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*Preliminary communication*

# IMPACT OF FOREIGN DIRECT INVESTMENTS ON CROATIAN FINANCIAL GROWTH

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## **Abstract**

Foreign direct investments are for the transition and less developed countries very important source of capital. Such investments have very positive impact on country's economy in terms of employment growth, industrial production growth, gross domestic product growth, favorable effects on the balance of payments and many other positive impacts for country economy, so it's not strange that countries in the absence of its domestic investors, are trying to attract foreign investors. Foreign investors analyze in detail possibilities and risks of each country, and if the risks exceed the opportunities there will be no inflow of foreign capital. Therefore every country which is trying to attract foreign direct investments must take care about the policy and its economy and try to be most attractive as it can be.

**Keywords:** foreign direct investment, brownfield investments, greenfield investments, economic growth.

*Jel Classification:* F21

## **INTRODUCTION**

This research is based on foreign direct investments in Croatia with respect to how Croatian economy looks to foreign investors and which sectors foreign investors find the best choice for investing. Croatia is country which is interested for foreign direct investments. Unfortunately, in Croatia there is a declining trend in foreign direct investment, the reasons are mainly attributed to the global financial crisis and the poor climate for investment in Croatia. This research is concentrating mainly on poor climate for investments in Croatia.

Investment can be defined as any investment in real or financial asset in the purpose of acquiring of certain economic benefits or profits. The investment can be defined as

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delay in spending which is very similar with spending. Unlike savings investments contain some risks associated with the realized effects of investment; because of that risk we can expect higher earnings from interest on savings. Financial investments represent investments in financial asset (stocks, bonds, T-bills and other securities). Revenues from financial investments are dividends, interest rates and other fees that are received as current income from financial investments. Except mentioned revenues it is possible to realize a capital gains if the market price exceeds the purchase price. Investors combine financial investments in the investment portfolio and thus produce a combination of return and risk, to gain maximal profit for minimal risk. Real investments are investments in tangible fixed assets. Real investments can be productive and non-productive. The most important non-productive investments are housing investments. Productive investments are classified as investments in fixed and working capital. Investments in fixed assets (buildings and equipment) can be gross and net. Some authors besides financial and real investments differ investments in intangible assets. These investments represent purchase of patents, royalties, copyrights etc.

Some basic investment motives can be: achieving the capacity that is necessary to conduct business. Maintaining the current position in the market or improving it. Replacement of physically and economically obsolete fixed assets. One of the possible motives can be business expansion or achieving funding structure that allows optimal utilization of company.

#### **FOREIGN DIRECT INVESTMENTS (FDI)**

According to Benito and Gripsrud (1992) a foreign direct investment is defined as ownership of 10% or more of the equity in a foreign company. However, in a majority of the actual cases the level of ownership is far higher, and 55% of the cases are wholly owned subsidiaries. The World Bank has defined foreign direct investments as net inflows of investment to acquire a lasting management interest (10 percent or more of voting stock) in an enterprise operating in an economy other than that of the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments. According to Perovic (2005) foreign direct investment culminate in eighties, when the world's flows are growing yearly average of 30%, which is three times more than the growth of world exports. Their strong growth undoubtedly is linked to the activities of transnational corporations, as well as changes in the global business environment. FDI is motivated by the permanent interest of investors in making a profit in the long run.

Opinions on foreign direct investment are divided. It is believed that FDI differ from other forms of inflows of private foreign capital, primarily, by a permanent interest in the target company and the active participation of foreign investors in the business. With the help of foreign capital countries technologically innovate production faster, they improve the quality and lower the cost of the product and thus act on raising the competitiveness of the domestic and foreign markets. Foreign direct investments increase the national income and standard of living. On the other hand they have negative effects also. According to Zilinske (2010) foreign direct investments can cause negative effects also. When investors try to earn more via cheap(er) resources- land and labor is the primary aim of investors. Foreign investors can reduce employment by dismissing

local workers, by crowding out local businesses that cannot compete with multinationals; technology transfers may not occur if the degree of market integration is insufficient; positive capital flows often turn to negative if investors use cheap local raw materials and resources and sell expensive final goods. Zilinske (2010) also claim when FDI takes a form of simple merge and acquisition (M&A) actions positive externalities are much lower if not negative.

The most common type of foreign direct investments especially in transition countries are acquisitions by some of the larger multinational companies, while completely new investments are much rarer. More about transition and foreign direct investments in Stancescu (2012). Foreign direct investments can be divided as greenfield and brownfield investments.

Greenfield investments are related to a brand new production, sales or any other physical capacity in an area where, they never existed before. This type of investment is expensive, but to the parent company it brings several advantages. The company has complete control over the new starting job. Investor is able to create a company based on its own technical know-how and business organization. Greenfield investments directly affect the increase in production capacity in the country and contribute to the formation of capital structure and employment. Greenfield investments can stimulate the development of infrastructure and new technologies in the country. Common example of greenfield investment is when a corporation enters the country, builds factory and start to produce. Positive side of greenfield investments are: new skills and technologies, in the recipient country investment have also positive effect on balance of payments they reduce import dependence and this type of investment create new jobs. Greenfield investments are opposite of brownfield investments.

Brownfield investments (Mergers and acquisitions – M&A) have similar character as greenfield investments. Brownfield investments represent the purchase of existing companies, with taking partial or complete control of them. Brownfield investments are related to the acquisition with local companies by foreign investors. Operations of mergers and acquisitions belong to methods of external company growth. The company is investing in existing or former production site with the aim of launching new or expanding of existing business activities. According to Ivanovic, Baresa and Bogdan (2011) in Croatia only a small part of investments went to greenfield investments most of the investments went to brownfield investments. Main aim of brownfield investments is to make company more profitable and the easiest way is downsizing (reducing the number of employees) best example in Croatia is HT company (Croatian Telecom), in 1999 Deutsche Telekom bought 35% of HT company for 850 million \$ and after 2001 another 16% for 500 million \$ (Deutsche Telekom total has 51% stocks) it has a plan till 2014 have 5000 employees, just to remember in 2002 it had 11.300 employees, this is only one example of negative effects in brownfield investments. Regarding the contribution of brownfield investments these investments represent a change of ownership from domestic to foreign owners. This type of investment as opposed to greenfield investment in the short term do not contribute to increase the production capacity. However, the long term effects of foreign direct investment through brownfield investments can have great beneficial effects. Foreign direct investment should not be identified with the company in a predominantly foreign ownership because it is just one of the ways in which such a company is funded by foreign sources.

## DETERMINANTS OF ATTRACTING FOREIGN DIRECT INVESTMENTS

Foreign direct investments are becoming very interesting in nineties for economic analysts and for economic policy makers in transition countries. In the early nineties, which are marked by the transition to a market economy, there was a significant inflow foreign direct investment in the countries of Eastern and Central Europe, which have become much more liberal to foreign direct investments. The privatization processes, in manufacturing companies and in the service sector, have enabled foreign investors buying shares in the largest and most important Croatian companies. Measures and activities to attract foreign direct investment and regulating the status of foreign investors, and the privatization of major enterprises, coincided with the most rapid growth of foreign direct investment in the world's history, what has happened in recent years of the 20th century. Foreign direct investments are one of the main factors of the investment cycle of a particular country and they have a lot of direct and indirect effects on the growth and stability of the entire economy. When a company decides to invest in another country there are risks that investors should consider. The market is always changing and there is always present risk which means there are required constant changes to adapt in order to survive in such a market.

Croatia in the regard of the foreign direct investments in the last several years was not very good example. There are many reasons for that situation. One of the reasons is the problem for foreign investors is in finding all required permits, except permits complications continue because Croatia has shared jurisdiction between the state, county, town or municipality and the issuance of various approvals, bureaucracy as a whole is made up of unconnected fragments which hampers investment approvals. Sometimes investor has to attach several times his proof of ownership. Investors in the beginning also refuse understatement and frequent changes in regulations for which there is no legal certainty. Besides legal certainty there are big problems with spatial plans, unresolved property relations, etc. All these reasons reduce possibility of attracting brownfield but especially greenfield investments that have great strategic importance for economy of country. One of the reasons for the decline in foreign direct investment is that the government has privatized valuable state assets and now part of state assets which is intended to sell is greatly reduced.

The most important facts in attracting foreign direct investments and to compete with competitors is to meet certain criteria which are essential preconditions for attracting foreign direct investments. These criteria are: *political stability, the stability of the national economy, a favorable business environment, infrastructure development, and the credibility of government policy*. Investments rarely come in politically unstable areas, considering that such situation increases the risks of the investment so we can conclude that political stability is the basic determinant of attracting investments. Politically unstable areas may attract only a speculative investment opportunities for quick profits in the short term but they have rarely a positive impact on the development of the country. National economy is important determinant for attracting foreign direct investments also. The national economy should be stable, which primarily relates to the stability of the national currency, a consistent monetary and fiscal policy, stable inflation rate and so on. A favorable business environment refers to the possibility for continuous operations without unnecessary costs, complicated administration, bureaucratic barriers, slow issuance of the necessary permits etc... Good infrastructure development in the form of transport and

telecommunications infrastructure, educated workforce, a developed market, will have a positive effect on attracting FDI also. Government policies must be consistent and credible in order to give investors confidence to decide on the investment over the long term.

## **FOREIGN DIRECT INVESTMENTS IN CROATIA**

Decreased volume of investments is certainly a result of the economic crisis, because of which many potential investors do not dare to invest because of the increased risk and lower profits than before crisis. If we want to overcome the crisis and achieve economic growth, it is necessary to create a good investment climate. It will not be easy, and besides the above mentioned essential criteria for attracting foreign direct investments there are numerous other reasons.

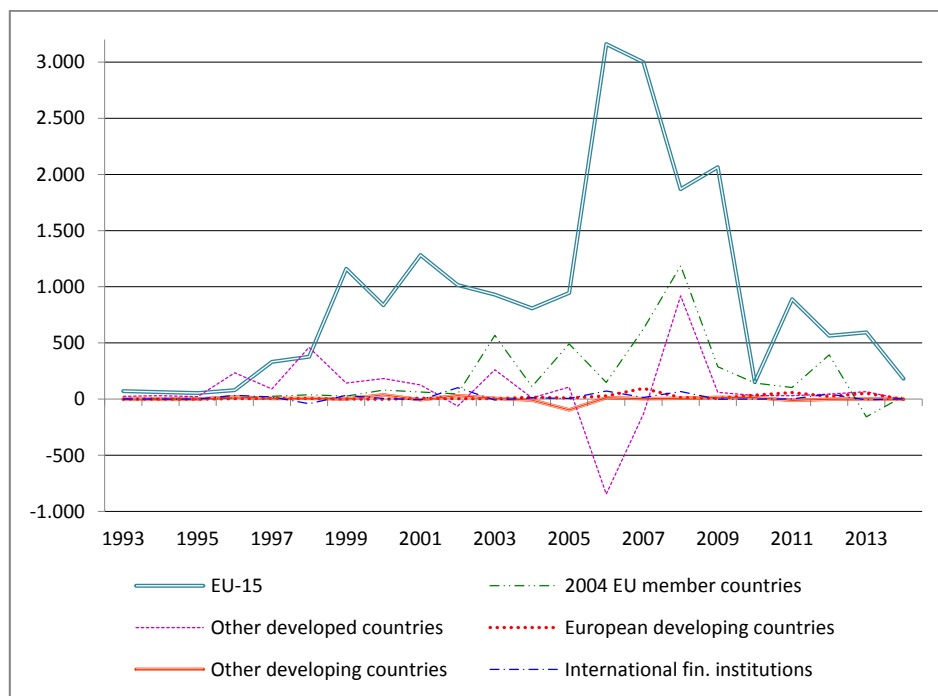
Foreign investors are already present in sectors where in Croatia they can achieve the greatest profits, such as the financial sector, telecommunications and trade. These sectors and activities are already occupied but in the manufacturing sector there is almost impossible to attract both foreign and domestic investors. The reason is mostly the unfavorable exchange rate of the HRK<sup>2</sup>, which favors imports rather than exports, high taxes, expensive labor compared to other transition countries, etc. These conditions are extremely unfavorable because they don't create new added value, or equity, and the economy is oriented to import. Most of the production relies on the domestic market. Therefore for most investors it is more profitable to invest their capital in other transitional countries where operating costs lower, there are larger markets, monetary and fiscal policy is more favorable. Such bad conditions for foreign direct investments will be very difficult to change in the future. Valuation of potential foreign direct investments in Croatia reveal that a further increase in incoming foreign direct investments can only be achieved through the further economic growth and increasing trade openness, therefore, the efforts in the field of economic policy should be focused on creating the conditions for sustainable economic growth which would reduce the development gap to potential foreign countries which are willing to invest.

Croatia, as a medium-developed country currently needs to concentrate more on the size of the market (including free access to the EU - the market) and macroeconomic stability, while in the future, more attention should be paid to factors which influence the competitive production costs such as taxes, foreign exchange rate and labor productivity. In order to attract foreign direct investment Croatia has established various working groups and agencies. So there's Agency for Investment and Competitiveness, which is an agency of the Croatian Government, whose main task is to promote Croatia as a desirable investment destination, it also seeks to proactively attract and realize investment projects of large firms and improve the competitiveness of the Croatian economy globally. Considering that the majority of foreign direct investment comes from EU countries, membership of Croatia in European Union will positively affect the

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<sup>2</sup> Considering HRK according to Croatian national bank Croatia implements a floating exchange rate regime. This means that the exchange rate of the national currency is not fixed by a foreign currency or a basket of currencies, but is freely determined in the foreign exchange market. The exchange rate therefore fluctuates depending on supply and demand of foreign currency on the foreign exchange market, but the Croatian National Bank occasional involves in the operation of the market to prevent excessive exchange rate fluctuations and tends to maintain a relatively stable exchange rate.

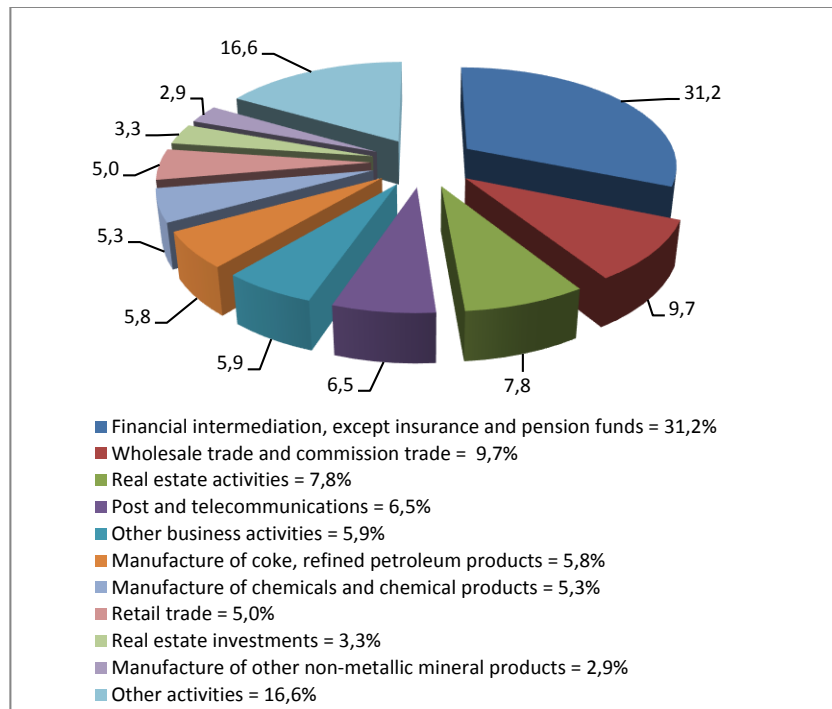
investors. Croatia should attract foreign investment from the countries of the European Union. Orientation to other markets such as Middle Eastern, Asian and American countries should be only in the long-term plans because investors from these countries generally have no experience with investing in Croatia. For attracting investors from EU countries Croatia needs to create a predictable investment environment in which corruption will be reduced to a minimum, the bureaucracy will not interfere with the laws will be effectively implemented. Croatia must use its comparative advantages as favorable geographical position. Croatia is located in Central Europe, close to major European countries and the economic powers such as Germany, Italy, Austria, and countries in transition in the southeast, which creates an extremely favorable traffic and trading position. Also, the great advantage is the access to the open sea, which contributes to cohesion. Transport and telecommunications infrastructure are very well-developed, highways are new and they are connected across the country and very well connected with European. There is no lack of qualified staff. The national currency is stable, which reduces the risk of investment. The great advantage is also that Croatia has recently joined to the European Union. Figure that follows shows foreign direct investments in Croatia by the countries of investors (data are used and analyzed from the Croatian National Bank, regular publications – the standard presentation format for the first quarter of 2014)



**Figure 1.** Foreign direct investment in Croatia, investing countries breakdown

Graph presents millions of EUR on x axis, while on y axis are years. As it can be seen from the graph majority of investments are made by the countries of EU 15. These

countries are: Austria, Belgium, Denmark, Finland, France, Germany, Greece, Ireland, Italy, Luxembourg, the Netherlands, Portugal, Spain, Sweden and the United Kingdom. While other developed countries and developing countries are in the minority in terms of foreign direct investment in Croatia. All foreign direct investments from 1993 – Q1/2014 are ranked and showed in the picture which follows (data used and analyzed from the Croatian National Bank).



**Figure 2.** Foreign direct investments in Croatia 1993–Q1/2014\* (27,224.1 million EUR)

Top five foreign direct investments in Croatia from 1993 are in: financial intermediation (except insurance and pension funds), wholesale trade and commission trade, real estate activities, post and telecommunications and other business activities. In first quarter in 2014 rank has changed and in first five places are: post and telecommunications, manufacture of chemicals and chemical products, financial intermediation (except insurance and pension funding), supporting and auxiliary transport activities (activities of travel agencies) and Real estate. Percentages are show in table 1 which follows (data used and analyzed from the Croatian National Bank).

**Table 1.** Foreign direct investments in Croatia Q1/2014

Name of the sector	In %
Post and telecommunications	22,2
	147



Manufacture of chemicals and chemical products	14,3
Financial intermediation, except insurance and pension funding	13,2
Supporting and auxiliary transport activities; activities of travel agencies	10,1
Real estate	9,5
Manufacture of coke, refined petroleum products and nuclear fuel	7,8
Construction	7,8
Manufacture of machinery and equipment n. e. c.	4,9
Retail trade, except of motor vehicles and motorcycles; repair of personal and household goods	4,8
Research and development	4,4
Other activities	0,9

If we turn the foreign direct investment into monetary amounts then we would obtain a line graph as shown in the picture, below. Lin graph in figure 3 represents foreign direct investments from 1993 till 2014.



**Figure 3.** Foreign direct investments in Croatia in millions EUR

The total amount of foreign direct investment flows in Croatia amounts to 27 billion and 224 millions of EUR since 1993 year. As it is in previous figure shown it can be noticed that foreign direct investment achieved constant growth until 2008 when it made a record increase of 4 billion and 63 million followed by a large drop in 2010 where was bottom with only 334 million EUR inflow in Croatia. As it can be seen from figure 3. these are not good results for Croatia as a country that aims at foreign investments. Low foreign investments are also caused by poor macroeconomic picture of the country, where gross domestic product declines the last few years. FDI are very important for GDP of the country. There are lost of researches made that prove connection between FDI and GDP like: Hansen and Rand<sup>3</sup> (2004), Sandalcilar and Altiner (2012), Mawugnon and Qiang (2011) and may others. But there are also few papers that found no positive relation between FDI and economic growth like Moran (1998) and Yan and Pokhrel

<sup>3</sup> proved impact in short run

(2011). Croatia has weak industrial production, current account deficit, high unemployment, and many other negative aspects that negatively affect investors. According to all of the above it can be expected further decline in foreign direct investments also. The foreign investments are mainly influenced by political and economical factors which are confirmed in paper written by Maitah and Salim (2010). The global financial crisis that began in 2008 has significantly reduced international capital flows and almost halved the total world foreign direct investments. Largest fall was recorded in developed countries, including the European Union (40–60%), and FDI inflows were followed by a mild recovery. The greatest risk for further positive developments related to foreign direct investment comes from the still unstable business environment and management problems in terms of the debt crisis and problems in the financial sector of the eurozone.

## **CONCLUSION**

In Croatia, most foreign investment comes down on buying majority ownership in domestic valuable companies, which causes reduction in employment. Previous investments did not raise the competitiveness of the economy as it was expected. And the revenues were used for state budgetary purposes. There is a lack in greenfield investments for which is responsible unfavorable investment climate and inadequate institutional framework. In Republic of Croatia, it is necessary to make an effort to attract foreign investors who would be willing to invest. Due to the lengthy process of attracting foreign investors and because of past experiences, short-term and medium-term policy should be oriented towards the eu countries, and only in the long term Croatia can think of other markets. To attract investment, both domestic and foreign ones, it is necessary to create a good business surrounding, only then we could expect contribution of FDI to economic growth Croatia. In conclusion, we can say that Croatia has not yet taken full advantage of all its resources and comparative advantages over the countries of the region, which are primarily favorable geographical position, mild Mediterranean climate, and educated workforce which are just some of the positive factors to attract the foreign direct investment in the Croatian economy. Just mentioned facts indicate that now is time to design effective economic development strategies, and to encourage foreign direct investment. Despit the fact that Croatia is a small country, it has a very great potential that has to be economically exploited to positively affect the Croatian economic condition.

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