parks development show, for example, Turkey (Mum, 2009) and Czech Republic (Pokorny, 2009). Development of free zones is recommended by OECD, to countries that have a potential to do it or where free zones do exist but are underdeveloped, in order to increase attractiveness of the country for foreign investors (OECD, 2009b).

Even an excellent investment promotion on its own can not attract many investors if the investment environment is not as good and simply understandable as that of rivals. Removal of specific policy barriers is considered to be an important and strategic factor oriented towards increase of FDI flows. If the countries have not been improving their investment environment before the crisis, the period of dramatic drop in FDI has actually enforced revision of own policies and implementation of all possible improvements and simplifications. Removal of policy barriers is also suggested by OECD to countries with still complex and non-transparent regulations and high level of corruption and bureaucracy.

To sum up, briefly the investment attraction techniques implemented (or planned to be implemented) as a response to the economic downturn, the techniques mainly touch upon following issues:

- * Concentration on specific sectors that reflect the core competences of the country;
- * Diversification of investment supported industries, and developing crisis-resilient industries and those with high value added;
- * Changing the way the investors are approached
- * Understanding of drawbacks of existing investment environment and removal of identified policy barriers.

Investment project portfolio

Previously, from what has been done thus far in Latvia and what is planned for the nearest future, it can be seen that all of the existing and planned activities tackle the supply side of investment attraction, i.e. what infrastructure the country has, the promotion of its investment climate etc. However, the demand side also needs to be tackled, i.e. what specific projects can be offered for investment. Hence, as a novelty, at least hardly found described in the contemporary literature on investment attraction or explicitly used by any known country, this paper offers the approach of institution of a project portfolio for investment attraction.

What can be concluded from the information above, is that at the present situation a specific tool for financing of projects in the times of crisis is needed. Financing needs to be available for projects that cannot be regarded as regular, i.e. where either the project is

sophisticated or the financing mechanism is so. Moreover, the funds need to be sought proactively with swift and focused way of reaching potential investors. The funds would be used for implementation of investment projects, financing of development efforts of companies, restoration of solvency of companies, and on a higher level – development of the national economy.

Project portfolio would be comprised of a number of projects ready for implementation but lacking financing. The projects should conform to a number of important criteria, such as but not limited to: being important for the national economy, being attractive to investors, already commenced or ready to be commenced, with clearly defined modes of collaboration etc. Projects included in the portfolio would have undergone at least initial due diligence to ensure their conformity with good praxis of doing business. Project portfolio would create the possibility of knowing the investment-ready projects and providing the opportunity of sorting them according to industry, type of investment, amount of investment, means of collaboration etc. Such a tool would actually provide investment promoters and IDAL at the forefront with an instrument that would help doing the investment promotion proactively, since the pool of available projects would be known as opposed to the current situation. Practical institution of investment project portfolio would ensure exploitation of several important investment promotion elements that were identified as useful by the experiences of other countries in times of crisis, such as identification of core competences of the country, sector specific approach, active investor targeting, and realization of long term sustainable investment strategy. According to the information available, Ukraine has recently started to implicitly use investment project portfolio approach, every year accepting set of projects at the level of government (InvestUkraine, 2009). However, this paper provides more specific approach to institution of project portfolio, putting specific attention on selection, financing, and promoting of financing of projects included in portfolio.

One focus group and some expert interviews carried out on the research subject show positive appreciation of the proposal to create portfolio of investment projects. Focus group results and results from the interviews show that the idea of creating the said portfolio needs to be elaborated more in detail as well as the benefits achieved need to be compared with the additional costs incurred. Proactive seeking of investment has been emphasized as necessary, and project portfolio has the potential in helping this task to be accomplished.

On the practical side, institution of an aforementioned project portfolio is neither prohibitively difficult, nor expensive. The ideological founders of the project portfolio idea could well be public sector institutions that work or deal with projects in different domains: IDAL with business projects, Ministry of Regional Development and Local Governments or Association of Regional and Local Governments with municipal projects, Societal Integration Fund with non-governmental projects etc. Users of the project portfolio would be numerous public sector institutions domestically and abroad, which deal with investment promotion to Latvia and its economic units. The crucial issue is keeping sufficient confidentiality of private proprietary information about the projects.

Conclusions and suggestions for further research

The current global financial and economic crisis has hit Latvia severely, which can be seen by a number of macroeconomic indicators that have worsened significantly since the breakout of the crisis. Latvia is also witnessing decreasing investment flows, with some quarters even witnessing reversing investment flows in some types of investment. Investment and FDI in particular help countries prosper, which in the particular case of Latvia would also mean recover from the crisis. However, the global competition for investment is rising, which means that countries need to be more proactive, more sophisticated in their investment attraction efforts.

Many countries around the world, some of which have been considered in this publication, undertake different tasks to promote investment from abroad. Some of them are

more similar to those of Latvia than the others. When analyzing the existing and foreseen activities for investment promotion of Latvia, it can be seen that they are minor and mostly concerned with the supply side for investors.

Considering the best foreign praxis of attracting foreign investment in conjunction with the existing foreign investment attraction activities in Latvia, this paper suggests taking another approach in investment attraction, which has not been widely used up to now. The paper proposes creating a project portfolio that would consist of projects ready for operation but without necessary investment. Availability of such an investment project portfolio would allow investment promoters to act proactively when promoting Latvia abroad and be aware of the demand side of the investment seekers. Moreover, institution of the project portfolio is neither overly difficult, nor expensive or impossible time-wise.

Since this paper describes the idea of investment project portfolio on a general level as a not widely used phenomenon, the suggestion for further research is to go deeper into devising the possible architecture of the project portfolio and the stakeholder analysis for its institution. Further research could also involve creation of a pilot-model and testing it in real life situation through, for instance, IDAL or some other institution that works with investment promotion.

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