FOREIGN DIRECT INVESTMENT IN BOSNIA AND HERZEGOVINA *LINGUA FRANCA* OR PERPLEXITY OF ORIGINAL SIN?

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Abstract

The aim of this paper is to investigate the nature and impact of foreign direct investment (FDI) inflows in Bosnia and Herzegovina (BiH). In stark contrast with theoretical predictions found in previous literature on FDI M E in small underdeveloped transition economies, even after controlling for Serbian M:TS's investment in Republic of Srpska's M:Tel, horizontal inbound FDI have been predominant in relation to vertical ones. However, in spite of diminishing tariffs and other international trade costs, as well as abundant natural resources and comparatively cheaper labour, all typically favourable for attracting vertical FDI, dominance of horizontal FDI recorded by available data for Bosnia and Herzegovina does not seem to go hand in hand with decrease of imports, once again contradicting the standard theoretical paradigm. After reviewing recent scientific background relevant for the topic, we analyse empirical data on FDI in BiH in recent years. The main contribution of the paper is in trying to reconcile a posteriori empirical findings with a priori theoretical expectations regarding the case of BiH.

Key words: *foreign direct investment, vertical vs. horizontal FDI, international trade (costs), economic transition, country determinants of FDI, absorption capacity, Bosnia and Herzegovin*

Introduction

Foreign direct investment is crucially important and -generally speaking- most desirable form of international capital inflow/foreign financing in contemporary transition economies. From the host country's standpoint, apparently obvious benefit of FDI as compared with other forms of global capital movement is captured by the fact that FDI provides external financial boost without creation of new indebtedness, or at least enables temporal coordination of repatriation outflows (which is debt repayment *sui generis*) and economic growth dynamics on both micro and macro level. Other benefits include knowledge, organisational and technology transfer (know-how) to host countries – domestic firms and local labour force alike. Provided they are not reduced to effective monopolisation, FDI tend to enforce production spillovers and enhance intra-industry competition. If export oriented, FDI also brings about balance of payments improvement and easier access to foreign markets, as well as more intangible political and economic benefits of greater integration with the world economy.

From an investor's standpoint, FDI represents the riskiest and most profitable form of international financial undertaking which has been widely studied in the recent past.[3] The literature differentiates between so-called greenfield FDI, which represent external investments in a completely new production facility and brownfield (aka greyfield) FDI, which boils down to merger or acquisition of the existing production facility in order to revitalise and relaunch a new production activity[4].

From a different perspective economic theory also identifies another two types of FDI: horizontal and vertical FDI. Horizontal FDI (HFDI) is market-seeking investment, aimed primarily at serving domestic market in the host country through producing/providing identical or rather similar (basket of) goods as at home, when local production is seen as a more efficient way to penetrate certain market than

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[3] For a good survey, see for example Navaretti, Vanables *et al.* (2005).

[4] Demekas *et al.*(2005).

exports from the source country.[5] Therefore, we expect to see HFDI in industries/countries where final goods have high(er) transportation costs and trade protection. Vertical FDI (VFDI) is cost-minimizing investment, when a multinational corporation chooses to internalise its production process by buying or establishing plants upstream or downstream. The location of each link of its production chain is intended either to minimize global costs and standard of quality flaws, or to address imperatives of just-in-time management. Thus, VFDI is expected to take place particularly between countries with different factor endowments and different costs of their engagement. As a result of these differences in motivation, a number of host country factors, such as market size, proximity and transport costs, trade restrictions, can have strikingly different effects on HFDI and VFDI. However, the difference between the two is by no means always a clear-cut case. There is broad agreement that HFDI is more prevalent, which is understandable owing to the North-North character of majority of FDI flows Navaretti-Venables *et al.,* 2004 . However, there is also overwhelming evidence that the recent surge in FDI flows to developing countries, in particular, was mainly VFDI Hanson-Mataloni-Slaughter, 2001 , Davies, 2002 , Slaughter, 2003 .

The aim of this paper is to investigate the nature and impact of foreign direct investment (FDI) inflows in Bosnia and Herzegovina (BiH). In stark contrast with theoretical predictions found in previous literature on FDI/MNE in small underdeveloped transition economies, even after controlling for Serbian M:TS's investment in Republic of Srpska's M Tel, horizontal inbound FDI have been predominant in relation to vertical ones. However, in spite of diminishing tariffs and other international trade costs, as well as abundant natural resources and comparatively cheaper labour, all typically favourable for attracting vertical FDI, dominance of horizontal FDI recorded by available data for Bosnia and Herzegovina does not seem to go hand in hand with decrease of imports, once again contradicting the standard theoretical paradigm. After reviewing recent scientific background relevant for the topic, we analyse empirical data on FDI in BiH in recent years. The main contribution of the paper is in trying to reconcile *a posteriori* empirical findings with *a priori* theoretical expectations regarding the case of BiH.

Portrayed against the clear distinctions in theoretical FDI models, it should be emphasized that the empirical work on the VFDI and HFDI models has two major problems. First, global data availability on various types of MNE affiliate activity is very limited except for the US and Swedish cases Tanaka, 2006 . Ideally, local sales of affiliates should be used to examine horizontal FDI and exports back to the home or third country should be for vertical FDI. However, such a neatly carved split cannot be done so often or occasionally turns out to be misleading. Second, as noted by Demekas *et.al.*(2005) and Tanaka (2006), econometric analysis is so often plagued by the fact that signs of regression coefficients are ambiguous for too mechanically carried splits as well as considering the high rate of mutual correlation of explanatory variables usually chosen. Consequently, this works relies upon desk-top research and local knowledge in evaluation of nature and impact of FDI in BiH.

1. FDI in BiH: the evidence

1.1. Size and distribution in relation to main economic indicators

BiH records real GDP growth of 6.8% in 2007 (6.7% in 2006, and estimated 7.1% in 2008). Similarly as elsewhere in the region, this was caused by acceleration of domestic lending together with fiscal relaxation, which fuelled economic growth by stimulating both consumption and investment. Driving forces behind the economic growth is a strong increase in domestic demand, as evidenced inter alia by a widening of the current account deficit and a pick-up in core inflation (excluding food and energy prices). Relatively satisfactory economic performance was achieved against a background of unfavourable domestic and external conditions, namely: the evolving international financial crisis and the increase in international energy and food prices.

[5] HFDI still does not assume the firm fully duplicating all its activities in the host country (split into two identical parts)., since some of the firm level assets typically have a public good character and should be spread firm-wide Navaretti-Vanables *et al.*, 2005 . They include know-how, managerial skills, brand name and reputation to the very least.

After narrowing temporarily to 8.4% of GDP in 2006, the current account deficit widened again to 12.7% of GDP in 2007. This development reflects the adverse effect of global food and energy prices on BiH's imports and the large swings in import and export patterns following the introduction of VAT in January 2006. As a result, the trade deficit widened from 35% of GDP in 2006 to around 37% of GDP in 2007, as imports rose by around 19% year-on-year, outperforming the 15% growth of exports. The positive balance of services, income and current transfers declined as a percentage of GDP from 2006 to 2007, compounding the deterioration of the trade deficit. During the first half of 2008, the current account deficit widened notably by almost 60% compared to the same period a year earlier. This deterioration was due to the expansion in the trade deficit by 24.1% year-on-year, as the value of imported goods rose by 19.6% year-on-year, exceeding the corresponding increase in exports by 5.6%. In conclusion, despite a temporary improvement in 2006 external imbalances widened again in 2007 and 2008.

In 2007, for the first time, the current account deficit was fully financed from net FDI inflow, as the major privatisations of Telekom Srpska and the RS refineries contributed to a surge in net FDI to 13.3% of GDP, thus replacing, albeit temporarily, the financial sector as the traditional main destination for FDI. Together with other strong financial inflows, such as private sector remittances that accounted for around 17% of GDP, net FDI led to an annual increase of around 23% in official foreign exchange reserves at the end of 2007. In the first six months of 2008, however, net FDI declined strongly compared to the same period in the previous year and covered only 24% of the current account deficit, highlighting its overdependence on privatisations and insufficient green-field investment. As a result, it was mainly financed through portfolio investments, a drawdown of the commercial banks' foreign assets, new external trade credits and a marginal fall in the central bank's official foreign exchange reserves. Total external debt is estimated at around 50% of GDP Central Bank of BiH, Agency for Statistics of BiH, 2008 .[6]

So far, much alike elsewhere in developing world [7], the international financial crisis has had only a limited direct impact on the economy although it may have contributed to declining FDI inflows and decreasing external loans. Moreover, the widening current account deficit creates additional external financing needs rendering the economy vulnerable to possible disruptions in capital flows.

* Foreign Investment Promotion Agency estimation, EC Delegation Report, November 2008.
[7] See, e.g. Gallagher (2008).

Table 1. **BiH general economic indicators**

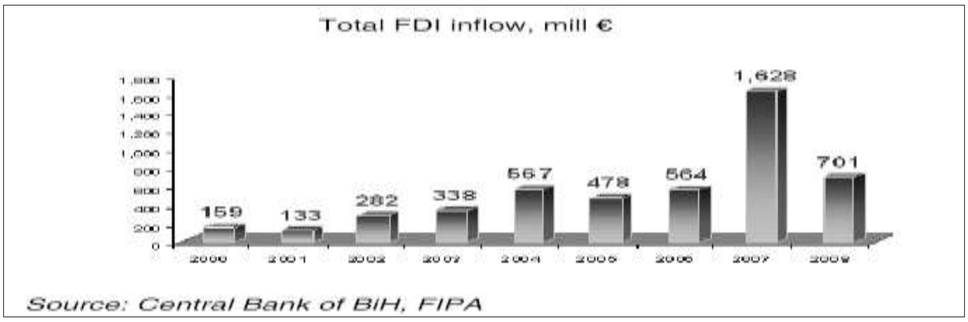
Indicators	2000	2001	2002	2003	2004	2005	2006	2007	2008
Nominal GDP (billion EUR)	5,5	5,9	6,6	7,4	8,1	8,7	9,8	11,1	12.5*
GDP per capita (EUR)	1,660	1,786	1,958	2,214	2,388	2,561	2,873	3,254	3,648*
Real GDP growth rate %	5.5	4.5	5.5	3.0	6.3	3.9	6.7	6.8	7.1*
Industrial production growth rate %	8.8	12.2	9.2	4.8	9.0	10.0	11.0	10.0	9.2*
Average net wages EUR	190	209	228	247	258	275	300	322	385
Annual inflation rate %	4.8	3.1	0.4	0.6	0.4	3.7	6.1	1.5	6.5*
Annual unempl. rate %	39.7	40.3	40.9	42.0	43.2	43.0	31.0	29.0	23.4
Currency reserves (mill.)	522	1,379	1,270	1,428	1,779	2,160	2,787	3,425	3,219
Trade balance (billion EUR)	-3.00	-3.31	-3,52	-3,67	-3,68	-4,01	-3,41	-4,14	-4.89
Total FDI (million EUR)	**159**	**133**	**282**	**338**	**567**	**478**	**564**	**1,628**	**701***
FDI contribution to GDP %	**2.9**	**2.2**	**4.3**	**4.6**	**7.0**	**5.5**	**5.8**	**14.7**	**5.6***
Deposits of households in Commercial Banks, mill EUR	267	740	829	985	1,273	1,629	2,097	2,641	2,662
Popullation (in million)	3.30	3.32	3.35	3.35	3.38	3.38	3.40	3.40	3.44

Source: *Central Bank of BiH, Agency for Statistics of BiH,*
*Foreign Investment Promotion Agency estimation

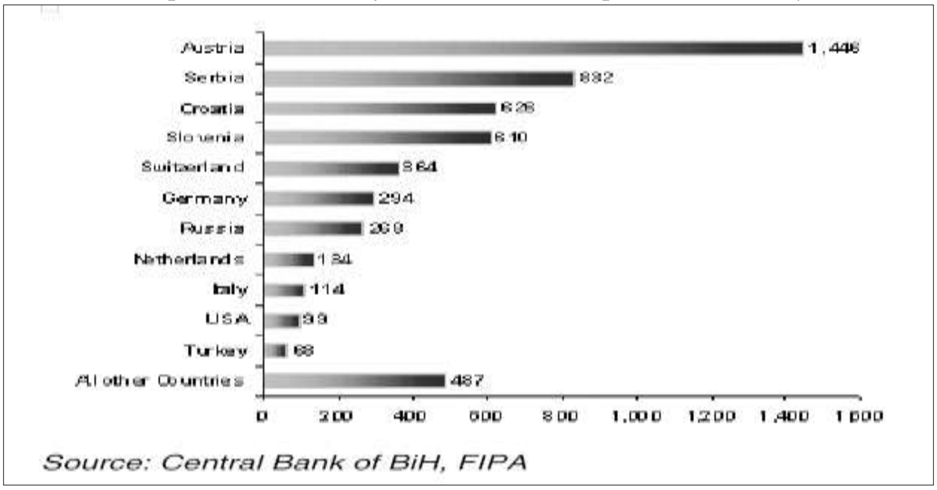
The relevant BiH institutions[8] registered approx. 90 investors and more than 3.5 billion of euros in investments in the period 1994-end of 2008. The largest chunk of investment in BiH in 2007 has come from Serbia, namely above 600 million of euro or 22,7% from the total amount of investments. Investments from European countries amount to 94% from the total amount, and according to the forms of investments the capital in money-cash has been 2.7 billion euro or 80,5%, in equipment and buildings 650 million (18,6%) and intelectual property 32 million or only 0,9% of the total foreign capital. The resources of FDI per sector show that manufacturing receives the most of foreign financial inflows, followed by banking, trade and transport sectors. Since May 1994 to December 2008, the most investment was made by companies from Austria 27.1 %, Serbia 15.6%, Croatia 11.7%, Slovenia 11.4%, Switzerland 6.8%, Germany 5.5%, Russia 5%, The Netherlands 2.5%, Italy 2.1%, USA 1.9%, Turkey 1.3%, and other countries 9.1%. It is very important to point out that investment in manufacturing still participates with 35% in total investment. Investment in telecommunication, transport, tourism and services records constant growth. Also real estate sector is being regulated in line with international standards to attract new investment (see graph below) FIPA, 2008 .

[8] BiH Ministry of foreign trade and economic relations, Central Bank and Foreign Investment Promotion Agency

Graph 1. FDI in BiH from 199□ till 2008. per year (in mil. KM)



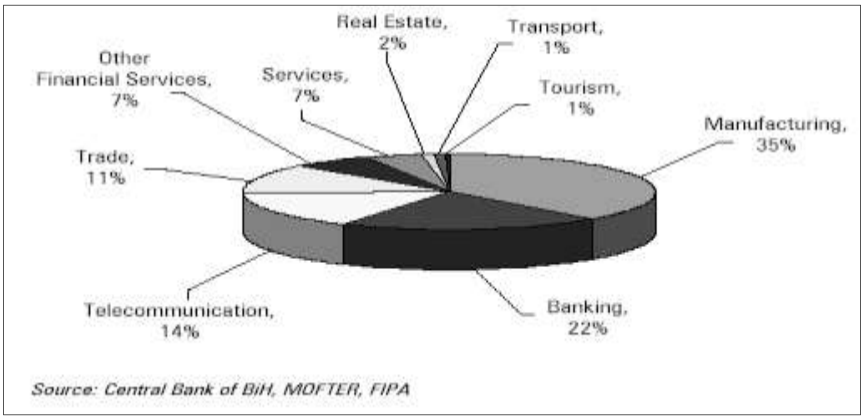
Graph 2. FDI in BiH from 199□ □2008. per home country



The most significant investment ammounting to 1,26 billion KM in 2007, as well as in the last 15 years, is related to privatisation of "Telekom Republike Srpske" Banja Luka to Telecom of Serbia. The second most significant investment linked with privatisation in RS is the investemnt of the Russian partner in the "Petroleum Rafinery" Bosanski Brod - 2 , million KM and "Oil Rafinery" Modri a - 153,9 million KM. Banjaluka brewery also received a significant investment from a company registered in Cayman Islands of 43,2 millon KM[9].

[9] However, most of the recorded FDI arguably represents the genuine inward type, and it seems that there have been almost no repatriated, "round tripping" capital, which has fled the country in the times of the violent conflict and post conflict crisis. The main reasons may be due to the imperative not to debunk the far-from-legal undertakings it has been made through in the first place, high investment/political risk, weak institutional capacities, or bad privatisation programmes.

Graph □ FDI in BiH per sector 199□ □2008.

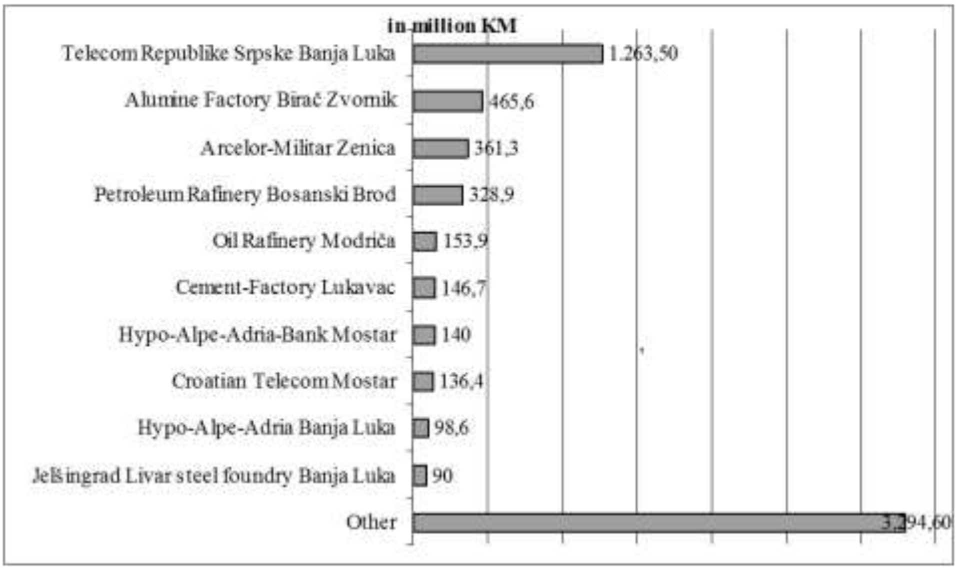


The other entity of BiH – Federation of BiH reports the major investments in Croatian Telecom in Mostar - 67,4 miliona KM by Croatian investor, Energopetrol Sarajevo - 46 million KM (23 million KM Croatian and Hungarian investors each).

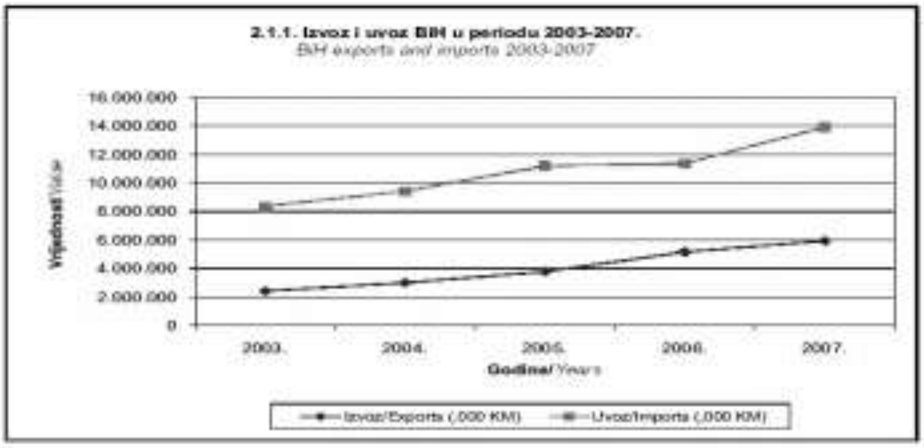
FDI in 2008. amounted to 577,8 million KM, which is approximately 8% of the total investment in that last 14 years. The most significant individual investment in a completely new firm reffers to "M-BL" Trading Company Banja Luka - KM 59,1 million and represents a typical market-seeking horizontal investment coming from Slovenia. The similar investments in trading sector have been - Slovenian investment in trading company "TU " Sarajevo - KM 20 million, "Dubicotton" company Kozarska Dubica for production, trade and services founded by Italian partner and KM 16,1 million, and Serbian investment of 13,7 million in a new commodities trading company in Banja Luka - "Delta Maxi".

From the total amount of the FDI registered in 2008. 47,7% is related to foundation of new companies and 52,3% refers to additional financing of already existing companies, therefore greenfield and brownfield FDI are roughly in balance. Some of the latter investments have been registered in ArcelorMittal Zenica, Argeta Sarajevo (Slovenian partner), Hypo Alpe-Adria-Bank Mostar (Austria), Volksbank Banja Luka (Austria), Hypo Alpe-Adria-Bank AD Banja Luka 22,3 miliona KM (Austria).

Exports and industrial production reveal a gradual but slow shift towards higher value-added goods. The restructuring and liquidation of SOEs has made very slow progress, which has also affected attraction of FDI. This process has been hampered by the SOE's accumulated unsettled arrears against the budget, employees, utilities and suppliers and by the vested interests of enterprise managers, trade unions and decision makers. In the RS, more than a hundred SOEs are in liquidation, and the RS Investment-Development Bank has been carrying out financial restructuring programmes for those enterprises being privatised. The Federation has similar legislation in place, but instead has come forward with plans to financially consolidate the loss-making mines and provide them with debt relief from the budget and from the electricity companies with whom they are envisaged to be merged. This has significant fiscal implications and may actually hold back the process of enterprise restructuring and therefore restrain foreign investors form investing in BiH.



Graph □ BiH companies with highest share of foreign capital in BiH 199□□200□



Graph □ Table 2. Selected external trade developments 200□2008.

EXTERNAL TRADE IN 2008

PRODUCT GROUPS - SITC	EXPORT (MILL EUR)	SHARE IN TOTAL EXPORT (%)
Food and Live animals	163	4.75
Beverages and tobacco	20	0.58
Crude materials, except fuels	444	12.94
Mineral fuels and lubricants	336	9.79
Animal and vegetable oils and fats	21	0.61
Chemicals	168	4.90
Manufactured goods classified chiefly by material	1,075	31.32
Machinery and transport equipment	508	14.80
Miscellaneous manufactured articles	697	20.31
Total	3,432	100.00

1.2. HFDI vs. VFDI: Puzzling nature and impact of FDI in BiH

Let us now focus more closely at the puzzling patterns in respect to the nature and impact of FDI in BiH. Once we turn our attention to the vertical vs. horizontal FDI dichotomy in the Bosnian context, several conclusions stemming from the data bitterly oppose standard theoretical paradigms.

First of all, as stated previously, **inbound FDI in small underdeveloped resource abundant emerging economy ought to be predominantly vertical** Markusen-Maskus, 2002 , Waldkirch, 2003 , Markusen-Vanables, 2005 , yet in contrast with the previous references, HFDI in BiH are more prevalent in comparison to VFDI. There have been three major horizontal investments (via privatisation of state property) in Republic of Srpska in 2007: Serbian MTS in RS Telecom – 1,26 billions KM and Russian partner in Oil Rafinery Brod and Modri a – 482 million KM.[10] Federation also registers HFDI in major privatisations of public companies in energy and telecommunication sector – Energopetrol, Sarajevo and Croatian Telecom Mostar. However, even after excluding the above mentioned, "one off ", privatisation-induced injections, majority of remaining, smaller FDI in BiH seem to be market seeking, i.e. horizontal activities too, such as Coca-Cola Company, pharmaceutical industry - Hemofarm, food processing - Ledo, Argeta, as well as major trading chains in the region of the Western Balkans: Serbian Delta Maxi trading, Slovenian Tu trading etc.

Furthermore, **theoretical literature on FDI expects dominance of HFDI in the presence of more serious trade barriers (and greater size of the host market)** Navaretti-Venables *et alia,* 2005 , Demekas *et alia,* 2005 , which is not the case of the small and effectively unprotected BiH market, particularly not since the CEFTA membership![11] Speaking of CEFTA, **theory predicts that regional integration decreases HFDI and stimulates VFDI** Navaretti-Vanables *et alia*, 2005 , Tanaka, 2006 ,[12] which is again not true for BiH! Be that as it may, in **theory, prevalence of HFDI in a given market tends to lower the imports from abroad** Demekas *et alia,* 2005 , which after abstracting from global depression effect does not seem to be the case in BiH!

Thirdly, still in the realm of country determinants for attracting FDI, **theory postulates that VFDI are more sensitive to tax incentives** (grace periods, subsidies, tax rebates etc.) than HFDI, yet it didn't make much difference according to Bosnian FDI statistics.
Lastly, Guerin and Manzocchi (2007), among others, find that **less democratic and/or politically riskier** countries **tend to attract more VFDI**, [13] which is overwhelmingly rejected by data on FDI flows in BiH.

Interestingly enough, the only country determinant which is **unambiguously[14] in line with theoretical predictions is proximity: geography matters**, as re-enforced by Brakman and van Marrewijk (2008) and, at that, usually dominates up to 60% of FDI carried out Demekas *et al.*, 2005 . Within HFDI in BiH, indeed, home countries are pretty much in the neighbourhood of the host, reaping all of scale, informational and political gravity benefits there are. However, several investments in so-called Lohn businesses either prove that cheaper and skilful labour can be exploited in other ways than through VFDI, or simply indicate that both local firms and government were warned against the fact that else-

[10] By the way, oil and related derivatives record a significant increase in exports of almost 40% in 2008 in relation to 2007.

[11] Free trade area may have broaden the concept of market size, but that should result in (statistically visible) establishing of exort-platforms, which is however not recorded outside oil/petroleum refining business.

[12] Tanaka (2006) points that larger host market absorbs greater part of final sales by vertical firms in the host country and the vertical affiliates can save transport costs to ship back final products to the home country. Navaretti, Venables *et al.* (2005) posit that reduced or eliminated trade costs may render HFDI pointless (unless transport costs&proximity matter, which is not the case in BiH since main foreign investors are from the region), while encouraging VFDI by easing up exporting.

[13] This being the case because, by definition, VFDI creates much more trade dependency which in turn lowers the probability of expropriation *Ibidem* .

[14] For HFDI in BiH, gravity factor apparently matters even after controlling for potential endogeneity with respect to the future industry growth as theoretically stressed by Stan ik (2007). If we exclude mobile telecommunications and oil refineries as idiosincratically profitable, distance still matters and than some.

where in the world domestic companies had been struggling in the presence of foreign companies, especially in upstream sectors when VFDI was greenfield rather than brownfield Stan ik, 2007 . That said, some undoubtedly vertical FDI have also been identified in BiH, like Indian investment of TNK Mittal in Steel Zenica and of Lithuanian partner in Aluminium processing factory in Zvornik.[15] However, it strikes us that factor endowment/price differences were obviously far more important than proximity in the case of these chief VFDI in BiH.

The last section of the paper concludes in an attempt to make sense of such a puzzling nature of FDI flows in BiH.

Conclusion

The analysis performed in this paper clearly shows that BiH hasn't been fully integrated in the world economy and that its FDI flows do not serve as and haven't been launched in accordance to the globally common financial tongue, but rather still suffer from perplexities of previous political and economic sins. Since the country lags behind in many economic indicators even when confronted with similar transition economies from the region, most intricate traits of Bosnian FDI flows lay in the nature and impact of HFDI vs. VFDI. In what follows, an attempt has been made to reconcile *a posteriori* empirical findings with *a priori* theoretical expectations regarding the case of BiH.

Entire body of empirical literature on OECD countries suggest that vast majority of HFDI takes place between rich countries, indicating that firms in XXI century look for high wages of consumers rather than for low wages of workers. Nevertheless, that cannot possibly serve as an explanation for HFDI dominance in BiH. Therefore, we are offering several alternatives instead. Unlike previous studies, when it comes to the impact of economic volatility and sovereign risk, Aizenman and Marion (2004) claim that uncertainty is more costly to MNE under vertical than horizontal mode, because supply shocks and predatory actions of host government disrupt the entire international production (chain). This reasoning seems to be in accord with investor's sentiment in BiH and consequential skittishness of VFDI. Another explanation for fewer VFDI in BiH (and elsewhere) may be that for some industries oil price hikes in recent years altered the relationship between transportation costs and cost-saving effects of abundant and/or cheaper inputs (we save less on resources than we spend on transporting them back home). Furthermore, privatisation-induced FDI and autonomous, "underlying" FDI inflows often have different determinants and investor's logic that drives their existence Demekas *et alia,* 2005 . Privatisation-induced FDI are swift-profit-seeking undertakings that typically engage in M A's towards ready-made facilities that do not rely upon broader economic infrastructure, agglomeration effects (presence of other foreign or capable domestic firms and supporting businesses) and do not require grand recapitalisation or exhausting lags between investment and proper return. Such investments in BiH were almost exclusively of horizontal breed and thus are arguably also perceived as easier to resell (than vertical ones) in the face of adversity. In a nutshell, VFDI seem to pursue positive externalities of a more mature market, the one that hasn't been burdened with weak and unattractive restructuring programmes for potential investors, corruption, political risk, institutional loopholes, destruction of production capacities and human capital etc. On a top of that, some natural resources in BiH haven't been offered for sale as yet,[16] whereas some strategically vertical (e.g. let's be close to water sources) FDI may appear as horizontal at the moment (host-based plant produces the whole range of fuzzy drinks). Not least important -in the case at hand- may prove special national/political and economic relations with neighbouring countries – Serbia and Croatia, but also some links with Islamic world that could explain certain relatively questionable economic investments in BiH as measured by mere NPV criterion. Finally, prevalence of HFDI in BiH is presently not followed by decrease of crisis-free import trend, possibly due to global food/oil price inflation in recent years and

[15] If we look at export data for those sectors it can be said that steel and aluminium products together register an increase of 20% in 2008 in relation to 2007, which is aligned with theoretical predictions.

[16] Notably power plants and hydro-potential, some ore-resources, natural beauty and tourism, and to a lesser extent (already being somewhat exploited) organic food and food processing as well as timber and wood processing.

the fact that no considerable HFDI has been deployed in manufacturing sector. [17] Tax incentives are clearly not enough. Whether any of mentioned specificities shall be worn out and reasonably improved towards more favourable economic constellation in the foreseeable future, remains yet to be seen. We may not have all the answers any time soon or ever, since FDI dynamics in the real world appears to be much more complex and even elusive than thought of in the near past.

One thing is certain though: for reasons stated throughout the paper, BiH still lacks absorption capacity for latter, quantitatively greater and qualitatively more sophisticated, wave of FDI inflows which would hopefully bring about slightly more balance in HFDI vs. VFDI debate as well as stronger impact in terms of employment and growth in both entities.

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[17] Apart from telecom, HFDIs in BiH have mainly gone in retail businesses, import dependent suppermaket chains&shopping moles and banking sector.