PART 3:

A Critical Discourse About Foreign Direct Investment Input in South East Europe

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The Role of Foreign Direct Investments[21]

Introduction

Foreign direct investment (FDI) is a resident entity in one economy investing in an enterprise entity in another economy and thus obtaining a lasting interest in an enterprise resident in another economy. Under the definition of the International Monetary Fund in the fifth edition of the Balance of Payments Manual, foreign direct investment is at hand when a direct investor (non-resident) owns 10% or more of ordinary shares or voting power in the resident (economic entity) of another country. The level of 10% is set arbitrarily because it is presumed that an investor with a higher ownership share has also a more significant influence in reaching decisions connected with managing a company. FDI is distinguished from other types of investments in that it is based on the fact that there is a permanent interest of the investor in the enterprise as well as interest in the management of the company. The IMF permits the possibility of an individual country deciding subjectively whether or not a particular investment belongs to the group of foreign direct investments. For example, if an investor owns more than 10% of an economic entity in a country but does not have an effective influence in the management of this entity, such an investment cannot be deemed FDI. Investors (non-residents) may be private or legal entities, groups of individuals or legal entities, governments or government agencies or any other similar foreign organisation that has a share in the domicile economic entity

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21 The views expressed in this paper are those of the authors and do not necessarily reflect the views of the Raiffeisenbank Austria.

pursuant to the above definition. One more characteristic of FDI is that the foreign investor reaches the decision on the investment on the highest, strategic level. In contrast, there are also portfolio investments, where the investor has no long term interest in the company that is taking part in reaching decisions. In its definition of portfolio investments the IMF includes shares, bonds, money market instruments and financial derivatives such as options as their basic instruments. Portfolio investments, in contrast to FDI, assume that an investment is conducted in an effort to maximise the value of the investor portfolio and achieve the expected yield against the least possible risk.

Foreign direct investments can be divided into two groups: greenfield investments and brownfield investments. Greenfield investments are all FDI through which new production assets are created, brownfield investments include all FDI through which existing plants and companies are acquired by taking control. The latter also includes foreign direct investments resulting from privatisation.

FDI – investor and receiver motives

If market economy principles are to be applied on the FDI market, then there needs to be interest for FDI from both an investor and a recipient. One of the investor's motives for making such an investment may be the way to optimise the portfolio of a multinational company[22]. However, here certain problems arise, mostly from the aspect of differentiating shares bought for management purposes (FDI) and shares related to portfolio investments, i.e. shares purchased for investment purposes. The second motive can be to eliminate the imperfections of the market via foreign investments, i.e. by linking the purchased company to the mother company. Through FDI the effect of the economy of scale of the mother company is enhanced. Another motive of the investor can be the expected higher yield from the subsidiary created by FDI compared to the mother company because the purchased company (branch/subsidiary), due to a certain market in close proximity and perhaps lower costs, may be in a more favourable position in the market. In addition, domestic producers hold the advantage of knowing the market, consumer preferences and local ways of doing business. A further

[22] A company with subsidiaries in different countries.

investor motive to buy a company in another country and open branches can be for the purpose of easier exports (export-oriented investments). In such a way the investor penetrates a foreign market which gives him access to resources, technology and/or cheaper labour force.

One of significant motives when deciding on a FDI is certainly the location as well as characteristics of the receiver country (so-called investment environment). Under this term we understand the infrastructure development level, economic power of the market and its consumer capacity (measured by GDP and GDP per capita), country risk, i.e. the government inability to repay its debts, etc., and of course, political stability.

All these elements make countries different and thus influence their ability to attract FDI. Therefore, governments implement different economic measures to stimulate FDI. Some of those measures are fiscal in nature such as income tax reductions, income tax payment deferrals, and exemption from import duties and double taxation avoidance. It should be said here that tax relief is a frequent incentive in transition countries, which leads to the danger of further competitive tax reductions. Financial incentives are another way of attracting FDI and include subsidising loan repayment, providing guarantees for non-commercial risks, and approving government aid. Accumulation of different FDI incentives and benefits can also lead to negative consequences in countries competing for FDI because investors may even doubt the country giving such wholehearted support to FDI and thus give up the investment.

On the other hand, FDI receivers also have their motives and they are all based on the advantages brought to a country by FDI. For example, advantages arise from taxes paid by the FDI receiver-company into the country's budget. One of the advantages, especially, in case of greenfield investments, lies in creating new jobs and consequently transferring knowledge, technology and management skills to domestic employees (the so-called spillover). There may be positive effects of the increased integration into multinational companies. Advantages brought about by FDI can arise in the form of a positive effect on other companies in that particular branch of business (increasing competition), which results in rising productivity. There is also one more important receiver motive that should be stressed: foreign direct investments are not counted into a country's external debt so they have and additional reason for wanting many such investments.

In listing all the advantages for receiver countries one should bare in mind the potential social costs of FDI. In the case of labour force rationalisation, disruptions in the labour market could arise. There can be problems in the balance of payments if companies import more than they export as well as if there is no sufficient spill-over, that is insufficient transfer of advanced technologies. One more negative effect of FDI is the emergence of monopolies in the receiver country. There is also the negative influence of excessive emphasis on FDI because support for one company at the expense of others causes a decline in effectiveness and competitiveness. Regional competition in attracting FDI, which leads to excessive concessions and incentives to foreign investors, can result in concentration in only one industrial activity.

In short, empirical research shows that domestic companies do not always benefit from FDI because the true nature of the relationship with the company which was invested into the domestic economy greatly differs from country to country and among different industrial branches. However, Croatia does not posess sufficient human resources, reputation and financial strength to be able to develop an efficient economy capable of standing up to competitors from developed countries within a short period of time. Attracting FDI should speed up this process because other East European countries from the immediate neighbourhood have gone far in the process of European integration and receive foreign investments.

FDI calculation methodology in transition countries

Many Eastern European countries try to comply with the IMF's definitions when processing FDI data. Therefore, they include reinvested earnings, loans from the mother company and cash purchase of securities etc. into their calculations. The basic methodological problem is how to cover all investment types. Although all Central and Eastern Europe countries try to comply with the IMF's definitions and methodological guidelines in reality there are numerous difficulties because national methodologies are often not clearly defined and are prone to changes. Still, the trend is improving both in accuracy and coverage. Central banks of aforementioned countries are the main institutions for collecting FDI data, although data is sometimes collected also by statistical offices or other agencies. According to international standards, data should be converted from the local currency into dollars at the exchange rate at the end of the period. One can notice that in case of the dollar gaining strength, as over past periods, FDIs are devaluated. This methodology is used by most central banks: the Czech, the Hungarian, the Polish, the Slovak, the Slovenian and central banks of the Baltic countries. Central banks from Bulgaria, Romania and former Soviet countries sum up their dollar inflows thus increasing their FDI levels compared to other countries. Such and similar methodological problems cause limited accuracy in comparing FDIs and regional cumulative data can be understood only as estimates. These facts should be kept in mind when making further FDI analyses.

The table of the levels of international investments in Croatia is compiled in line with the methodology recommended by the IMF as explained in more detail at the beginning of this article. Statements of commercial banks, companies, the central national bank (CNB) and the Zagreb Stock Exchange are used as data sources. Data on foreign direct and portfolio investments are taken over from the CNB's statistical research. Foreign investments in the Republic of Croatia are shown in American dollars and, depending on the source, converted from original currencies into dollars at the current or average monthly mid-point exchange rate of the CNB taken for transaction or at the CNB's mid-point exchange rate as at the report date.

Attracting and retaining FDI

One of the most important challenges of transition economies, in the medium-term, will be to maintain a stable FDI inflow both to cover the external deficit and to raise competitiveness. A reduction in the growth of the global economy could negatively influence the expansion of multinational companies and consequently FDI. During recent years there has been a notable increase in the FDI inflow into CEB countries[23] attracted mostly by lower production costs, proximity of the European Union and improvement in the business environment. In the beginning FDI inflow was connected to mass privatization, especially within the banking and telecommunication sectors.

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[23] According to EBRD, CEB (Central eastern Europe and the Baltic States) are: Croatia, the Czech Republic, Estonia, Hungary, Lithuania, Latvia, Poland, Slovakia and Slovenia.

Some of the most significant privatization accomplishments in the past three years have been the privatisation of Slovakia's Blobtel (USD 180 million) and Slovenian Telekomunikacije (USD 939 million), Lithuanian Lietuvos Telekomas (USD 161 million), Polish Telekomunikacja Polska (USD 4.3 billion) and Croatian Hrvatske Telekomunikacije (USD 859 million for a 35% stake in 1999 and another EUR 500 million for additional 16% stake in 2001). In the banking sector we can list numerous privatization examples: Bulbank in Bulgaria (USD 316 million), Slovenska Sporitelna (USD 373 million) in Slovakia, Lithuanian Taupomasis (USD 37.5 million), PBZ in Croatia (USD 300 million in 2000, not including the sale of the remaining state-owned share at the end of last year in the amount of USD 140 million). However, the privatization process is nearing its end in the more advanced transition countries. As a result, attracting the so-called greenfield investments and supporting merger and acquisition processes in the private sector has become more and more important. Up to date, the largest Greenfield investment in the region was realised in January of 2002 when the French PSA Peugeot Citroën announced its EUR 700 million investment in construction of a car plant in the Slovak town of Trillionava. The production of 300,000 cars and employment of 3,500 workers is expected to commence in 2006.

The example of Hungary best illustrates the challenge arising from keeping FDI once the privatization neared its end. Ever since 1995 – 1996 Hungary collected around USD 6.7 billion foreign direct investments only to see their decline ever since, often going down to below USD 1.5 billion a year. However, Hungary represents a specific case of a country which managed to attract investment into exporting sectors resulting in a substantial rise in its exports.

The European Bank for Reconstruction and Development (EBRD) has been systematically monitoring transition countries and consequently their investment environment, i.e. the characteristics of FDI receiver countries According to their records, Hungary, the Czech Republic and Slovakia have gone the furthest in privatisation of large companies, with over 50% in private hands. The last big privatization was arranged in Slovakia (sale of a large gas transport company for USD 2.8 billion). In the privatization of smaller companies, in addition to already mentioned states, Slovenia and Croatia have also gone far. The characteristics shared by all these states is that none owns a small company any longer.

The South East European countries[24], with the exception of Bulgaria and Romania, are far behind Central European and Baltic countries with regards to FDI primarily due to high political instability and slow reform. Therefore, the privatization process, especially of large companies, is at significantly lower level compared to Central Europe and Baltic countries.

FDI in Croatia

A significant increase of FDI inflows in Croatia began in 1996, when war operations on Croatian territory were concluded and shares of the pharmaceutical company "Pliva" and the major Croatian bank "Zagrebačka Banka" were quoted on London Stock Exchange. Croatia obtained a sovereign rating in early 1997 and further inflow of FDI was generated.

Ever since 1999 foreign direct investments (FDI) had regularly exceeded one billion dollars, but last year this trend was not continued. According to the data by the Croatian National Bank, in 2002 foreign direct investment in Croatia registered USD 980.5 million. A record high was recorded in 2001 at USD 1.53 billion and last year did not reach even two thirds of that amount. Although the end of last year saw the sale of the remaining state-held stake in one of Croatia's leading banks, FDI failed to reach their record levels due to a delay in the privatisation of the state insurer Croatia Osiguranje and the state oil and gas concern INA. Analysis broken down by economic activity showed that last year (2002) was dominated by the item "other money business", which accounted for 63.75% of total foreign direct investments. Almost two thirds of last year's FDI came from Austria and Italy. Cumulatively, in the period from 1993 to 2002 foreign direct investment totalled USD 7.47 billion, out of which telecommunications account for roughly one fourth (26.25%).

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[24] According to the EBRD's definition SEE (Southeastern Europe) countries are: Albania, Bulgaria, Bosnia and Herzegovina, Yugoslavia and Rumania.

Foreign direct investments in Croatia
In million USD

	Equity investments		Reinvested earnings	Debt securities		Other capital		Total
	Claims	Liabilities		Claims	Liabilities	Claims	Liabilities	
1993	0,00	120,26	n/a	n/a	n/a	n/a	n/a	120,26
1994	0,00	116,96	n/a	n/a	n/a	n/a	n/a	116,96
1995	0,00	114,21	n/a	n/a	n/a	n/a	n/a	114,21
1996	0,00	510,77	n/a	n/a	n/a	n/a	n/a	510,77
1997	0,00	359,48	40,35	0,00	2,65	-7,95	140,99	535,52
1998	0,00	635,57	68,26	0,00	0,00	-14,65	243,24	932,42
1999	0,00	1.283,68	47,08	0,00	0,36	-0,61	137,07	1.467,58
2000	0,00	711,38	93,91	0,00	0,01	0,01	283,40	1.088,70
2001	0,00	814,97	153,00	0,00	-1,63	0,13	593,22	1.559,69
2002	0,00	502,84	169,86	0,00	0,00	-0,30	308,11	980,51
2003 Q1, Q2	0,00	2,76	684,30	0,00	0,00	0,10	303,49	990,65
Total	**0,00**	**5.172,87**	**1.256,77**	**0,00**	**1,39**	**-23,27**	**2.009,51**	**8.417,27**

Source: Croatian National Bank

FDI in Croatia reached in the first half of this year USD 990.65 million, thus exCentral and Eastern Europeding the last year's USD 980.1 million. FDI data in the second half of the year should be influenced by the sale of the 25% share in INA (state oil and gas company). Broken down by different activities, analysis has showed that the first half of this year was dominated by categories “other retail trade in non-specialised stores” and “other monetary intermediation” which together accounted for over 51% of FDI over the period in question. FDI in the abovementioned economic activities were largely seen in the second quarter of the year. The lion's share of FDI in the first half of the year came from Austria (30.23%) and USA (27.54%), especially over the second quarter.

Telecommunications is the activity that from 1993 to the middle of 2003 attracted the most investments (sale stakes in high technology), with a share of 25.5% in the overall result.

FDI inflows

	FDI, inflow, mn USD					average
		1998	1999	2000	2001	2002e	
CEE	Croatia*	932	1.468	1.089	1.560	981	1.206
	Slovakia	684	354	2.052	1.654	5.080	1.965
	Poland	6.365	7.270	9.341	5.713	3.900	6.518
	Hungary	2.036	1.977	1.646	2.440	1.300	1.880
	Slovenia	248	107	136	503	700	339
	Czech Rep.	3.718	6.313	4.987	4.924	8.226	5.634
SEE	Bulgaria	537	806	1.002	692	458	699
	Romania	2.031	1.041	1.025	1.157	1.300	1.311
	Serbia and M.	n.a.	112	25	165	450	188
	Macedonia	n.a.	30	176	443	75	181
	Albania	n.a.	41	143	207	135	132
	Bosnia and H.	n.a.	177	146	125	284	183

e-estimate; *-complete data; source: worldmarketsanalysis, central banks, WIIW, EBRD

FDI per capita

	FDI, per capita, USD						average
		1998	1999	2000	2001	2002e	
CEE	Croatia*	210	331	245	351	221	272
	Slovakia	126	65	378	305	941	363
	Poland	165	188	242	148	101	169
	Hungary	203	197	164	243	127	187
	Slovenia	128	55	70	259	361	175
	Czech Rep.	363	616	487	480	803	550
SEE	Bulgaria	71	107	133	92	61	93
	Romania	91	47	46	52	58	59
	Serbia and M.	n.a.	11	2	15	42	18
	Macedonia	n.a.	15	87	218	37	89
	Albania	n.a.	12	42	61	40	39
	Bosnia and H.	n.a.	45	37	32	73	47

e-estimate; *-complete data; source: worldmarketsanalysis, central banks, WIIW, EBRD

Albania

Foreign investments in Albania in 2003 will not meet the USD 300 million target, Albanian Agency for Foreign Investment Encouragement (AFIE) reported early in October 2003. Despite the non-achievable profit, the agency expects nearly double year-on-year increase in foreign investments during the year. The foreign investments in the country are expected to reach USD 1.0 billion in the period between 2003 and 2006. According to AFIE data, which started a campaign promoting economic opportunities in Albania in an effort to boost foreign direct investments, foreign investments in Albania totalled USD 180 million in 2001, and around USD 135 million in 2002. AFIE together with the Agency for Imports Encouragement and the Agency for Small and Medium-Sized Enterprises were created as part of an international programme for boosting foreign investments in South Eastern Europe and particularly in the Balkans. The agencies aim to create a favourable climate for development of active private domestic and foreign companies in Albania.

Macedonia

Foreign investments flow into Macedonia increased to more than USD 400 million in 2001 from USD 178 million, mainly due to the privatisation of local telecom monopoly MakTel in 2001. The country was out of the global negative trend of international foreign investment flows in 2001. Macedonia rated 66th, among 140 countries included in the World Investment Report 2002 (of United Nations Conference on Trade and Development) in terms of foreign investments as an active part of the country's GDP for the period 1998-2000. Foreign investments accounted for an average 0.9% of Macedonia's GDP over the period.

Macedonian experts see foreign direct investments in 2003 as even smaller than in 2001, when the country was shaken by a seven-month armed conflict. The Government does not expect any significant foreign investment for the remaining months of 2003 and the year is seen as having the lowest FDI rate in years. The cabinet has drafted a programme for promotion of investments, setting priority on the introduction of tax holidays for FDI, fighting corruption, easing the legislative framework for foreign investments and setting up a state agency for investment promotion. The programme sees the lack of political stability in the region, the small market of two million consumers with low purchasing power, the lack of decentralisation of authorities, outdated industrial capacities and sluggish judiciary system as the main obstacles to FDI. In addition the programme points out the permanent ethnic tension in the country, the increasing competition from neighbouring economies and the heavy reliance of local economy on state subsidies as weak points of the Macedonian market. On the other hand, the cabinet sees the stable macroeconomic indicators, low labour cost, the closeness to the Adriatic and Mediterranean seas and good road infrastructure as the country's key advantages.

Bulgaria and Romania

Bulgaria and Romania account for slightly less than 10% of the foreign direct investment (FDI) in the Central and Eastern European region in the period between 1997 and 2001. Although the global investment flow decreased from USD 1.4 trillion in 2000 to USD 650 billion in 2002, the Central and Eastern European region has avoided being overwhelmed by the trend. The total flow of foreign direct investment to Central and Eastern Europe and the Baltic states grew by 51% in the period from 1997 to 2001, from USD 19 billion to USD 28.7 billion. The positive data concerning the FDI flow is not confined only to the countries joining the EU in 2004, as Southeastern states remain an attractive FDI destination. Bulgaria and Romania accounted for over USD 1.0 billion of foreign direct investment in the first half of 2003, a 36% annual increase. The chief drawback remains the disproportionate distribution of investment in the region, with the Czech Republic, Poland, Hungary and Slovakia accounting for 60% of the total FDI flow in the region, while Romania and Bulgaria jointly garner 10%.

Foreign direct investment flows to Bulgaria reached USD 526.9 million in the first half of the year, up 50.3% on the same period in 2002, according to data released by the country's Foreign Investment Agency. This does not include proCentral and Eastern Europeds from privatisation. The capital flows from abroad financed 53.6% of the current-account deficit for the year to date, which marks a major decrease on the same period last year when investment flows almost covered the entire deficit. The cause is ultimately the deterioration in the current account balance over the same period. Investments made in the first half of the year exCentral and Eastern Europeded investments for the entire 2002 and the agency is hoping that Bulgaria will exCentral and Eastern Europed the USD 1 billion mark for the year's end. The increase in investment is a direct consequence of the increasing confidence in Bulgaria, brought about by the western-orientated administration and the macroeconomic stability engendered by the IMF support for the sovereign for the past five years, in the wake of the 1997 financial crisis.

Romania looks as if it will now have difficulty meeting the foreign direct investment target it has set itself for 2003 after disappointing figures for the first two quarters. FDI inflows between January and June amounted to USD 449 million, down by USD 156 million over the same period in 2002. This was in spite of good first quarter figures, which showed a doubling of FDI inflow year-on-year to reach USD 316 million and which led the head of the foreign investment agency, ARIS, to come up with the optimistic forecast of USD 2billion for the whole year. Quarter 2, however, saw a dramatic decline in the amount of FDI coming in, with only USD 29 million registered in June, for example. ARIS head Marian Sanuta still appears confident that Romania can reach its official target of USD 1.7 billion in FDI for 2003, but has admitted that this will require an acceleration of the privatisation process. However, the target is dependent on the flagship privatisation of Petrom bringing in around USD 1 billion, and this now looks in danger of being postponed until 2004.

Romania remains a reasonably attractive investment destination and has seen an increase in FDI levels over the past two years as labour costs have risen in the 2004 European Union (EU) candidate countries in central Europe while, at the same time, Romania has moved closer to EU legislative norms. However, with the slowdown in Western Europe now likely to last longer than originally expected, prospective investors may be drawing in their horns. The country's healthy first quarter figures were also likely to have been artificially buoyed by the effect of the completion of land restitution procedures. Given the relatively low absolute levels of FDI, moreover, major deals can easily swing the figures one way or another. The target FDI revenues for 2003's budget are unlikely to be met, especially if, as seems likely, the Petrom sale is delayed. However, with Romania's consolidated first two quarters budget deficit at only 0.8% of GDP, even without the Petrom revenue, the 2003 deficit is likely to come in within the International Monetary Fund's target for Romania.

Serbia and Montenegro

Political risk was affecting foreign direct investment since the start of 2003 and that it would have to work hard to meet a USD 600 million target agreed with the International Monetary Fund. Since the assassination of Prime Minister on March 12, Serbia's ruling reformers have engaged in a series of bitter political squabbles, affecting reforms and investment. Western diplomats have expressed alarm that the two sides, which both want closer links with the European Union and Western-style market economies, are devoting so much energy to damaging each other rather than implementing reforms. According to an IMF estimate, foreign direct investment and privatisation receipts in 2003 should reach some USD 600 million, mainly coming from privatisations. So far in 2003 there had been some capital outflow - Serbia spent earlier this year EUR 120 million as a part payment to buy back a 29% stake in its Telekom Srbija monopoly from Telekom Italia. Before the Prime Minister's assassination, Serbia had hoped for USD 400 million in greenfield investment and USD 1.0 billion in privatisation receipts.

Conclusion

Theoretically, FDI inflow should generate a general rise in investments, especially in cases where domestic companies have limited access to sources of capital. However, the influence of FDI depends on the recipient country, local economic policies, type of FDI as well as the strength and development level of domestic companies, in other words, starting position of the receiver country. In some cases FDI has a positive effect on GDP by stimulating other domestic and foreign investments (so-called crowding in). This is mostly the case when FDI creates new production assets or a new economy sector (greenfield investments). It should be stressed here that FDI in European transition countries is mostly a consequence of the government portfolio privatization and to a lesser extent greenfield investments. At the beginning FDI rarely entered production or exporting sectors because they arose from large-scale telecommunication and financial sector privatization.

Expected FDI effects can be monitored through several indicators: the influence on GDP, economic growth, employment, investment, improved efficiency and competitiveness, exports etc. It is extremely important which economic sector FDI is directed to. Therefore, positive and negative effects of FDI on a particular sector, and economy in general, should be kept in mind. By expecting a positive effect on economic activity individual countries stimulate FDI inflow through fiscal, financial and other measures which can and must be managed for the benefit of a country's further development.

A remarkable economic transition is underway in South East Europe and it is being facilitated by international investment. By world historical standards, FDI has come to South East Europe at a remarkable rapid pace, starting from literally zero in some countries only 6-7 years ago. As a percentage of GDP, FDI inflows into South East Europe are running at the same rate as the Central and Eastern European region achieved in the 1990s. South East Europe is the new investment opportunity, uniquely providing high returns with diminishing risks.

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