CHAPTER

19

FDI TRANSFUSION IN SERBIA: ARE WE GETTING THE BLOOD TYPE THAT WE NEED?*

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Abstract

The aim of this policy brief is to objectively examine pros and cons of FDI as a form of international capital movement, analyze the dynamics and structure of FDI in post-Milosevic Serbia, with special attention paid to stressing its ambiguous relationship with balance of payments position and overall economic growth in the country.

Key words: *FDI, Serbia, external-equilibrium-myth, exogenous-growth-myth, transition.*

INTRODUCTION

Foreign direct investment is crucially important and -generally speaking- most desirable form of international capital inflow/foreign financing in contemporary transition economies. *Stricto sensu,* FDI is defined as the increase in the equity position of a non-resident owner who holds more than 10 percent of the shares of the firm. It also includes the loans received by the local company from the parent foreign owner [Fernandez-Arias-Hausmann, 2000].[2]

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 tends 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 re-launch existing production facility[4].

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[2] On a practical level, whatever the share may be, it is supposed to achieve effective control over the company at hand.

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

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

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 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.

Be that as it may, both in theory and even more in policy circles, FDI is typically perceived as the "good cholesterol", proper and thus desirable type of foreign capital inflow, as opposed to short-term debt finance representing "bad cholesterol". That, however, does not have to be entirely true.

The aim of this paper is to objectively examine pros and cons of FDI as a form of international capital movement, analyze the dynamics and structure of FDI in post-Milosevic Serbia, with special attention paid to stressing its ambiguous relationship with balance of payments position and overall economic growth in the country.

FDI TRANSFUSION IN SERBIA: STYLIZED FACTS

In spite of high spirits and even greater expectations after democratic changes of October 2000, FDI dynamics in Serbia could be best described as neither spectacular nor disappointing. On one hand, within ex-Yugoslavia featuring Albania, throughout the new millennium, Serbia accounts for about one third of cumulative inbound FDI in the region, hence at first glance it is impressive that Serbia (and Montenegro at the time) managed to attract global FDI percentage of a magnitude almost 4 times its GDP share in the world GDP. On the other hand, if we omit gigantic 2006 Telenor investment as well as recent recession plummet, inward FDI growth trend in Serbia appears to be fairly modest. Its FDI indices are roughly comparable with performances of other Western Balkans economies, but inferior to golden age of Central European recipients or Ireland, for instance.[6]

Table 19.1. FDI indices in Serbia (with one period lagged impact)[7]

2002	2003	2004	2005	2006	2007
1.13%	2.83%	6.3%	3.8%	5.27%	6.25%

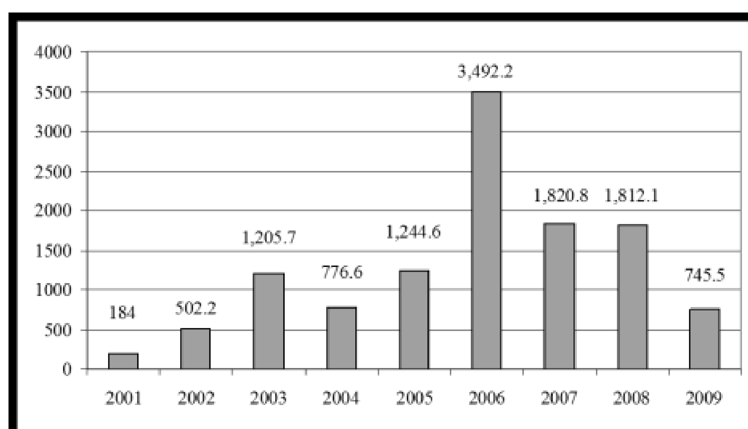
Source: Author's calculations

[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.

[6] Performance index is a simple ratio of country's share of the total world FDI and country's share of total world GDP. For more extensive discussion consult (Kostadinov, 2007). Here, however, FDI index is constructed for illustrative purposes as a bit more dynamic relationship between the FDIt-1 deployed and the lagged GDPt it is supposed to influence, which seems to be a feasible assumption at an infant stage of a small open economy like post-Milošević Serbia. Also compare with CDLS (2007) study.

[7] We stopped at onset of global financial crisis, since this lagged relationship might arguably become fairly unreliable in 2008 and 2009, or at least not really comparable with the tranquil period.

Figure 19.1. Foreign direct investments in Serbia, net, in million € (2001-2009)



Source: Ministry of Finance

Composition of capital inflows across industries, however, is more openly unfavourable. Over the past five years, service sectors have proven to be the most attractive to international investors. The financial intermediation sector recorded the biggest FDI inflow of $ 5,2 billion, with telecommunications holding the 2nd place with $3.1 billion, whereas manufacturing sectors ranked only 3rd with $2.77 billion. Those FDI seem to be predominantly market-seeking, while somewhat hasty privatisation of domestic banking system coupled with disindustrialisation of Serbia left us with almost none of the local competitors/suppliers to benefit from technological, organisational and knowledge spillovers in certain industries. In the manufacturing sector, FDI has been placed in the primary and secondary processing of metals and non-metals, the exploitation of mineral water, food processing, breweries and dairy products. Agriculture and agro-industry, sector believed to contain relative advantage in (export led) development strategy of the country, received no more than 10% of FDI in Serbia so far. During 2010, IKEA is expected to enter the Serbian market, at first as an HFDI in five different locations country-wide (3-4 objects, 250-300 mill.€ per location), as well as some new HFDI by “Merkur” and “Mr.Bricolage” retailers.

Table 19.2. Inbound FDI across industries in mill US$ (2004-March 2009)

Industry	**Investment total**
Financial intermediation	5193.4
Transport and telecommunications	3107.2
Manufacturing	2773.6
Real estate	1954.5
Wholesale, retail, repairs	1909.6
Mining and quarrying	576.1
Construction	345.4
Agriculture	119.2
Hotels&restaurants	93.2
Electricity, gas, water	89

Source: National Bank of Serbia

In a nutshell, FDI deployed in the Serbian economy can be characterized by the following: buying the market rather than buying production capacity, too few green-field inflows still, only about 60% of the FDI controlled businesses have any export orientation whatsoever, some of the greatest exporters are also the greatest importers (e.g. US Steel), notable market distortions (oligopoly in the wholesale distribution and hypermarket chains, in banking, coffee market, milk production, monopoly in the production of steel).

Leading foreign investors in Serbia that recognized the country's virtues have usually expressed their sympathies summarized in *a)* the favourable growth prospects (after achieving macroeconomic stability propped by relatively good fundamentals), *b)* skilled labour force and abundant natural endowments, *c)* liberalized foreign trade and attractive location, and interestingly *d)* good understanding of the (Serbian) market.[8]

Table19.3. Leading Foreign Investors in Serbia (2002-2009)

Company	**Country**	**Industry**	**Investment type**	**Amount (mill €)**
Telenor	Norway	Telecommunications	Privatisation	1602
Gazprom Neft	Russia	Energy	Privatisation	947
Philip Morris	USA	Tobbaco	Privatisation	611
Mobilkom	Austria	Telecommunications	Greenfield	570
Intesa Sanpaolo	Italy	Financial intermediation	Acquisition	508
Stada	Germany	Pharmaceuticals	Acquisition	475
AB InBev	Belgium	Food	Acquisition	427
NBG	Greece	Financial intermediation	Privatisation	425
Mercator	Slovenia	Retail	Greenfield	240
Fondiaria SAI	Italy	Financial intermediation	Privatisation	220
Lukoil	Russia	Energy	Privatisation	210
Airport City BG	Israel	Real estate	Greenfield	200
Block 67	Austria&Serbia	Real estate	Joint venture/Greenfield	180
Holcim	Switzerland	Construction	Privatisation	170
OTP Bank	Hungary	Financial intermediation	Privatisation	166
Carlsberg	Dennmark	Food	Acquisition	152
US Steel	USA	Manufacturing	Privatisation	150
METRO	Germany	Wholesale	Greenfield	150
Coca-Colla	USA	Food	Acquisition	142
Lafarge	France	Construction	Privatisation	141
Droga Kolinska	Slovenia	Food	Greenfield	100

Source: SIEPA

However, most common complaints (or indeed barriers for potential investors that opted to stay out of Serbia after all) which could be identified in both academic (analysts) and business (foreign investors) community in Serbia are: *1)* Bureaucracy/Corruption, *2)* Lack of property rights enforcement, *3)* Poor Infrastructure and *4)* Political Risk.[9]

[8] See also Domarchi and Nkengapa (2007), as well as Strategic Marketing-USAID (2008).
[9] See Strategic Marketing-USAID (2008) study of 119 foreign investors in Serbia, but also Barolli *et alia* (2007).

ARE WE GETTING THE BLOOD TYPE THAT WE NEED?

This last section of the paper deals with several widespread misconceptions about FDI among the policymakers/politicians not only in Serbia, but in transition countries by and large. In my opinion, lack of understanding of the nature, determinants and effects of foreign capital inflows is one of the principal «culprits» behind suboptimal growth performance and deepening external disequilibrium in Republic of Serbia.

First set of misconceptions, let us dub it external-equilibrium-myth, has to do with tricky relationship between country's balance of payments (external economic position) and inbound FDI. On numerous occasions, Serbian top officials asserted in media 'that the only way to overturn such a huge balance of payments deficit and enable growth and prosperity is to attract as much FDI as possible'. Early enough, the statement won the overwhelming aura of indisputable truth in the Serbian public, among the policymakers and in academia alike. However, on a scale between being an axiom and being patently wrong, this expression is dangerously close to the latter! If the country turns to be successful in attracting massive sums of FDI, its short-to-medium term BoP shall certainly deteriorate, not improve![10] On the other hand, its long-term BoP position might recuperate only under half a dozen of «if-s» and «*caeteri paribi»*. But, prior to exploring those long-run prerequisites for FDI-led surplus and growth, one must ask what are the intellectual seeds of this FDI vs. BoP misconception?

One is erroneous Lawson's doctrine: Serbian authorities made clear in several instances in last couple of years that they consider 'trade deficit to be sustainable for as long as Serbia manages to cover it through remittances and FDI, moreover, for as long as Serbia's foreign exchange reserves are mounting'. 'There is no such thing as a free lunch', of course, moreover, every serious regional political instability or global financial crisis could evidently endanger the long-term stability of foreign capital inflows, *i.e.* the long-term solvency of the country. In addition, private investors'/consumers' behaviour is not always rational in the short to medium run, since lots of capital inflows in Serbia have been currently consumed rather than invested, therefore some of the net FDI inflows might be actually postponing necessary reforms and enlarging their eventual scale![11]

The other intellectual sophism behind the external equilibrium myth is the belief that capital transfusion is the cure for every economic condition in transition countries and that, furthermore, every "blood type" of FDI will do. Closely intertwined, as it happens, is still deeply-rooted legacy of in fact long-disavowed Harrod-Domar growth model, according to which economic growth ought to be proportional to the share of capital investment in the country's GDP.[12] Finally, the last pitfall within the external-equilibrium-myth is dogma about FDI not creating an external liability at all. As a matter of fact, all of the above statements are false! Blood type matters, and than some, since potentially re-confiscated capital flight from Serbia in 1990's and investment by Serbian "Gastarbeiter" and diaspora, for instance, would not constitute external liabilities and therefore could alleviate external financing gap. Similarly, privatisation-induced FDI and autonomous, "underlying" FDI inflows often have completely different determinants and investor's logic that drives their existence [Demekas *et al.*, 2005]. In addition, Easterly and Levine (2001) rejected the Harrod-Domar hypothesis by asserting that physical capital is relatively unimportant in explaining long run growth, since most of the cross-country differences in growth were due to technical progress. Worse still, identity between FDI receipts (cashed in by the state) and capital investment is far from secured. Moreover, if not reinvested via retained earnings, dividend (re)payments to foreign investors are unavoidable capital outflows which debit the current account, while previous corresponding FDI inflows are often less generous

[10] Since the current account equals the difference between national accumulation and overall investments committed in the economy, $B=S-I$, so long as we need net capital inflows from abroad we shall unavoidably accumulate BoP deficits [Malović, 2008].

[11] For in depth analysis of the issue, consult Malović (2008).

[12] For more on this, see Easterly (2001, Ch.2).

than it originally looks. Namely, opportunistic and myopic governments proved capable of switching from granting subsidies to loss-making state enterprises to guaranteeing bank loans/tax rebates etc. for new foreign "investor", thereby creating the appearance of a deficit reduction.[13] Thus, FDI may be heavily leveraged domestically and/or also swiftly resold (in part or entirely) to domestic savers, in which case the resulting net capital transfusion is substantially smaller than the initial gross amount recorded as proud and precious FDI inflow in BoP statistics [Razin-Sadka, 2001].

The second set of misconceptions about FDI, let us dub it the exogenous-growth-myth, stems from the ambiguous relationship between FDI, financial development and economic growth. FDI is primarily considered as more stable, bolted down form of foreign financing, since -unlike portfolio investment- it allegedly cannot leave so easily at the first sign of trouble. On a top of that, it is widely believed in transition countries (Serbia very much included) that FDI brings about economic growth! In theory, indeed, FDI brings in advanced technology that leads to increasing returns in domestic production and increases the value-added content of FDI-related production. The greatest and longer-term impact of FDI is that of spillovers which occurs when the advanced technology from FDI is able to trickle down to the entire economy [Domarchi-Nkengapa, 2007, p. 8]. Here, crucial is the fact that the effect of FDI on economic growth depends on whether FDI is complementing or substituting domestic investment! In many host sectors in Serbia FDIs were substituting vanishing domestic production or simply abstaining from larger scale engagement of local firms as subcontractors.[14] Nevertheless, as pointed out earlier, privatisation-induced FDI and autonomous, "underlying" FDI inflows typically have different determinants and investor's logic that drives their existence. Privatisation-induced FDIs 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 [Malović-Petrović, 2009]. Such investments in Serbia too were almost exclusively of horizontal breed and thus are arguably also perceived as easier to resell (than vertical ones) in the face of adversity. Therefore, some of the inward FDI in Serbia were not meant to or unable to spillover onto the rest of economy, while great deal of it aimed at ready-made sectors/businesses which could be abandoned (resold with discount) if push comes to shove.

In other words, if you want to attract more serious FDI and quantities of capital that "mean business", you've got to have robust growth underway already, rather than *vice versa*! This proposition, hitherto verified with the benefit of hindsight, that it is not large inflows of FDI that cause high growth rates, but strong growth that acts as a magnet for the "underlying" FDI, has been profoundly ignored in Serbian public discourse and economic policy-making thus far.

Finally, it is fair to say that there are some independent limitations for FDI transfusion in Serbia. Admittedly, Serbia is running a decade late through its transition process, hence many North-South FDI flows were already deployed by the time Serbia opened up for foreign investors. Also, prevalence of FDI flows in initial phases of transition is not necessarily a sign of good economic and financial health.[15] In more mature stages of transition, however, broader financial development is expected to excel in order to propel national R&D, human capital and technology upgrades in local firms, compulsory for spillover effects of the "underlying" FDI to gain momentum across the Serbian economy.

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[13] For more on this see Easterly (2001, Ch.6) Usually, there was some kind of round-tripping operation or clear-cut corruption behind such a staged scene.

[14] Often because -in terms of know-how, standards of safety/quality, technology and human capital- Serbian enterprises honestly couldn't deliver.

[15] Fernandes-Arias and Hausmann (2000) in their famous empirical study found that he share of FDI in total flows tends to be larger in countries that are riskier, more distant, resource rich, financially underdeveloped, institutionally weak and suffering from original sin.

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