FOREIGN DIRECT INVESTMENT AND ITS IMPACT ON THE CROATIAN ECONOMY

The round table, Zagreb, November 26, 2004

Review*

According to the roundtable *Foreign Direct Investment and its Impact on the Croatian Economy* organised in 2003 by the Friedrich Ebert Stiftung and the Institute for Public Finance in Zagreb, in the first six months of 2004, half a billion dollars of foreign direct investment arrived in Croatia. During the whole of 2003, this investment came to almost two billion US dollars. Although in attracting foreign investment Croatia is not so badly off in comparison with the advanced transition countries, it is clear that there was a shortage of high quality greenfield investment.

Foreign direct investment tends in several ways to produce a rise in exports. Above all these are the export-oriented production of foreign-owned companies (primarily those created in greenfield investment) and the spillover effects (increased productivity). A rise in imports can be brought about directly too through facilitating access to export markets for domestic producers. If we know of such effects, it is very clear why countries, particularly transition countries, fight for the maximum inflow of foreign direct investment. But what do Croatian experts have to say about this?

Katarina Ott from the Institute of Public Finance said that this is a theme that is much written and spoken of, often manipulated, but concerning which there are a great many quandaries. The discipline has not unambiguously made up its mind about the real effect on the development of a country and the best manner of attracting FDI, she thought. Research into FDI in Croatia is particularly important in the context of the accession to the EU and the possible benefits entailed (mainly to do with trade liberalisation and a growth in FDI). But in order to attract as much direct investment as possible, a country has to provide a suitable environment. What Croatian can learn from the new EU members is that success depends primarily on the quality and speed of fiscal reforms and reforms of the labour market. In Slovakia many major reforms spurred investment, exports and domestic demand, and this country became the most attractive country in Central Europe for foreign investment. As against this, Poland, the Czech Republic and Hungary are countries that still, in spite of great foreign investment, are

* *Received: December 20, 2004*
Accepted: January 20, 2005

still burdened with high public spending, large budgetary deficits, high taxes on labour, inflexible labour legislation and great welfare outlays, which is the picture of the harsh Croatian reality too.

Alen Škudar from the CNB analysed FDI into Croatia in the 1993-2004 period. Croatia had the greatest influx of foreign investment during 1999, 2001 and 2003. One problem is that most of these investments were used for the privatisation of the telecommunications and financial sectors, i.e., the banks (more than 70% of all investment). Skudar said that if the situation of FDI is considered in terms of percentage of GDP, then Croatia is in the same group as Slovakia, while the leading countries are the Czech Republic and Hungary. In Croatia, privatisation meant reorganisation, i.e., lay-offs, and then later new jobs; however, never in the same extent as before.

After privatisation investment came greenfield investment, in which no existing firm is taken over, rather new firms are created. Such investment is mainly oriented to the tertiary sector (services and trade).

Individually, the biggest investor in Croatia was Austria, almost exclusively for the sake of market share. Up to 1996 the biggest resources were invested in the relatively most attractive firms (27 companies with a capital of 5 billion kuna). From 1997 to 1998 the purchase of firms was financed, which showed more rapid growth after takeover (particularly firms for the production of construction materials). Škudar was very upbeat about the estimate of the Word Investment Report of 2004, according to which Croatia had a high potential for attracting foreign investment (on a level with Hungary, and considerably higher than Bulgaria).

Goran Vukšić from the Institute of Public Finance analysed the impact of FDI on the exports of the Croatian manufacturing industry. According to his calculations, the exports involved were practically stagnant in the period from the implementation of the stabilisation programme, which with an increase in imports of goods led to a large deficit in the foreign trade balance. Because of this deficit, the promotion of exports in Croatia had taken on additional importance.

Foreign direct investment in Croatia, though, had had a positive and statistically significant effect on the exports of the Croatian manufacturing industry. Some of this influence was manifested in increased productivity. But the positive effects of this investment were not great, and in future measures of economic policy should boost this impact. The increased productivity that had occurred by reduction of the workforce had not led to any marked increase in exports. Unit labour costs and domestic investment were also important determinants of exports, while the results of the research into the effect of changes in the foreign currency exchange rate are not unambiguous. Vuksic thinks that Croatia needs a more active policy to attract foreign investment to Croatia, particularly export-oriented greenfield investment. A vital precondition for this is an effective investment promotion agency at a national level and an up-to-date law for investment incentives. But above all he thought it very important that there should be a convincing and long-term commitment from the people in power to the creation of an incentivising environment for foreign and also for domestic investors and to a reduction of administrative barriers. In this context it was essential to improve the general conditions for doing business in Croatia and to undertake measures to enhance the positive effects of spillovers (by facilitating the transfer of modern technology in production and by retraining of the labour force).

Mario Holzner of the Vienna Institute for International Economic Research analysed the direct investments in 2003, when the influx of FDI into SE Europe was the highest (about $7 billion). Most FDI was drawn into SE Europe by the privatisation process (of the financial sector, telecommunications, commerce and the cement, beer and tobacco industries), only a smaller part of it being directed to export-oriented business. The author forecasts that the new EU members will during 2004 attract 50% more FDI than in the previous year. Holzner concluded that Croatia, with about $2500 of FDI per capita was in the same position as the countries of Central Europe with respect to volume, but the structure was closer to that of the countries of SE Europe. Potential targets of forthcoming investment might be the production of electrical and optical equipment and machinery.

The institutional conditions for investment in Croatia were analysed by **Dražen Derado** from the Economics Faculty in Split. He agreed with Vukšić and Holzner in saying that foreign investment into Croatia had not brought with it the desire effects because there had been a shortage of greenfield investment in the manufacturing industry and of spillover effects (growth in production, employment and productivity, economic restructuring, growth in competitiveness and exports). He saw the greatest problems in the corporate environment (absence of appropriate sources of financing, the dilatoriness and ineffectiveness of the courts, the high tax burden and the many changes in the tax system which tended to affect the profitability of operations and to lead to corruption). Like Vuksic, he highlighted the many administrative obstacles to investment (obtaining residence and work permits, the lack of coordination among the bodies of the government administration, lack of teamwork in the personnel, various interpretations of the laws, the lack of harmonisation between the cadastre and the land registers, the procedure for obtaining building permits and the physical plans and physical zones). What gave rise to most concern, thought Derado, was that the knowledge and skills of the active working population did not meet the needs of contemporary development, and that the unit costs of labour were exceptionally high. He saw a solution in the implementation of appropriate institutional changes (which was less of a problem) and in harmonising the FDI policy with the objectives of economic growth (a major problem) for the sake of creating the capacity to achieve spillover effects. Apart from that, Croatia should develop industries with high added value, the more so because foreign investment to date had almost without exception gone into the monopolistic sectors and into dirty industry (the cement industry).

Also in favour of attracting as much greenfield investment as possible was **Igor Maričić** from the Export and Investment Promotion Agency. Investment in tourism and real estate was already very high and did not need attracting. But greenfield investment is long-term investment, for which stability is required, a problem in this country because of the war. Luckily, the situation is now much better. A limiting factor is the problems in communications at all levels. Quite often, and with some justice, it is thought that we are bad at attracting investment and lag behind others. This is accurate, but if we look at the overall level of FDI in the region (not including the Baltic countries) then we are third. Along with Slovakia, Croatia is the most expensive country in the area for investment, and it is necessary to introduce institutional and structural changes, reduce the cost of labour, improve the business and investment environment and the habits of the people. The need for such changes appears immediately when we bear in mind the direct benefits from FDI ($1 billion FDI will bring 8000 direct and another 8000 indirect new jobs, depending on the industry). He concluded that what was most important was investment in high-tech, however, for this there were not enough highly educated people.

The opinion of **Željko Lovrinčević** of the Economic Institute of Zagreb was that little benefit and no desirable effects despite the great inflow and growth of FDI characterised investment efforts in Croatia to date. He thought that the trend of there being almost no benefits from accelerated privatisation would continue. He saw the problems, like others, in the environment and the domestic infrastructure. Because of its marked comparative advantages, Croatia had to specialise. Investment in science and education was slow and without specialisation. Croatia was a semi-literate nation, we had an expensive labour force, and there was an ever more marked need for dramatically greater investment in science, naturally, with the introduction of criteria and controls. But in spite of any increased investment in science there might be, he said that because of the negative democratic trend productivity and the costs of labour would be able to be changed only with great difficulty. He was concerned because it was not known who in the coming period was to control domestic resources and whether the domestic labour force was to continue working for mere subsistence, or at some time for something more. Lovrinčević would make possible investment at the local level, and stressed the need to invest in second generation services with a high degree of value added (e.g. accountancy and financial agency work).

Ante Čičin-Šain, independent economic expert, agreed with the facts that Croatia had an unsatisfactory rate of growth and an aging population. He stressed that anyone who advocated a change in the exchange rate "offered certain harm in exchange for a vague benefit" because devaluation would certainly impact the national budget and the banking and pensions systems. The takeover of the cement works was a positive example (750-80% are foreign-owned), because it had led to solving the problems of the employment of a certain number of people, pollution (the new owners were investing large sums in environmental conservation) and production itself. He thought it paradoxical that there were no adequate sources of financing in a situation in which the banks were brimming with money.

Dario Vukić, former MP, added that the key problems were that the Government and Parliament had in 2002 adopted 15 different strategies, not one of which was being implemented today, and that knowledge was not respected. He thought it particularly irresponsible that now, when we are looking towards joining the EU, we were signing numerous documents without any proper analysis. He was particularly sceptical about the issue of the seriousness of the work in the corridors of power now when we were expected to go in for the privatisation of certain strategic branches such as the energy sector, agricultural land and land along the coast.

Ivanka Maričković-Putrić from the Croatian Bank for Reconstruction and Development (HBOR) reminded Derado and Čičin-Šajn that financing was not a problem, for HBOR had differentiated export programmes and soft interest rates, but there was no readiness to make use of these opportunities. She said that we very soon had to think up how to make the maximum use of the resources from the EU's pre-accession funds, made available for programmes for legislative harmonisation and infrastructure development.

At the end we can say that the expected results of FDI, such as growth in exports (productivity and competitiveness) and fall in unemployment (increased investment activity and finding new markets) very largely depend on the initial conditions in the investment-receiving country, on its economic policy, the education of the labour force and the degree of technological development. Bearing in mind Croatian reality, we can and must agree with Katarina Ott who said that a large though not the biggest problem was that it was not possible to expect the considerable reforms in the public sector that were really necessary from the current administration. There should be no surprise then in the conclusion of the majority of the participants of the meeting that foreign investment in Croatia had not as yet brought the expected positive results it had in the transition countries of Central Europe. There were few countries that had managed, like Slovenia, considerably to enlarge their own exports with a relatively low share of FDI. Foreign investment in Croatia had to date largely been directed towards the service sector (banking, telecommunications, commerce), and only to a minor extent towards greenfield projects, mostly rather involving the takeover of existing domestic companies. Unfortunately, this unpropitious state of affairs in attracting foreign investment could well go on in the future (we are only just expecting the privatisation of the energy sector), and clearly would go on where there had long been signs of crisis, important for the attraction of foreign investments, and that is the long-term demographic problem. But in spite of all these problems, it is up to us to aspire towards the ideal in the attraction of FDI to Croatia, and that is that we should at least attempt to shepherd such investment into sectors with high added value products, into the high-tech industry and into the service sector.

Vjekoslav Bratić