

FOREIGN DIRECT INVESTMENTS IN CROATIA: DYNAMICS, COMPONENTS AND INTERNATIONAL COMPARISON

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Abstract Foreign direct investments benefit the economy of the recipient-country, as they has a positive impact on components of GDP and economy in general. To analyse the impact of foreign direct investments on the recipient country's economy and other factors that are important for the development of the economy and its competitiveness on the market, it is essential to understand dynamics and structure of the foreign direct investments. Thus, the subject of the analysis in this study are the dynamics and structure of foreign direct investments in Croatia. We based the study on the review of available data on foreign direct investments in Croatia and EU-CEE countries, where economic and market conditions are similar. In comparison to studies published earlier, this study used a relatively new time series of collected data on foreign direct investments for the analysis.

Keywords:

foreign direct
investments,
Croatia, dynamics,
components,
comparison.

1 Introduction

Foreign direct investments (FDI) represent all investments in a domestic company where a foreign investor acquires 10% or more of the company's common stock. Total FDI comprises equity investments, retained earnings and debt instruments between equity-linked foreign investors and domestic enterprises. When it comes to the types of FDI, we divide them into greenfield and brownfield investments. Greenfield investments generate the most significant benefits for the recipient country because the invested capital creates new products and creates jobs, which creates added value and represents a potential export of the country. Brownfield investments also generate benefits for the country, resulting from the privatisation of an existing business. For a better understanding of greenfield and brownfield investments, we should take into account that such investments are often motivated by portfolio optimisation and the exploitation of the advantages of the investing country (market size, location, natural resources, developed infrastructure, cheaper labour, technology availability) (Borensztein, De Gregorio, & Lee, 1998; Carkovic & Levine, 2005; Moran, 2012).

FDI is an integral part of the European transition countries financing, including Croatia. Countries recognised the opportunity in the mentioned markets and started investing in those activities from which they could derive the most significant benefit (Marić, 2008). Investments have a favourable effect on the economy of the recipient country because they stimulate employment, exports, the development of new technology, investment and other components of GDP (Jošić, 2008). Still, to analyse the impact of FDI on the factors mentioned above relevant to the competitiveness of a particular economy, we need to study the dynamics and the structure of FDI for a specific economy or country. Primarily, we need to understand the structure of investments concerning the main activities of a particular economy or country and investing country. Also, it is necessary to have insight into FDI in similar economies (with similar characteristics and similar business climate) (Marinova, 2018; Sass, 2017).

Previous studies state that in the global economy, FDI is one of the most significant forms of international business. FDI brings capital, technology and knowledge, thus contributing to the growth of competitiveness and productivity of the local economies (Busse & Hefeker, 2007; Driffield, Munday, & Roberts, 2002; Janicki &

Wunnava, 2004). The consequence is also more convenient access to international markets and internationalisation of business, which enables less advanced (transition) countries, including Croatia, to participate in global production and to compete in narrower niches. However, when looking at the total FDI in the financial crisis years (2008 and 2009), we note that levels were almost halved. Besides, the most significant decline in FDI in the years mentioned above, we see in developed EU countries (Derado, 2014; Marić, 2008). In the years following the financial crisis, the relative recovery of FDI followed but was still affected by an unstable business environment, crisis management problems and problems in the financial sector. To accelerate the recovery and to make further internationalisation of business sustainable, multinational companies to which FDI is an integral part of business, had restructure in order to improve business performance and generate new FDI (Zhan, 2012).

In this paper, we analyse the dynamics, components and structure of FDI in Croatia according to the latest available data of the Croatian National Bank (CNB), in the period from 2000 to 2018. Additionally, we compare FDI in Croatia with Central and Eastern European countries (the EU-CEE region), to define Croatian relative position as a recipient of investment among comparable economies.

2 Background on FDI in Croatia

Škudar (2004) compared the productivity of domestic and FDI firms. Companies receiving FDI have shown faster growth in revenues and equity than local companies. Škudar concluded that the structure of FDI is unfavourable for the development of the Croatian economy, despite the relatively high inflows of FDI in Croatia, as well as that investment in technology and new organisational solutions crucial for further development. Furthermore, Vukšić (2005) analysed the impact of FDI on Croatian product exports and concluded that FDI has a positive effect on export, but on a relatively small scale. He also finds that export-oriented greenfield projects would improve exports within the manufacturing industry in Croatia. Hunya and Škudar (2007) analysed the role of FDI in the Croatian economy and concluded the positive effects of FDI on the banking sector and the manufacturing industry. The study also argues the positive long-term impact of FDI on employment in both brownfield and greenfield projects. One of the reasons for the lack of greenfield projects is the scarcity of tax incentives in Croatia, which attracts

less FDI in such projects. An additional observation in the study relates to the fact that FDI did not significantly improve the Croatian position on the international market. Additionally, Marić (2008) investigated the effects of FDI inflows on the productivity of recipient firms and other firms operating in the Croatian industry. The results of the analysis confirm the positive impact of FDI on the productivity of Croatian companies and indicate that a large part of the potential positive effects of foreign capital inflows has been utilised, despite a smaller share of greenfield investment and a more inferior sectoral distribution of FDI.

Furthermore, the CNB (Bilas, Bosnjak, & Novak, 2017; Fabritz, Falck, & Saavedra, 2016) states that there is no clear evidence for companies established by FDI that the crisis has affected them more or less than other companies. In addition to state-owned and export-oriented companies, companies established by FDI are listed as those which significantly reduced the workforce in the wake of the crisis. Also, as a result of the recovery, export-oriented companies generate income faster than the recipient firms relative to domestic demand, while the recipient firms responded more quickly to the requirements of their owners.

In Croatia, the importance of FDI is beginning to be a topic of interest due to Croatian transition to a market economy and the first financial inflows from abroad. Accordingly, the CNB started its FDI survey in 1997. The survey was first conducted solely based on equity information, and only later on information on retained earnings and debt instruments (Cvijanović & Kušić, 2002; Vukšić, 2005).

3 Dynamics and Components of FDI in Croatia

We observed FDI in Croatia in the period 2000 to 2018, which amounted to 33.7 billion EUR and averaged 4% of Croatian GDP each year. In the period before the financial crisis (2008), this average was 5.2% of GDP, and after the financial crisis, 2.9% of Croatian GDP. This decrease between the two periods can be linked to the effects of the financial crisis, and on the intensity and dynamics of FDI in all European countries. In terms of structure, the majority of FDI in Croatia for the period 2000 to 2018 were equity investments, about 50% in total, while the share of retained earnings and debt instruments make up about 16% and 10% of total FDIs, respectively (Figure 1).

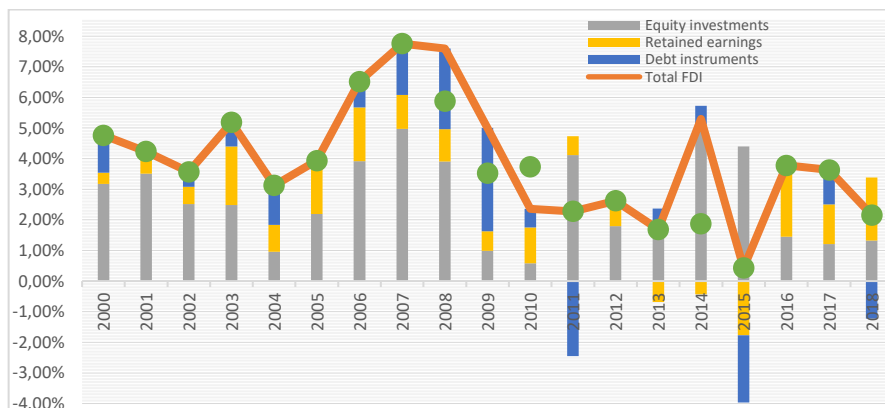


Figure 1: Dynamics and essential components of FDI in Croatia 2000 to 2018 in% of GDP

Source: data derived from the Croatian National Bank database, visualised by authors.

Looking back at the dynamics, in the early 2000s, FDI inflows were generally between 3% and 4% of GDP, with a relatively large jump in 2003 when they reached 5.2% of Croatian GDP. In the same year, the retained earnings component increased by 1.3% of GDP and debt instruments by 0.3% of GDP compared to the previous year, while equity investments remained at the same level of 2.5% of GDP. Furthermore, only in 2004, there is a higher proportion of debt instruments and retained earnings from equity investments in the period before the financial crisis.

Between 2005 and 2007, there was the highest increase in FDI within the observed period. This increase resulted in a maximum recorded amount of investments in the observed period of 3.6 billion EUR, or 7.8% of Croatian GDP in 2007. In that period, the largest share of total FDI was made by equity investments. The percentage of debt instruments also increased, which doubled in 2007 compared to the previous year (1.7% of GDP), while retained earnings declined.

In the years of the financial crisis, there has been a continuous decline in FDI in Croatia to 1.7% of GDP in 2013, from 6.1% from the 2007 record level. Also, circular FDI was recorded in the mentioned period. If the effects of circular investments on total recorded investments are eliminated, in 2008 and 2009 total FDI amounts to 2% of GDP less and in 2010 to 1.3% more of GDP. The negative share of debt instruments, amounting to -2.5% of GDP, which reduced the positive impact of equity growth on total FDI, was recorded in 2011. By 2013, the share of

equity investments has fallen again to 1.5% of GDP. In the same year, debt instruments amounted to 0.9% of GDP and, for the first time in the observed period, recorded a negative amount of retained earnings of -0.7% of Croatia's GDP.

Between 2014 and 2018, recorded amounts of total FDI fluctuated; increase to 5.3% of GDP, a fall to 0.4% of GDP, a rebound to 3.8% of GDP, and a slight decline to 2.2% of GDP. For the big jump in recorded investments in 2014, the reason is the registered circular investment without which total FDI would amount to only 1.9% of GDP in the same year, similar to the previous year. In terms of components, this jump was driven by a doubling of retained earnings and an increase in the share of equity investments, while debt instruments decreased compared to 2013. The lowest recorded amount of FDI in the observed period was recorded in 2015. This decline was due to the relatively large negative shares of retained earnings (-1.8% of GDP) and debt instruments (-2.2% of GDP) and a reduced share of equity investments by 0.5% of GDP. FDI rebounded in 2016, followed by a slight decline in 2017 and 2018.

At the beginning of the observed period, FDI was mostly generated by bank privatisations (PBZ by BCI, Splitska banka by UniCredit, Rijeka bank by Bayerische Landesbank, etc.), privatisation of Croatian Telekom by Deutsche Telekom and privatisation of insurance companies. The stated increase in FDI in 2003 is reflected in the end of the first phase of INA privatisation, in which MOL became a strategic partner of INA by buying 25% plus one share. The period of the most significant inflows of FDI can be interpreted by the recapitalisation of domestic commercial banks and foreign-owned banks (PBZ by BCI through a Luxembourg subsidiary, acquisition of Sonic Bank and Gospodarsko-kreditna banka), acquisition of Pliva, INA shares offering at the Zagreb Stock Exchange and shares public offering of Croatian Telekom. The fluctuations and relatively smaller investment inflows in the years following the financial crisis can be partly explained by the losses of foreign-owned domestic banks, related to the effects of credit conversion in the CHF and the deteriorated net foreign position of the CNB. Most of the equity investments of the period concerned recapitalisations and concurrent debt repayments to affiliated companies. Also, the overall lower average of FDI in the post-crisis period should be viewed from the perspective of economically, investment and financially unfavourable climate in the investing countries, as well as in the developed EU

countries - the largest investors in Croatia and other countries of the EU-CEE region (Cho, Daim, & Dabic, 2017; Vukšić, 2016).

4 Comparison of FDI in Croatia with EU-CEE Countries

By 2010, FDI inflows to Croatia were about 2% of GDP higher than average inflows to other EU-CEE countries but were falling steadily. This decrease is the result of the above-mentioned record amount of investments in 2007, which in comparison are inflows in later years significantly smaller.

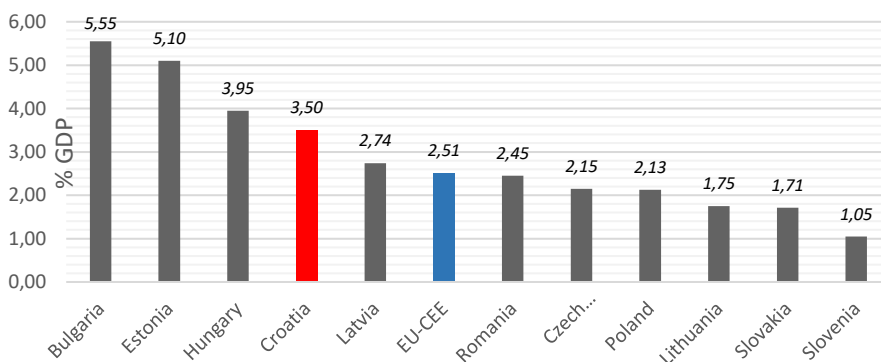


Figure 2: Average FDI inflows by EU-CEE countries from 2010 to 2018 as % of GDP

Source: data derived from the Croatian National Bank database, visualized by authors.

According to Figure 2, in the period from 2010 to the end of 2012, FDI in Croatia generally move in parallel with investment trends in other countries of the EU-CEE region. Overall, the lower recorded amounts of FDI during this period, should be viewed from the perspective of the unfavourable economic and business climate, that is, the financial crisis, both in investing and investing countries. In 2014, Croatia recorded a massive inflow of FDI, 2.5% of GDP higher than the EU-CEE region average in the same year. In considering this, the aforementioned impact of circular investments, which increased the recorded amount of total FDI by 3.4% of GDP, without really affecting the Croatian economy, should be taken into account. In contrast, in 2015, Croatia recorded a significantly lower average inflow, 1.7% of GDP less than the average in the EU-CEE countries in the same year. In 2016 and 2017, there was an increase in investment inflows to Croatia, while the EU-CEE region experienced an average fall in investment.

The decline in FDI in the EU-CEE region in 2017 was primarily driven by a sharp drop in investment in Poland and the Czech Republic, whose effect on the overall result of recorded investments was partly offset by the recorded jump in investment in Slovakia. In the same year, FDI growth was recorded by Croatia, Latvia, Lithuania and Romania (Marinova, 2018; Sass, 2017; Xiang, Zhang, Bai, & Ma, 2018).

Between 2010 and 2017, Croatia, together with Latvia, is the fourth largest force of average FDI inflows in GDP among EU-CEE countries. This makes Croatia relatively high on the scale (3 places above the EU-CEE average). Bulgaria (3.2% of GDP) and Estonia (3.9% of GDP) received on average more investments than Croatia in the observed period. At the very bottom of the scale is Slovakia, with an average 1.2% share of total investment received in relation to the GDP. Neighboring Slovenia, with an average investment inflow of 1.6% of GDP, no longer ranks last on the scale shown, which was the case between 2008 and 2014.

5 Discussion

Based on the secondary research conducted, FDI has a positive impact on the development of the recipient country. On the other hand, the development rate and growth rate of a country's market attract FDI. Given that FDI has a positive effect on the national budget and enterprises of a particular country, drawing FDI results in better positioning of a country's economy in the global market. However, while the concept of FDI is often cited in a positive context, it is vital to maintain a critical approach when looking at the characteristics of a particular investment. In other words, the recipient country needs to identify those investments that could potentially impair its national interests and economic stability.

For the recipient country to benefit from the investment, the foreign investor must provide a sufficient number of jobs, employee salaries following the principle of marketability, and that the business generated by the investment is not predominantly export-oriented. Precisely this means the development of the market and economy due to attracting FDI leads to the development of technology. This potentially means the robotisation and mechanisation of production processes. If the population is demographically old and does not invest enough in restructuring programs to qualify competent, but also modern workers and professionals, the

preceding can lead to increased unemployment and redundancies. Also, given the higher salaries power of foreign companies investing in the countries concerned, the competence of domestic companies as employers may be impaired, since they would not be able to pay their employees equally. Furthermore, investment firms may be more likely to import goods and resources for production, which can harm the balance of payments of the recipient country. Besides, countries that invest relatively less in research and development segments may be less attractive to foreign investors, since this may indicate insufficient human resources and adequate technology needed to implement cost-effective and sustainable production processes.

On the other hand, for a foreign investor to reap the benefits of investing in a particular country, the recipient country must have sound laws and tax policies, which contribute to a favourable business climate and make it easier for investors to cope with investment risks. Also, to make a country attractive to foreign investors, it needs to continuously invest in the infrastructure of its industrial sectors, education and specialisation of the workforce, a stable political environment, and reduce the risks of corruption. It is also essential for foreign investors that the economy of the recipient country is open.

Croatian predispositions as a recipient of investment are evident in its favourable geostrategic position, open economy, access to the Adriatic Sea and EU membership. Also, Croatian historical and cultural predispositions are a sound basis for attracting additional FDI in the tourism sector, as evidenced by the relatively higher inflows in the industry so far compared to other EU-CEE countries. Also, Croatia is characterized as being a secure country in terms of national peace with currently stable political circumstances.

However, in line with the slow economic recovery in Croatia, the structure and type of FDI in Croatia has not changed significantly in the post-crisis years. An increase in recorded inflows of investments and a slight increase in the number of greenfield projects are not sufficient to realise the benefits that the Croatian economy could and should have.

Commenting on Croatia, the criticisms and recommendations of international and domestic regulatory institutions, representatives of foreign investors in Croatia and

other relevant stakeholders mainly relate to difficult-to-digest and contradictory administrative obstacles, legal uncertainty, high levels of corruption, high pessimism of workers and domestic investors, too low levels of public investment (education, research and development, etc.) and the slow implementation of the adopted measures and regulations (Bandelj, 2002; Sohinger, 2005; Vukšić, 2005).

The preceding does not contribute to the development of characteristics of the Croatian market that would make it more attractive for foreign investors in the long run. Regardless of the recorded economic growth and growth of FDI, Croatia is not achieving results in line with its potential as an investment destination, mainly because of obstacles that should be bridged and influenced by competent national authorities. It means that the problem is not in the geostrategic disadvantage, but in the relatively complicated process of obtaining a building permit among the countries of the EU-CEE region. To realise this potential, Croatia should focus on public investment in sectors that will bring high added value in the future, like computerisation.

5 Conclusion and Future Research

The structure and type of FDI in Croatia has not changed significantly in the post-crisis years, with the most substantial investments being made in manufacturing and real estate, while the majority of investments in Croatia came from the EU-15. We compared the dynamics and investment structure of FDI in Croatia and the EU-CEE region. The main focus is on greenfield investments. The movement of FDI in Croatia characterises the beginning of the observed period from our study compared to the flow of investments in other EU-CEE countries. As we move by the end of the observed period, we see fluctuating patterns in investment dynamics, caused by recorded circular investments and a decline in investments in the Czech Republic and Poland. In Croatia, a relatively high amount of investment was recorded in financial intermediation, hotels and restaurants.

To attract more greenfield investments, Croatia needs to implement the adopted measures and regulations faster, invest more in computerisation and digitisation, research and development in dominant industrial sectors and in an education system that will be able to meet current and future labour market requirements.

At the very beginning of this paper, we emphasised that it is necessary to know the dynamics and structure of FDI and that specific research goals of the paper are in line with the above. FDI is defined as an investment in a domestic company where a foreign investor acquires 10% or more of the common stock of an enterprise. The available literature concluded that FDI generally had a positive effect on the development of the recipient country. Still, for better insight into investments in Croatia, the research should more often address the reasons why certain types of investments bring more benefits than others.

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