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Trade Reintegration of Southeast Europe in View of Projected Balance of Payment Developments: The Role of Neighbouring Slovenia

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The wiiw Balkan Observatory

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The wiiw Balkan Observatory

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About

Shortly after the end of the Kosovo war, the last of the Yugoslav dissolution wars, the Balkan Reconstruction Observatory was set up jointly by the Hellenic Observatory, the Centre for the Study of Global Governance, both institutes at the London School of Economics (LSE), and the Vienna Institute for International Economic Studies (wiiw). A brainstorming meeting on Reconstruction and Regional Co-operation in the Balkans was held in Vouliagmeni on 8-10 July 1999, covering the issues of security, democratisation, economic reconstruction and the role of civil society. It was attended by academics and policy makers from all the countries in the region, from a number of EU countries, from the European Commission, the USA and Russia. Based on ideas and discussions generated at this meeting, a policy paper on Balkan Reconstruction and European Integration was the product of a collaborative effort by the two LSE institutes and the wiiw. The paper was presented at a follow-up meeting on Reconstruction and Integration in Southeast Europe in Vienna on 12-13 November 1999, which focused on the economic aspects of the process of reconstruction in the Balkans. It is this policy paper that became the very first Working Paper of the wiiw Balkan Observatory Working Papers series. The Working Papers are published online at www.balkan-observatory.net, the internet portal of the wiiw Balkan Observatory. It is a portal for research and communication in relation to economic developments in Southeast Europe maintained by the wiiw since 1999. Since 2000 it also serves as a forum for the Global Development Network Southeast Europe (GDN-SEE) project, which is based on an initiative by The World Bank with financial support from the Austrian Ministry of Finance and the Oesterreichische Nationalbank. The purpose of the GDN-SEE project is the creation of research networks throughout Southeast Europe in order to enhance the economic research capacity in Southeast Europe, to build new research capacities by mobilising young researchers, to promote knowledge transfer into the region, to facilitate networking between researchers within the region, and to assist in securing knowledge transfer from researchers to policy makers. The wiiw Balkan Observatory Working Papers series is one way to achieve these objectives.



The wiiw Balkan Observatory

Global Development Network Southeast Europe

This study has been developed in the framework of research networks initiated and monitored by wiiw under the premises of the GDN–SEE partnership.

The Global Development Network, initiated by The World Bank, is a global network of research and policy institutes working together to address the problems of national and regional development. It promotes the generation of local knowledge in developing and transition countries and aims at building research capacities in the different regions.

The Vienna Institute for International Economic Studies is a GDN Partner Institute and acts as a hub for Southeast Europe. The GDN–wiiw partnership aims to support the enhancement of economic research capacity in Southeast Europe, to promote knowledge transfer to SEE, to facilitate networking among researchers within SEE and to assist in securing knowledge transfer from researchers to policy makers.

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TRADE REINTEGRATION OF SOUTHEAST EUROPE IN VIEW OF PROJECTED BALANCE OF PAYMENT DEVELOPMENTS : THE ROLE OF NEIGHBOURING SLOVENIA

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I. Introduction

After a decade of wars and economic destruction in the region of Southeast Europe (SEE) most of the successor states of former Yugoslavia are far from their economic performances before 1990¹. Most heavily harmed has with no doubt been FRY with manufacturing output in 1999 amounting to only 22% of that in 1989, while on the other edge Slovenian manufacturing output in 1999 reached 75% of the 1989 level. Suspension of bilateral trade links following the introduction of protectionistic trade policies by individual republics of former Yugoslavia at the end of 1980s² can be listed as one of the key reasons for consequent tremendous output fall in the region. For illustration, in only three years (1990-1993) Slovenian sales to former Yugoslav markets decreased from \$6,662 million to \$965 million (Damijan and Majcen 2000). The decline of Slovenian purchases from this region occurred in the same magnitude. After 1993 there is observable slightly increasing trend in Slovenian exports as well as imports with the region of former Yugoslavia.

From the Slovenian point of view, the markets of former Yugoslavia before 1990 served as a base for the necessary inputs, such as deficient raw materials, semi-manufactured products and agricultural products for Slovenian manufacturing sector. After processing either in Slovenian headquarters or in local affiliates of Slovenian firms, final products were then sold further to western markets as well as in the former single Yugoslav

¹ In this paper, terms “region of the Southeast Europe (SEE)” and “SEE countries” are used as synonym and include include all countries of the former SFRY with exception of Slovenia, i.e., Bosnia and Herzegovina (BiH), Croatia, Federal Republic of Yugoslavia (FRY) and Macedonia.

² Starting in 1988, the former Yugoslav single market began to fall apart due to impositions of some quasi import taxes between republics. After the official break-up of Yugoslavia in 1991, additional barriers on bilateral trade were created followed by war in Croatia and BiH, and the trade embargo against Serbia and Montenegro.

market.³ The crucial part in these patterns of Slovenian purchases in the region was the vertical supply-chain organisation of production as well as intra-firm trade – the organisation that is characteristic for multinational companies (MNCs). In fact, this MNCs pattern of trade has also formally been based upon appropriate ownership framework with Slovenian firms being the major “foreign” acquirers and greenfield investors in the region. Leaving aside negative political connotations this pattern of production and trade has provoked in the past,⁴ it is ultimately true that in the period before 1990 it helped to stimulate economic growth and to sustain a kind of economic and social stability in the region. Fidrmuc (2000) shows that according to the above pronounced pattern of intra-firm and inter-republic trade the volume of bilateral trade flows between republics of former Yugoslavia was about 24 times higher than that predicted by gravity model which is based on normal trade flows between EU countries.

Recently, the key role of Slovenia to promote economic stabilisation in the SEE region could be again based on a kind of trade reintegration and on creation of new or restoration of former supply-chain organisation. Current trends in Slovenian aggregate trade flows as well as outward FDI flows already reflect the tendency towards increased trade and investment activities in the SEE region. Are we, in fact, witnessing the restoration of pattern of trade and production specialisation that was characteristic for this region before 1990?

The aim of the paper is twofold. *First*, to provide a macro-economic framework for analysing economic cooperation between Slovenia and other countries of the former Yugoslavia, including a systematic review of Slovenia’s “regional” balance of payments with this region. *Second*, to analyse current investment activity of Slovenian firms in the region in order to reveal the motivation of Slovenian firms investing in SEE. The hypothesis is that trade promoting rather than efficiency seeking motives are a driving force behind present increased investment activity of Slovenian firms in the region. Slovenian firms might be predominantly aimed at increasing sales to the region from their Slovenian headquarters rather than at setting up local production facilities due to comparative advantage reasons (lower costs of local labour). The reasons for this belief lie in a still very unstable political and economic environment of the SEE region, in low financial discipline of local customers as well as in still under-utilised resources of Slovenian headquarter firms. Trade promotion might be a short run strategy of Slovenian firms, in the longer run, however, efficiency seeking and comparative advantage reasons might prevail.

An analysis of balance of payments flows between the Republic of Slovenia on the one hand and the other former Yugoslav republic on the other hand is based on the Bank of Slovenia’s data processed especially for this study, and on the investment position of Slovenia in relation to other countries of the region. As far as present and planned trade

³ On the other side, a lot of exports of final products from other parts of the region were directed through Slovenian trade firms which were licensed for foreign trade operations.

⁴ At the end of 1980s, there was given rise to the political accusations in other republics of the former Yugoslavia that Slovenian firms do “exploit” other republics of the region through exploitation of their economic resources.

and investment behaviour of Slovenian firms vis-à-vis SEE region is concerned, the analysis is based on the survey conducted among 115 largest Slovenian companies. These data are combined with income statements and balance sheets of these companies.

In addition to this *Introduction* and *Conclusions*, the paper consists of four chapters. The *second chapter* discusses key factors that will decisively influence economic cooperation of the SEE countries with the rest of the world in the coming medium-term period. The chapter focuses on the examination of balance of payments sustainability of the countries in the region. In the *third chapter*, key features of the Slovenia's "regional" balance of payments, i.e., its current and capital accounts transactions with countries of SEE are explored. The following two chapters provide a detailed analysis of present and planned trade and investment behaviour of Slovenian firms vis-à-vis SEE. *Chapter four* discusses the two existing modes of Slovenian companies' investments in SEE markets, i.e., trade-promoting investments and efficiency-seeking investments. In the *fifth chapter*, a simple probit model is used to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004.

II. Key country risk factors influencing economic cooperation of SEE countries with the rest of the world

Sources that regularly assess country risk position of an individual country provide a comprehensive overview of how international economic and especially financial community sees opportunities and risks associated with that particular country. All these sources rank countries on the territory of the former Yugoslavia as either highly risky (BiH, FRY, Macedonia) or as moderate risk countries (Croatia). High country risk in fact means that due to political and/or socio-economic factors the country is not able to take advantage of its developmental potentials. On the external finance side, high country risk prevents the country and its entities from tapping resources on international capital market, and in addition, it also represents an obstacle for attracting direct foreign investments.

The interplay of the following two groups of factors explains why countries of the region are classified as high country risk countries: (i) continuation of political instability and institutional weaknesses, including problems associated with inadequate rule of law and corruption, and (ii) slow process of transition towards a market economy.

Although all these groups of factors exist in each country of the region, their relative importance differs from one country to another. In BiH, FRY and recently also in Macedonia political factors and also institutional weaknesses dominate the overall country risk assessment of these countries. In Croatia, however, political risk is considered as moderate and country risk analysts are more concerned with economic and financial risks. In this respect, attention is focused on the sustainability of the country's fiscal and balance of payment deficits.

As a consequence of unfavourable developments in SEE over the last decade, economic situation in countries of the region deteriorated not only *vis-à-vis* their economic performance in the pre-transition period but also in relations *vis-à-vis* other countries in Central Eastern Europe. In the year 2000, for example, the estimated level of real GDP in all countries of the region was below the 1989 level. In Croatia, Macedonia and BiH it was 80%, 77% and 70% respectively, and in FRY even only 48% (Transition Report Update 2001, p. 15). With exception of Croatia, the region is lagging behind countries in Central Eastern Europe also in terms of transition processes. This is clearly confirmed by the EBRD's overall transition indicators that are each year presented for all transition economies.

2.1. Political and institutional risks

Ever since violent dissolution of the former Yugoslavia, socio-economic developments of the countries in the region continue to be under decisive influence of political factors. Although peace has been reestablished, many questions remained unanswered and long-term political solution for the region as a whole seems to be no much closer today than it was immediately after the break of hostilities. With exception of Croatia where political risk is considered to be moderate, all other three countries of the region continue to be assessed as countries with high or very high political risk. This is confirmed by the very fact that on territory of all the three countries or on parts of their territory presence of international peacekeeping forces is still needed.

Political risk in these three countries has, however, very different country specific patterns. FRY, for example, at the moment faces problems associated with the consolidation of democratic structures and with the unresolved constitutional relationship with Montenegro and Kosovo. In BiH, high level of political risk continues to be expressed primarily through distrust among constitutive nations of the country. This distrust does not create conditions required for an efficient functioning of the state and consequently for a comprehensive socio-economic development. In the year 2001, political risk increased also in Macedonia as a result of hostilities that broke out between Macedonian majority and Albanian minority

Such implications can be driven already from the fact that international peacekeeping presence is still needed in the region. We are dealing with formally sovereign countries, which are however more protectorates or, say, half protectorates since single country cannot *de-facto* or *de-iure* control its territory or at least some parts of its terrain. Still a completely unclear future relationship between Serbs and Montenegrins must be borne in mind as well.

Political risk in countries of the former Yugoslavia is closely associated their institutional weaknesses. One of important patterns of countries in this region namely is so-called "a weak state" what is closely interrelated with procedures of how these states are governed. It is namely a typical pattern for each of these countries that their way of governing states is strongly based on a discretionary decision making system. There is a clear lack of the

rule of law throughout the region and corruption in both public and private sector seems to be quite widespread.

2.2. Economic and financial risks

The war, which after the collapse of the former Yugoslavia involved most of its former republics, represents with doubt the key reason for a late start of economic reforms in the region. It should be stressed, however, that transition process proceeded relatively slowly and cautiously also in countries not involved in the war (the case of Macedonia) as well as in war-affected countries in the period following the end of hostilities (the case in BiH and to some extent also in Croatia). In the case of the FRY, and more precisely of Serbia, the beginning of transition started only this year, while Montenegro in the framework of its efforts to gain independence took first steps for economic reform already several years ago.

Economic growth and purchase power; In economic terms, the period of last ten years can be assessed as a period of large set backs for majority of SEE countries. This can be confirmed with various macro-economic data, including declining GDP and per capita GDP and increasing unemployment, as well as by the fact that all the three countries have today an IDA status at the World Bank. With exception of Croatia, all other three countries in the region are consequently characterised with very low purchasing of their population what is *per se* a limiting factor for economic cooperation with the region.

Balance of payments; Internal imbalances in SEE countries are putting under question sustainability of their increasing external deficits. As Table 1 shows, one of the fundamental economic and financial characteristics of all four countries in the region is their high current account deficit. For two countries, the deficit, expressed as a percentage of GDP, reaches double digit (12% for FRY and even more than 20% for BiH).

Table 1: Current account balance of SEE countries (in \$ billion)

	BiH		Croatia		Macedonia		FRY(*)	
	1999	2000	1999	2000	1999	2000	1999	2000
Current account balance	-1,0	-0,9	-1,5	-0,9	-0,1	-0,3	-1,3	-1,3
Trade balance	-1,9	-1,6	-3,3	-3,4	-0,4	-0,6	-1,8	-1,9
⇒ Exports	0,6	0,7	4,4	4,6	1,2	1,4	1,5	1,7
⇒ Imports	2,5	2,3	7,7	7,9	1,6	1,9	3,3	3,6
Current account balance / BDP (%)	-22,2	-21,0	-7,6	-4,7	-4,0	-8,3	-13,1	-12,6
Foreign direct investment / BDP (%)	2,1	2,8	6,8	4,0	0,8	5,0	0,5	...

* Estimate

Source: Transition Report Update 2001. April 2001

When assessing current account position of countries in the region, the following two specific patterns should be taken into account:

- *Trade deficit decisively influences overall current account deficit;* The current account deficit of all analysed countries is almost exclusively a result of a trade deficit. Table 1 shows the import-export coverage is low in all countries in the region. In the year 2000, it amounted to around 75% for Macedonia, 58% for Croatia, 47 % for FRY and only to 30% for BiH. This clearly indicates that trade deficit may be in future one of important limiting factors for economic development of the region, and that consequently economic policy aimed at reducing the deficit will be very high on the agenda of economic policy-makers.
- *Financial grants represent an important funding source for covering trade deficit;* With exception of Croatia, financial grants received from international community represent an important source of foreign exchange required to finance large import needs. This is in particular the case for BiH – it continues to be strongly dependent on foreign financial assistance – and to a lower extent also for Macedonia and FRY. As foreign assistance represents an important instrument for maintaining the existing level of imports, their planned reduction in the years to come will be directly associated with import restrictions if not accompanied with simultaneously increased export revenues and/or increased inflows of capital.

To finance a current account deficit, countries in the region have two major funding sources: (i) debt financing, especially credits from multilateral development banks, and (ii) equity financing, and within this framework primarily FDI.

- *Debt financing;* Croatia is the only country in the region that has established a normal access to the international capital market. With its investment grade rating, the country has established its presence on both segments of the market, i.e., on a market for syndicated commercial bank loans as well as on the eurobond market. For all other three countries in the region, private sources of debt financing remain either entirely closed or accessible only in very exceptional cases. This means, that BIH, FRY and Macedonia can borrow primarily from multilateral finance institutions, especially from IMF, World Bank and EBRD and EIB, as well as from bilateral official sources. It has been mentioned already that all three countries are eligible for IDA concessional assistance. For the time being, foreign commercial banks still concentrate their activity in the region on short-term transactions.
- *Foreign direct investments;* For some countries of the region, this is a very important source of current account financing. Most of FDI has flown into these countries within the framework of privatisation transactions while the volume of so-called “greenfield” investments remains rather small. In recent years, sale of state property to foreigners has been particularly important for Croatia and to a less extent also for Macedonia. In contrast, FDI have been relatively insignificant funding source for BIH and for FRY. It can be expected, however, that at least in the latter one the volume of FDI associated with privatisation will increase considerably in the years to come.

External debt and external debt burden; With exception of FRY, all other republics of the former Yugoslavia completed their negotiations with all three groups of their foreign creditors, i.e., with international finance institutions, with bilateral creditors through the Paris club and with commercial banks through the London club. In these negotiations, each of the successor states took over a part of external debt of the former Yugoslavia which is now being serviced according to bilateral agreements reached between individual successor states and each of the three groups of foreign creditors. It should be mentioned that as a part of these negotiations, partial write-off of external debt was approved to BiH while Croatia and Macedonia arranged a restructuring of their debt obligations *vis-a-vis* the Paris and the London clubs. As far as FRY is concerned, it has recently regularised its debt obligations *vis-à-vis* multilateral finance institutions and the Paris club – from the latter it also obtained a generous partial write-off – while negotiations with the London club are expected to be completed in early 2002.

Table 2 summarizes key external debt data and debt-burden indicators for individual countries of the region. These indicators show that apart of FRY – its external debt situation has not yet been entirely settled – other countries of the region have, for the time being, relatively stable foreign debt situation. This has, however, to be judged with understanding that only Croatia have relatively unrestricted access to international capital markets while for the remaining two countries this access is still almost completely denied.

Table 2: External debt and external debt burden of SEE countries

	BiH		Croatia		Macedonia		FRY(*)	
	1999	2000	1999	2000	1999	2000	1999	2000
External debt (\$ billion)	3,1	2,6	9,9	10,3	1,5	1,6	12,6	12,2
External debt / BDP (%)	71	63	49	54	44	46	126	116
Debt service ratio (%)	13	13	20	18	13	12	2**	2**

* Data for 2000 are estimates.

**FR Yugoslavia does not service its external debt obligations since 1992.

Source: Transition Report Update 2001. April 2001

III. “Regional” balance of payments of the Republic of Slovenia with SEE countries

In contrast to the previous chapter that has discussed an overall balance of payment position of SEE countries, the subject of this chapter are economic transactions carried out between the Republic of Slovenia on the one hand and the other four countries on the territory of the former Yugoslavia taken as a group on the other hand. Therefore, the main tool for the analysis that follows is Slovenia’s “regional” balance of payments with the other four countries in the region.

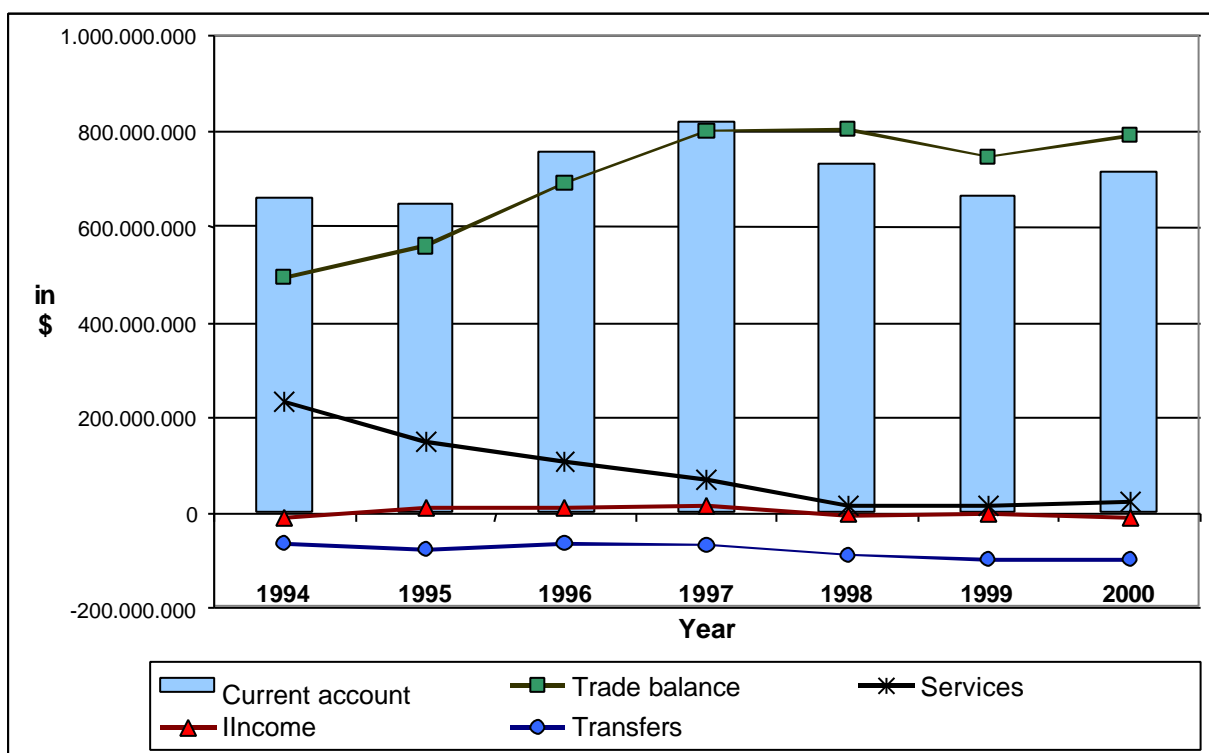
The analysis, which is based on the Bank of Slovenia’s data, covers the 1994-2000 period. As far as data used for the analysis are concerned, two methodological

qualifications have to be made. *First*, while data on current account are fully consistent with the *Balance of Payments Manual* of the IMF, this is not the case with data on the capital and financial account of the “regional” balance of payments. Since the information on capital flows is not available, data on capital stocks have been used. Although data on capital stocks measured at different moments can not be directly applied to calculate flows, changes in capital stocks nevertheless provide some insight into the direction and volume of capital flows.

Second, in contrast to an overall balance of payments of a country that due to the double-entry accounting system must be in equilibrium, “regional” balance of payments of that same country is in equilibrium only exceptionally. The country’s deficit in its “regional” balance of payments is namely financed by a capital inflows from third countries while a country’s surplus in its “regional” results in a capital outflows to third countries. This means that a possible current account surplus in Slovenia’s “regional” balance of payments with the SEE countries is not necessarily to be covered with an equal amount of capital outflow to the region.

3.1. “Regional” current account

Figure 1: Current account transactions in Slovenia’s “regional” balance of payments, 1994 – 2000



Source: Internal data from the Bank of Slovenia

In contrast to the overall current account of the Republic of Slovenia that was in balance between 1995 – 1998 and even moved into a deficit of 3 - 4 % of GDP in last two years, the current account of Slovenia's "regional" balance of payments shows a continued surplus. As Figure 1 illustrates this surplus ranged from \$600 million to \$800 million a year in the 1994 – 2000 period. These data suggest that over the recent years economic transactions carried out by economic entities in Slovenia with their partners in the four SEE countries have represented an important source of net foreign exchange revenues for Slovenia and therefore also an important factor for neutralising an increasing deficit the country has been recording in its "regional" current account with the EU countries.

Trade account; Merchandise trade represents by far the most important segment of Slovenia's "regional" current account with the rest former Yugoslav republics. Slovenia has been exporting to these countries much more than it has been importing. The trade account surplus increased from about \$500 million in 1995 to between \$700 and \$800 million a year in the 1997 – 2000 period (see Figure 1 and Table 3) and is expected to rise to around \$1 billion in 2001⁵.

The import-export coverage differs strongly from one country to another. In the first half of 2001, the coverage stood at 200% in trading with Croatia and even at more than 400% in trading with the other three countries (at 443 % with FRY, 509% with Macedonia and 582% with BiH). Large trade account imbalances already represent a serious obstacle to further growth of Slovenian exports to Macedonia and it is only a matter of time when this problem will be raised also in Slovenia's trade relations with BiH and FRY. If not earlier, this will undoubtedly happen when the balance of payments deficits of these countries discussed in the previous chapter will become unsustainable.

As can be seen from Table 3, by far the most important trading partner of Slovenia in the region is Croatia. In the year 2000, it accounted for 50 % of Slovenia's export to SEE countries – in previous years this share was even much higher – and for over 75% of Slovenia's import from those countries.

On the side of Slovenian exports, the second most important trading partner with a continuously growing share is BiH while in the following years also a fast growth of trade flows between Slovenia and FRY is expected. Due to rather limited export potential of both, Macedonia and BiH, imports from these two countries remain at annual levels that do not exceed \$15 million per country.

⁵ Measured in EUR, the trade surplus would be even larger.

Table 3: Trade flows between Slovenia and SEE countries, 1994 – 2000 period, (in million \$)

Country / Year	1994	1995	1996	1997	1998	1999	2000
Croatia (balance)	275,7	332,0	277,2	376,0	382,9	248,2	263,3
⇒ exports	761,7	898,9	862,5	837,4	811,4	688,8	709,8
⇒ imports	486,0	566,9	585,3	461,3	428,5	440,6	446,6
BiH (balance)	63,6	111,5	249,2	258,6	270,6	306,7	313,6
⇒ exports	68,6	119,4	263,9	287,8	316,5	361,0	370,4
⇒ imports	5,0	7,9	14,7	29,2	46,0	54,3	56,8
FRY (balance)	15,4	7,8	65,0	72,2	37,3	49,6	103,1
⇒ exports	15,7	9,5	95,9	112,9	102,7	84,8	143,0
⇒ imports	0,3	1,7	30,9	40,7	65,3	35,2	39,8
Macedonia (balance)	139,8	107,0	100,8	93,2	113,8	138,7	109,9
⇒ exports	217,6	189,4	170,8	148,8	159,1	174,4	156,4
⇒ imports	77,8	82,4	70,0	55,6	45,3	35,7	46,5
Region (balance)	494,5	558,3	692,2	800,0	804,6	743,2	789,8
⇒ exports	1.063,6	1.217,1	1.393,1	1.386,9	1.389,7	1.309,0	1.379,6
⇒ imports	569,0	658,9	700,9	586,9	585,1	565,8	589,8

Source: Internal data of the Bank of Slovenia

In order to get additional insight into trade flows between Slovenia and the other four countries of the former Yugoslavia, another standard tool for trade flow analysis will be applied, namely analysis of intra-industry trade (IIT) and revealed comparative advantage (RCA). Table 4 reveals that bilateral trade between Slovenia and SEE countries consists mainly of one-way trade due to comparative advantage reasons. In almost all product lines Slovenia is a net exporter. There is some scope for intra-industry trade with Croatia, especially in textiles, wood, chemicals and metal products. However, share of two-way trade is mostly tied to some 20% of total trade. With BiH and FRY there is some scope for two-way trade in wood & furniture and textiles sectors, respectively. Note that share of two-way trade between Slovenia and EU ranges between 60 and 70%.

Sources of attractiveness of SEE markets for Slovenian firms can be easily identified in Figures 2 and 3. Figure 2 compares brand awareness of firms' major brands in SEE markets relative to EU markets and the importance of SEE markets relative to EU markets (in terms of market shares)⁶. A positive value reflects higher importance of SEE relative to EU markets. It is straightforward to see that higher relative brand awareness in SEE markets corresponds to higher relative importance of these markets in terms of market shares relative to EU markets. Especially firms operating in food, leather and footwear,

⁶ Figures are based on firms' estimates of their brand awareness in different markets and importance of different markets in terms of market shares as conducted in our survey (N=115). Estimates of manufacturing firms only are aggregate to NACE 2-digit level.

chemicals, paper and machinery sectors find their products more competitive in SEE markets resulting in higher export performance to these markets.

Table 4: Pattern of bilateral trade between Slovenia and SEE countries in 2000 – one-way (RCA) vs. two-way trade (IIT)

NACE-2	Sector	Intra-industry trade (IIT) ¹				Revealed comparative advantage (RCA) ²			
		CRO	BiH	M	FRY	CRO	BiH	M	FRY
A	Agriculture	4.4	2.2	0.1	14.4	0.1	0.0	4.8	0.0
DA	Food, bev., tobacco	18.8	0.5	2.6	1.0	0.1	1.5	0.7	1.6
DB	Textiles	23.2	9.1	4.6	46.3	0.0	0.3	0.1	-2.1
DC	Wood and products	29.3	56.0	10.2	5.8	0.0	-3.2	0.0	0.1
DD	Leather, footwear	10.5	3.4	0.0	0.7	0.3	0.3	2.0	3.0
DE	Paper, publishing	10.6	4.6	0.5	2.2	0.4	0.2	0.5	1.8
DG	Chemicals	21.1	1.1	6.7	3.7	0.9	0.6	-0.1	0.3
DH	Rubber and tyres	16.5	3.7	0.3	5.4	0.3	0.2	0.4	0.7
DI	Non-ferrous prod.	12.5	0.8	6.3	4.3	0.1	0.2	-0.1	0.2
DJ	Metal prod.	20.9	8.2	1.2	4.8	0.1	0.0	0.2	0.1
DK	Machinery	9.5	1.9	1.0	1.3	0.5	0.6	0.5	1.6
DL	Elec. appliances	14.2	2.7	1.3	2.4	0.1	0.2	0.4	0.5
DM	Vehicles, parts	15.3	11.8	1.9	4.0	1.2	-0.1	0.4	0.3
DN	Furniture, misc.	14.8	21.8	4.3	6.8	0.4	-0.1	0.3	0.1

$$^1 \text{GL index: } IIT_i = \left(1 - \frac{|x_i - m_i|}{x_i + m_i}\right) * 100, \quad ^2 \text{RCA index: } RCA_i = \left(\frac{x_i}{\sum x_i} - \frac{m_i}{\sum m_i}\right) * 100$$

Note: IIT and RCA indices are calculated at the CN 9-digit level and aggregated to NACE 2-digit level with export shares used as weights.

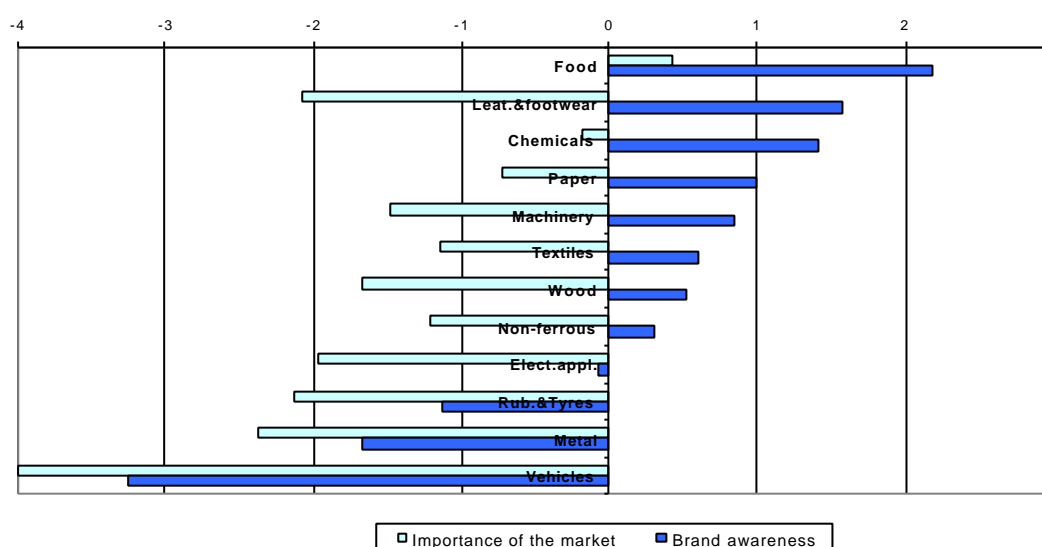
Source: SURS; authors' calculations.

Almost the same picture can be depicted from Figure 3, which switches from firms' perceptions to real data. Figure 3 relates average export prices (unit values) of Slovenian products in SEE and EU markets to export shares of these markets. In order to calculate export unit values a highly detailed trade data at CN 9-digit level for 2000 has been used. After adapting for different trade structures, 1506 different products, which are simultaneously exported to all observed markets, were matched. These products account for 75% of total Slovenian exports to EU, Croatia and BiH, and to 85% of exports to FRY and Macedonia.⁷ Individual average export prices were then aggregated to NACE 2-digit level with export shares used as weights. In Figure 3 sectors are ranked by increasing export shares of individual sectors to EU. In the Figure, one can observe a complete overlap between export attractiveness measured by average export prices and export performance in both EU as well as SEE markets. More importantly, Figure 3 points towards completely opposite exports attractiveness of EU and SEE markets for

⁷ After excluding FRY and Macedonia from our analysis, 3042 simultaneously exported products to EU, Croatia and BiH could be matched. Adding up, these products account for 90% of total exports to individual markets. However, sample expansion did not alter the magnitude of export unit values for EU, Croatia and BiH.

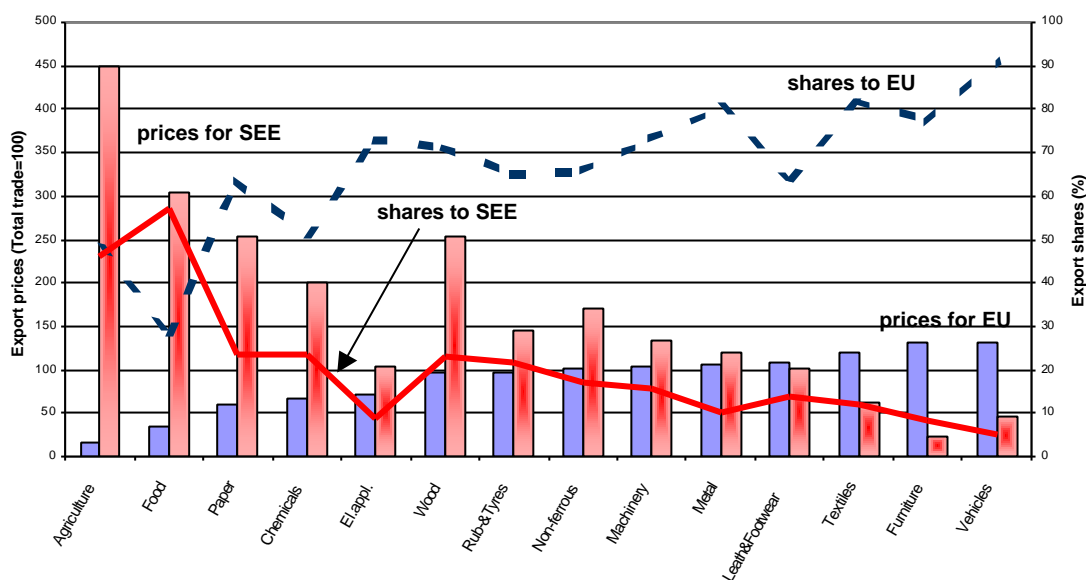
Slovenian products. Slovenian firms in agriculture, food, paper, chemicals and wood sectors can on average obtain twice as high export prices when exporting to SEE markets relative to EU markets. Consequently, a clear pattern of export specialisation by sectors appears, i.e. sectors that are less competitive in EU markets tend to specialise in exports for SEE markets. Hence, it is not surprising that more than 50% of exports of agricultural and food goods is sold to SEE markets.

Figure 2: Importance of markets and brand awareness of Slovenian products in SEE markets relative to EU markets



These "undecently high" export prices in SEE markets, nevertheless how attractive they may appear for current operations of firms, might in the longer run lead to unfavourable macroeconomic developments. As exporting to SEE markets is less demanding in terms of quality of products an increased export orientation towards these markets might hinder further restructuring of firms and increase technology gap against firms exporting to EU markets. A kind of dual economy may be the long run outcome. Relocation of manufacturing activity of these sectors via FDI to SEE countries instead of export specialisation might be a better policy. In particular, when having in mind that production in all of above listed sectors is intensive in natural resources.

Figure 3: Export prices and shares in exports to SEE and EU markets in 2000



Services; Slovenia records a surplus also in the services account with SEE countries (see Figure 1 and Table 5). It should be underlined, however, that the trend of the services balance moved in the opposite direction than the trend of the trade account. While the annual level of the latter increased for some \$300 million in the 1994 – 1998 period, the annual level of the services surplus declined in the same period for about \$200 million.

Data shown in Table 5 indicate that reasons for the reduced net foreign exchange inflow from services from the region have again to be searched in bilateral flows between Slovenia and Croatia. Reduced inflows to Slovenia have been caused, on the one hand, by diminishing net inflows from foreign exchange offices, and on the other hand, by increasing net outflows from Slovenia, due to tourist travels into the neighbouring country.

Among other services, the item “other business services” deserve some attention, and among them especially two specific sub-items. The first one, called “trade related services”, has continuously been an important factor for an overall surplus in the services account of Slovenia’s “regional” balance of payments. The second sub-item, called “miscellaneous business, professional and technical services” is interesting due to its trend over the recent years. The common characteristic of these transactions – they include legal and accountancy services, rents, etc. – is that they are directly related to the increased physical presence of Slovenian companies in countries of the region, either through trading or through FDI. The balance resulting mainly from bilateral relations with Croatia – it is by far the most important destination of Slovenian direct foreign investments – has switched from a relatively high surplus in early 1990s to a continuous and growing deficit in the second half of the decade. Deficit, although at a significantly lower level, has been registered in this sub-item also in Slovenia’s economic transactions with other three countries of region.

**Table 5: Flow of services between Slovenia and SEE countries, 1994 – 2000 period
(in million \$)**

Country / Year	1994	1995	1996	1997	1998	1999	2000
Croatia (balance)	209,8	133,4	92,0	58,6	5,6	-11,8	-6,9
⇒ exports	348,5	303,3	304,5	291,1	275,4	274,8	288,0
⇒ imports	138,6	169,8	212,5	232,5	269,8	286,7	294,9
BiH (balance)	12,8	4,9	9,0	8,5	8,4	22,7	30,3
⇒ exports	14,8	8,3	14,4	16,0	19,5	35,9	48,4
⇒ imports	2,0	3,4	5,4	7,4	11,1	13,2	18,1
FRY (balance)	2,0	2,3	2,2	2,9	1,8	-0,8	-0,1
⇒ exports	2,3	3,0	4,3	6,4	7,5	3,5	5,8
⇒ imports	0,2	0,6	2,2	3,5	5,7	4,3	6,0
Macedonia (balance)	8,4	10,8	6,6	2,9	2,4	5,7	2,3
⇒ exports	16,9	19,8	15,9	12,2	11,3	16,0	11,5
⇒ imports	8,6	9,0	9,3	9,3	8,9	10,2	9,2
Region (balance)	233,0	151,4	109,7	73,0	18,2	15,8	25,6
⇒ exports	382,5	334,3	339,1	325,8	313,7	330,1	353,7
⇒ imports	149,4	182,9	229,4	252,8	295,5	314,4	328,2

Source: Internal data of the Bank of Slovenia

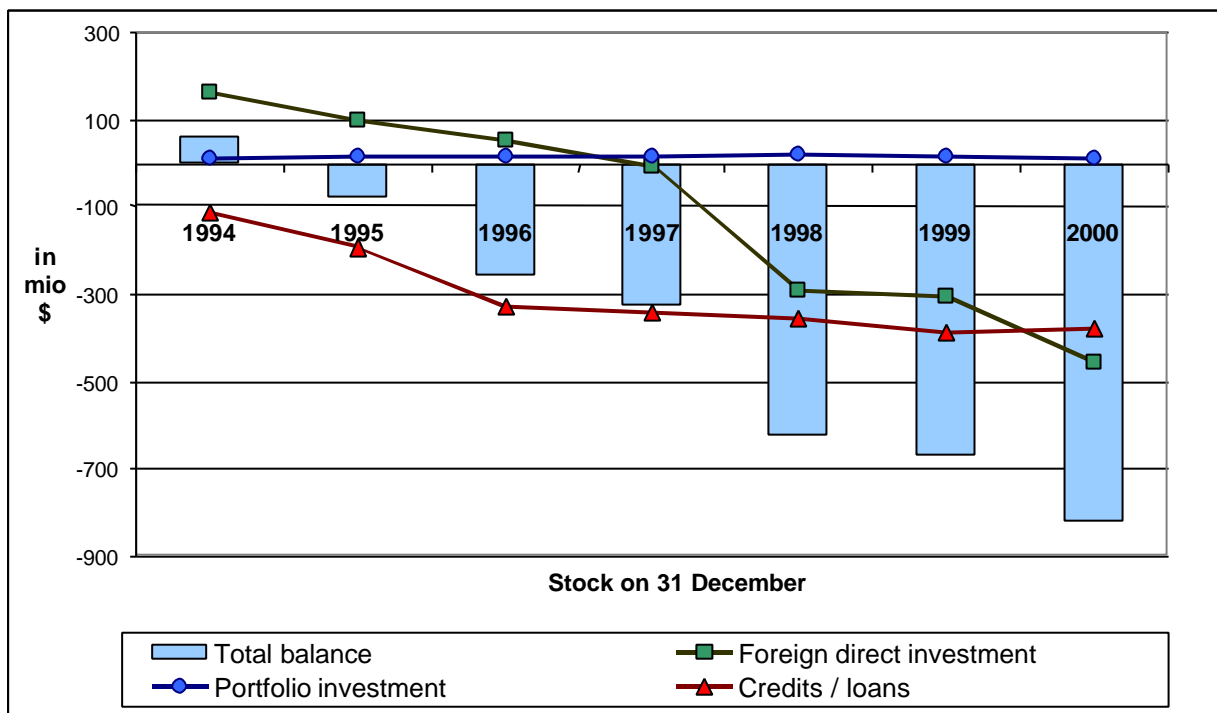
3.2. “Regional” capital and financial account

Similarly as the examination of the current account also the analysis of the capital and financial account of the “regional” balance of payments will follow the methodology of the IMF, therefore three groups of financial transactions will be studied (i) direct foreign investment (FDI), (ii) portfolio investment, and (iii) other investment, consisting mainly of trade credits and bank loans. It should be mentioned again, however, that the examination of this part of the “regional” balance of payments is based on the end-year stock statistics of financial liabilities and financial assets Slovenian entities hold on the territory of SEE countries⁸.

⁸ The capital and financial account of a country’s balance of payments records transactions associated with capital movements into the country and out of the country. Capital may enter into the country in very different forms, from various types of borrowing, including debt write-off, over selling of overseas assets to various forms of inward equity investment. All these items are referred to as capital inflows and are recorded as credit items in the country’s balance of payments. Capital inflows are, in effect, either a decrease in the country’s holding of assets abroad or an increase in its liabilities to foreigners. From the methodological point of view, a deficit in the country’s current account has to be covered by a net inflow in the capital and financial account of the balance of payments.

As we saw in the previous sub-chapter, Slovenia records a considerable surplus in the current account of the “regional” balance of payments, what makes Slovenia a net exporter of capital to the countries of former Yugoslavia, while the country still has been a net capital importer when taking into consideration all its economic transactions with the rest of the world. The aggregated overview of trends in balances of capital transactions carried out between Slovenia on one side and the group of four former Yugoslav countries on the other side in the period 1994-2000 is shown in Figure 4.

Figure 4: Slovenia’s assets and liabilities vis-à-vis other SEE countries, 1994 – 2000



Source: Internal data from the Bank of Slovenia

The Figure 4 suggests the following:

- *Continuous net outflow of Slovenian capital in the region in the second half of the 1990s;* As a net capital exporter to the countries of former Yugoslavia, Slovenia records net financial assets with this part of the world (*minus* in the Figure 4 is a sign of net assets) in practically all segments of the “regional” capital and financial account. Portfolio investments are the only exception as economic entities from the region purchase more securities on Ljubljana Stock Exchange than the other way round. This is primarily a result of the fact that financial markets in the countries of the former Yugoslavia, with notable exception of Croatia, are still rather poorly developed and therefore not attractive for foreign portfolio investors.

- *The increased dynamics of capital export to the countries in the region;* While at the end of 1995 Slovenian entities' net financial assets in the region amounted to less than \$100 million, the figure reached \$800 million by the end of 2000. In that year alone, the volume of Slovenian net financial assets in the region increased for some \$150 million.

Foreign direct investment; At the end-2000, total stock of Slovenian FDI into SEE countries amounted to some \$513 millions, which represent about 65% of total Slovenian stock of outward FDI (see Table 6). Due to proximity a majority (45%) of total outward FDI has been directed to Croatia, while 8% has been located both into BiH and Macedonia. Until the end of 2000 there have been 804 investment projects conducted by Slovenian firms in the SEE region. Only one half of them, however, has been directed into establishment of new or acquisitions of existing firms. Other half of Slovenian outward FDI projects is being directed into real estate, bankrupt local firms, etc. In contrast to this, a majority of outward FDI into non-SEE countries consists of establishments of new or acquisitions of existing firms. This fact reflects specific cautiousness of Slovenian firms regarding the type of investments in SEE region. This fact will become even more characteristic in next section, in which survey data of largest Slovenian companies will be analysed.

Table 6: Stock of Slovenian FDI in SEE countries, 1994 – 2000 (at the end of the year; in \$ million)*

	1994	1995	1996	1997	1998	1999	2000
Slovenia's FDI in the region	251,65	319,75	310,95	310,79	402,59	391,49	512,26
⇒ equity investment	189,46	204,47	186,32	171,86	215,71	209,46	269,82
⇒ claims	76,05	123,80	130,40	150,81	194,30	186,56	254,64
⇒ liabilities	13,86	8,52	5,77	11,88	7,42	4,52	12,19
Region's FDI in Slovenia	414,76	417,52	362,02	305,43	110,27	87,14	57,45
⇒ equity investment	252,17	256,10	229,87	199,61	87,64	68,42	47,72
⇒ claims	57,91	78,63	102,03	101,30	6,30	6,42	7,43
⇒ liabilities	220,50	240,06	234,18	207,12	28,93	25,14	17,17
Balance	163,11	97,77	51,08	-5,36	-292,31	-304,36	-454,81

* Sign (+) in the category »Balance« means that the volume of the region's FDI in Slovenia is larger than the volume of Slovenia's FDI in the region while sign (-) means the opposite.

Source: Internal data from the Bank of Slovenia

As revealed in Table 6, the balance of Slovenian FDI with countries in the region was positive (net FDI inflows to Slovenia) until 1996. Since then, Slovenian FDI outflows to SEE has been continuously exceeding FDI inflows made by investors from SEE countries in Slovenia. Substantial increase of Slovenian net FDI outflows to the region has been primarily a result of the reduced FDI stock of Croatia in Slovenia in 1998. This reduction was associated with the decision of the Slovenian government related to the ownership share of Croatia in the nuclear power plant Krško. In the following two years, rising net

FDI outflows to the region has been mainly the result of Slovenia's increasing investments in SEE countries.

When analysing data on the stock of Slovenian outward FDI in the region two additional points should be made. First, the stock of Slovenian FDI in the region is larger than the volume presented in Table 6. This figure namely does not comprise FDI made in the region by entities that are controlled by Slovenian interests but have headquarters outside Slovenia. Since these entities are not Slovenian residents, their transactions, in this case FDI, are not registered in Slovenia's balance of payments.

Second, as can be seen from Table 6, FDI includes two types of transactions: (i) equity capital, including reinvested earnings, and (ii) other claims and liabilities associated with equity investment. Within the structure of Slovenian FDI outflow stock in the region there is a high and quickly rising proportion of claims stock. Its volume more than tripled in the 1994 – 2000 period while the stock of equity outflows increased for less than 50% over the same period. As a consequence, the share of equity capital in the total stock of Slovenian FDI in the region was reduced to not more than half of total FDI stock at the end of 2000 (compared to 75% at the end of 1994). The share of equity in the total FDI stock in the region is significantly smaller (and consequently the share of claims higher) than this is the case for the total stock of Slovenian FDI abroad. Higher share of claims stock within the total volume of FDI outflow – this has not been the case with Slovenia's FDI into EU members and in Central Europe countries – can be explained with the fact that investment activity of Slovenian entities in SEE countries is more directed towards strengthening trade flows than towards establishing production units in the region.

Portfolio investment; According to the IMF balance of payments methodology, this type of economic transactions includes both, portfolio equity investment (shares) and portfolio debt investment (bonds). By and large, portfolio investments are rather unimportant type of economic transactions in balance of payments of all countries in the region. As far as bonds are concerned, Croatia is the only of the four countries that has issued eurobonds on the international financial market while the only fixed-income instruments issued abroad by BiH and Macedonia are bonds issued as part of their arrangements with the London club⁹. Taking into account that these bonds were received by commercial bank creditors of the former SFRY and taking into account that investors in eurobonds issued by Slovenia and Croatia are primarily from industrialised countries it is understandable that bonds practically do not figure in Slovenia's "regional" balance of payments.

As shown in figure 4, investment in shares are the only type of "regional" capital flows where Slovenia is a net importer of capital. It has to be underlined, however, that overall regional flows are determined exclusively with flows between Slovenia and Croatia. This is not surprising as these are the only two counties on the territory of the former Yugoslavia with capital markets that provide at least limited potential for foreigners to trade on their stock exchanges.

⁹ According to arrangements of Slovenia, Croatia, BiH and Macedonia with the London club, each of the four successor states to the former SFRY has exchanged a portion of ex-Yugoslav commercial bank for bonds.

Trade credits and bank loans; While FDI are the main form of equity flows between Slovenia and the region, trade credits and loans dominate on the debt side of the “regional” capital and financial account. As shown in the figure 4, Slovenia has become an important net creditor of SEE countries.

Tabela 7: Stock of trade credits and loans between Slovenia and SEE countries 1994 – 2000* (includes relationship among »non-connected« as well as among »connected« entities)

in \$ million	31.12.94	31.12.95	31.12.96	31.12.97	31.12.98	31.12.99	31.12.00
Net short-term trade credits	0,25	-118,76	-273,58	-327,58	-430,07	-446,26	-452,69
⇒ Croatia	2,09	-112,25	-202,83	-228,97	-290,94	-280,12	-262,76
⇒ BiH	-0,66	-1,42	-30,77	-46,93	-63,22	-84,42	-96,54
⇒ FRY	-0,25	0,97	-11,57	-20,08	-32,40	-30,39	-40,69
⇒ Macedonia	-0,93	-6,07	-28,41	-31,61	-43,51	-51,33	-52,71
Net short-term loans	-0,10	-1,22	-1,73	-5,95	-2,98	-10,61	-21,97
⇒ Croatia	-0,44	-1,22	-1,26	-2,99	-0,76	-3,22	-6,02
⇒ BiH	0,34	0,05	-0,47	0,04	-0,22	-0,17	-11,73
⇒ FRY	0,00	0,00	0,00	0,00	0,00	0,00	-0,05
⇒ Macedonia	0,00	-0,05	0,00	-3,00	-2,00	-7,22	-4,16
Net long-term trade credits	-16,51	-22,36	-31,55	-26,26	-31,85	-26,07	-26,16
⇒ Croatia	-6,18	-11,49	-21,45	-16,86	-18,05	-10,52	-9,00
⇒ BiH	-3,41	-3,54	-3,87	-3,37	-6,14	-8,97	-11,89
⇒ FRY	-4,95	-5,50	-4,99	-4,10	-4,51	-3,65	-3,17
⇒ Macedonia	-1,97	-1,83	-1,24	-1,94	-3,15	-2,93	-2,11
Net long-term loans	1,92	-4,73	-11,96	-12,51	-52,62	-65,98	-109,66
⇒ Croatia	1,08	-5,50	-12,52	-12,81	-41,88	-49,81	-82,54
⇒ BiH	0,17	0,19	0,17	0,11	-4,02	-7,54	-21,79
⇒ FRY	0,00	0,00	0,00	0,00	-0,15	-0,19	-0,14
⇒ Macedonia	0,68	0,58	0,38	0,18	-6,58	-8,44	-5,19

* Sign (-) means net claims of Slovenia vis-à-vis the region; sign (+) means net liabilities of Slovenia vis-à-vis the region.

Source: Internal data from the Bank of Slovenia

At the end of the year 2000, the total volume of net claims increased to as much as \$610 million¹⁰ (see Table 7) and was therefore more than twice the total stock of Slovenian outward FDI in the region. Growing volume of net claims vis-à-vis the region reflects

¹⁰ In this part of the sub-chapter 3.2., all trade credits and bank loans are included. This means that figures include also all debt financing that takes place among so-called “connected persons”, such as credits given by entities in Slovenia to their subsidiaries in countries of the region. If only trade credits and bank loans between “non-connected persons” are included, the volume was \$ 378 million at the end of 2000.

clearly the volume and the dynamics of the surplus Slovenia has in its trade with the SEE region. Although a portion of Slovenia's exports to the region is being paid on a cash basis (this is particularly the case for trade with partners in countries with high country risk), a large majority of goods is being exported through traditional forms of trade financing and therefore with at least some delay in payments.

Based on data from the Table 7, the following patterns of trade financing between Slovenia and the SEE region can be identified:

- *concentration of net claims on Croatia*; The volume of net claims is strongly concentrated on Croatia. This is a result of two factors, first, large share of the trade with Croatia in the overall trade flows between Slovenia and the region, and second, relatively good creditworthiness of Croatia creates conditions required for trade financing.
- *concentration of net claims on short-term financing*; In the term structure of net claims, there is a strong dominance of short-term transactions while medium-term financing is strongly concentrated on Croatia as the least risky country in the region. Over the last two years, small volumes of medium-term financing have been approved also to BiH and Macedonia.
- *trade credits dominate short-term financing*; Within the structure of short-term financing there, there is a strong concentration on trade credits. This clearly indicates that companies themselves take a large majority of all payment risks associated with their export to the region. Banks continue to be rather conservative in financing Slovenian exports to rest of former Yugoslavia and this can at least partly be explained with high reservations they are required to create for their exposure in the region.
- *bank loans dominate medium-term financing*; As far as medium-term transactions are concerned, they are strongly concentrated on bank loans. Fragmental data indicate that a large majority of these loans is associated with equity investments made by Slovenian entities in the region.

IV. Firms' strategies for penetrating SEE markets

Following usual international business literature there are two basic approaches for a firm to penetrate exports markets. Firm can either choose regular export mode or an investment (FDI) mode of market entry. Decision for one of the two depends on many factors such as entry costs (tariffs, distance and transportation costs, etc.), technology (in case of important internal and external scale economies relative to entry costs it does not pay off to divide production among many locations) comparative advantage reasons (differences costs of labour and resource abundance between home and foreign country), country risk, etc.

Major advantage of export mode of foreign market penetration over the investment mode is in lower funds needed to start selling in foreign markets. Major disadvantages of export mode, however, are lower efficiency in case of high entry costs, low financial discipline in exports markets, etc. The advantages of investment mode over the export mode are in possibility of avoiding high entry costs, possibility to make use of cheaper local labour and materials, in the possibility of influencing local authorities and getting subsidies, tax exemptions, etc. for starting operations, etc. Major drawbacks of investment mode lie in large funds required for setting up local production, distribution networks, etc. and in a potentially higher risk of operations in foreign markets. In subsequent section we shall analyse above entry modes of Slovenian firms when penetrating SEE markets.

In this sub-chapter we analyse data obtained through surveys of largest Slovenian companies. Special questionnaires on firms' operations in SEE markets were sent out to 410 privatised manufacturing as well as non-manufacturing firms. In return, 115 completed questionnaires were collected. Firms' responds give a picture of prevalent modes of entry into SEE markets, estimates of entry costs, main reasons for each of the two entry modes, characteristics of individual SEE markets as well as of firms' present and planned investment activities in SEE region in the future.

4.1. Entry costs and modes of entry into SEE markets

Following Dunning (1993), motives for outward FDI by parent firms can be classified into market-seeking, efficiency-seeking and resources-seeking. Trade-barriers-jumping motives for FDI are a clear case of market-seeking FDI. However, due to lower labour costs and possible relative resource abundance in developing countries efficiency-seeking and resource-seeking motives may often prevail over market-seeking motives. In international trade theory and theory of multinational firm trade barriers (e.g. tariffs and transport costs) were given a crucial role in firms' considerations of internalisation of their operations through FDI. Evidence show that in early 1960s US multinational companies (MNCs) started to penetrate European markets via FDI more extensively in order to avoid transport costs as well as new trade barriers set up by recently established European Economic Community (see WIR 1998). In order to study substitutability-complementarity relation between international trade and capital mobility, Brainard (1993) provides a formal proximity-concentration model of international trade, which points out to trade-off between proximity to consumers and loss of economies of scale due to division of production into many smaller locations. Using firm level trade data for US MNCs, Brainard shows that US outward FDI substitute for US exports.

In case of SEE markets the (perception of) different kinds of entry costs may play a crucial role in determination of firm's penetration strategy. In case of high entry costs relative to other factors (such as stability of local business environment, scale of operations, etc.) firms are more likely to penetrate these markets through FDI. In case of low relative entry costs firms will keep penetrating the markets through exports. In our survey, firms were asked to assess the level of entry costs into individual SEE countries as well as the degree of stability of local economic and political environment.

**Table 8: Estimates of entry costs and of stability of local business environment
(1 - low, 5 - very high)**

Entry costs	EU	Croatia	BiH	FRY	Macedonia
Transport costs	3.0	2.3	2.8	3.5	3.8
Tariffs	1.8	2.7	2.7	3.4	2.9
Entry into local store chains	3.4	2.7	2.6	2.8	2.6
Technical and health standards	3.4	2.1	1.9	2.0	1.9
Non-tariff trade barriers)	1.9	2.0	1.8	2.3	2.0
Informal administrative barriers	1.4	1.9	1.8	2.5	2.0
Stability of business environment	4.4	3.1	2.4	1.5	1.7

Source: RCEF & ISEE Survey; author's calculations.

According to Table 8, major entry barriers Slovenian firms are faced with in Croatia and BiH are high tariffs and hindered entry into local store chains followed by transport costs. Due to larger distance for FRY and Macedonia firms claim transport costs to be the major trade barrier, followed by high tariffs and hindered entry into local store chains. However, what is important is the magnitude of estimated entry barriers. In Croatia and BiH entry barriers are modest (not exceeding score 2.8 with 5 the maximum value) while in FRY and Macedonia the barriers are higher by order one. For comparison, in EU markets technical & health standards and hindered entry into local store chains are estimated to be higher than in SEE markets. Tariff barriers in EU are estimated much lower than in SEE markets while transport costs are assessed to be higher than in Croatia and BiH but lower than in FRY and Macedonia. Based upon these estimates one can hardly make suggestions upon modes of entry into SEE markets. In order to do so one should refer to estimates of stability of local business environments. Business environment in Croatia has been estimated by firms to be modest, in BiH as unstable, while in FRY and Macedonia it has been estimated as extremely unstable. Adding it up, estimates of trade barriers relative to stability of local business environments would not suggest much of FDI as a way of penetrating SEE markets. In Croatia (and partly in Bosnia) with modest stability the trade barriers are also modest, which may or may not encourage much of FDI. Here, industry-by-industry and case-by-case considerations are important. In contrast, in FRY and Macedonia higher probability of FDI encouraged by higher trade barriers is then offset by extremely unstable economic and political climate. Very little FDI into these countries might be the outcome.

Above considerations find support in the data. Table 9 compares prevalent modes of entry of Slovenian firms into individual SEE markets by 2000. In general, Slovenian firms prefer conventional export to FDI mode of entry into all of SEE countries. As expected, there is some FDI promoted sales taking place in Croatia. On average about one third of total firms' sales to this market can be accounted to local affiliates of Slovenian firms. In BiH and Macedonia, 85% of total firms' sales in these markets have been achieved through regular exports, while in FRY share of exports in total firms' sales to this country reaches 95%. A breakdown of firms' responds by sectors reveals almost unaltered picture. Only in Croatia, in some sectors (e.g. foods, chemicals, metal and non-

ferrous products) firms' market penetration through local affiliates exceeds 50% of total sales.

Table 9: Modes of entry - share of firms' sales to SEE markets through regular exports and through sales by local affiliates in 2000 (in %)

Mode of entry	Croatia	BiH	Macedonia	FRY
Exports	66.1	83.2	84.6	95.5
Sales through local affiliates	33.9	16.8	15.4	4.5

Source: RCEF & ISEE Survey; author's calculations.

4.2. Reasons for choosing trade entry mode into SEE markets

In this subsection reasons for preferred trade entry mode into SEE markets are further explored. Firms exporting to Croatia claim good business co-operation and lower investments required than in case of FDI to be major reasons for preferring exports mode. In BiH, FRY and Macedonia, firms stress low investment needed and low scale of current operations. In FRY poor local legislation is also very pronounced. Trade and transaction costs seem to play very little role.

Table 10: Major reasons for export entry mode in 2000 (1 - unimportant; 5 – very important)

Reasons	EU	Croatia	BiH	FRY	Macedonia
Good business cooperation	3.9	4.1	3.4	3.2	3.0
Lower investments required than in case of	3.8	3.8	3.7	3.6	3.6
Low scale of sales	3.3	3.3	3.4	3.4	3.4
Specific products	3.4	3.2	3.3	3.3	2.8
Good financial discipline	4.1	2.9	2.7	2.7	2.7
Low trade and transaction costs	2.9	2.9	2.6	2.6	2.4
Poor local legislation	1.8	2.7	3.1	3.4	2.9

Source: RCEF & ISEE Survey; author's calculations.

4.3. Reasons for choosing investment entry mode into SEE markets

As argued above, despite trade barriers FDI into SEE countries might well be driven by lower labour costs and possible relative resource abundance. However, none of the above key theoretical reasons for FDI seem to be very important for Slovenian firms conducting businesses with SEE countries. Slovenian firms, on the contrary, stress the importance of investment mode of penetration into these markets in order to secure payments in the first place. Bad financial discipline of local customers is being estimated as major reasons for choosing investment mode. Large scale of sales and access to adjacent local markets also stimulate Slovenian investments into region. High entry costs and low costs of labour and materials in SEE countries are important investment motives relative to EU figures, however, much less important when compared to above motivation.

Table 11: Major reasons for investment entry mode in 2000 (1 - unimportant; 5 - very important)

Reasons	EU	Croatia	BiH	FRY	Macedonia
Bad financial discipline	1.3	3.8	3.7	3.7	3.4
Large scale of sales	3.8	3.8	3.5	3.2	3.2
Access to adjacent local markets	3.7	3.6	3.5	3.7	3.3
Low costs of labour and materials	2.3	3.2	3.6	3.5	3.3
Specific products	2.9	2.8	2.7	2.6	2.6
High entry costs	1.8	2.7	3.1	3.1	2.7

Source: RCEF & ISEE Survey; author's calculations.

Breakdown by sectors reveals some slight differences to above general picture. Firms in textiles, chemicals and rubber&tyres sectors claim high entry cost as major reason for choosing investment mode of entry. On the other side, firms in textiles, wood, rubber&tyres and electric appliances sectors stress importance of low costs of local labour and materials. These reasons may become important after SEE countries will get stabilised in terms of stable political systems and basic macroeconomic stabilisation.

As terms of business with SEE countries in still very specific Slovenian firms try to make use of their past experience with the region in order to achieve some first-mover-advantages over western firms which are still very cautious in this respect. Doing business with most of the firms in the region is very risky as there are no firm guarantees that export shipments will in fact be paid. Firms in our survey claim that key mode of payments in this region is cash, followed by completely insecure payments to open account and barter deals. Documentary credit or letter of credit as one of the most secure modes of payments in international trade is almost unsuitable for this region as local banks are either untrustworthy or they have no relations to Slovenian and western banks. Hence, in the short run Slovenian firms make use of investments into SEE region predominantly to secure payments for their shipments. So far, Slovenian firms invested mainly into representative offices and own stores with their major task to promote trade, i.e. imports of goods produced in Slovenian parent firms. Only 20% of Slovenian firms that have invested into the region have established local production facilities.

IV. Trade-promoting or efficiency seeking-investments?

Major conclusion that can be drawn upon analysis in previous section is that, so far, trade-promoting motivation of present Slovenian FDI in the SEE region clearly dominates the efficiency-seeking motivation. In this section this finding is further explored by analysing intra-firm trade flows and investment plans of Slovenian firms.

5.1. Intra-firm trade

Theory of multinational firm suggest that FDI should result in increased intra-firm trade between parent firm and affiliates (Ethier 1986, Markusen 1995, Markusen and Venables

1995). This might be the outcome both in the case of horizontal as well as vertical organisation of MNC. In case of vertical organisation affiliates serve as suppliers of intermediate goods of parent company. In case of horizontal organisation affiliates and parent firm specialise in production of horizontally differentiated intermediate goods, such as different parts of a final good (Damijan 1999). Intermediate goods are then exchanged among all affiliates and final goods are then simply assembled from intermediates. Globalised automotive industry may be thought of as a case where this particular mode of investment and trade takes place.

We discussed earlier our anticipations that Slovenian firms investing into SEE region might be aimed at creation of new or restoration of former supply-chain organisation resulting in a kind of trade reintegration. Due to a huge technology gap between Slovenian firms and local firms in SEE region one can expect only vertical organisation of production within a MNC to take place. Hence, according to the theory a majority of intra-firm trade flows should be directed from affiliates towards parent company and not vice versa. The evidence, however, does not support these anticipations, as sales of parent firms to affiliates are on average three times higher than sales in the opposite directions (see Table 12).

Table 12: Volume of intra-firm trade among Slovenian parent firms and their affiliates in SEE countries in 2000 (in % of total sales of parent firms)

	Sales of parent firms to affiliates	Sales of affiliates to parent firms
Croatia	10.8	1.9
BiH	2.3	0.1
FRY	0.0	0.0
Macedonia	5.2	4.6
Total SEE	18.3	6.6
EU	6.5	0.9

Source: RCEF & ISEE Survey; author's calculations.

Only in case of Macedonia, shipments in both directions are balanced indicating that Macedonian affiliates (especially in food and tobacco sector) serve as a resource base for Slovenian parent firms. On average, Slovenian parent firms perform some 18% of their total sales in SEE countries via shipments to their affiliates in SEE region. However, these shipments are mainly consisting of final goods intended for sales, where function of local affiliates (mainly trade representative offices and stores) in individual countries is limited to whole-sale or retail-sale activities only. The evidence, hence, is again rejecting the anticipation of efficiency seeking motivation of Slovenian firms in SEE markets.

5.2. Firm characteristics and investment behaviour of Slovenian firms in SEE markets

In this subsection, present and planned investment behaviour of Slovenian firms in SEE region is analysed. We make use of data on time varying investment activity of largest Slovenian companies drawn from survey and combine these data with firms' income

statements and balance sheets. In doing so, we believe to obtain more insights into potential time varying changes in investment preferences of Slovenian firms. Simple probit model is used to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004.

In our questionnaires firms were asked to indicate their past and planned investment activities in SEE. Firms' responds suggest that largest Slovenian firms captured in our survey have performed very few FDI projects in SEE region before 2001. Before 1990, out of 115 surveyed firms there were only 27 FDI projects in SEE region, 80% of them being directed into manufacturing sector. Between 1990 and 2000 42 FDI projects in SEE among our sample of firms is recorded, 70% of them in manufacturing sector. Short run (until the end of 2001) and long run (until 2004) investment plans reveal significant differences. In short run only 16% of surveyed firms plan an investment into SEE region, while in the long run 42% of firms indicate serious intention to perform FDI in SEE region. In long run, the highest investment propensity to SEE is recorded amongst manufacturing firms, i.e. 50% of manufacturing firms in our sample confirm to perform FDI in SEE. Manufacturing firms state to spend about 3% and 8% of their annual total income for their short run and long run investment activities in SEE region. There are significant differences among manufacturing and commercial firms in respect of attractiveness of investment location. Commercial firms, both in short and long run prefer investment to Croatia, while manufacturing firms in both periods prefer FRY. One can ascertain that commercial firms are looking for higher purchasing power of Croatian market, while for manufacturing firms efficiency-seeking motives for FDI in FRY may prevail.

Table 13: Location preferences of Slovenian manufacturing and commercial firms for their investment plans in SEE countries until 2004 (in % of firms)

	Short run (2001)		Long run (2002-2004)	
	Manufacturing	Commercial	Manufacturing	Commercial
Croatia	50	80	39	100
BiH	50	20	45	43
FRY	60	60	77	57
Macedonia	0	40	0	29
N	10	5	31	7

Source: RCEF & ISEE Survey; author's calculations.

In order to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004 we employ simple probit model. The dependent variable in our model (FDI_t) is existence of FDI by a firm. Dependent variable has the value 1 ($FDI_t=1$) if in observed period a firm has had or plan to have a FDI in one of the SEE countries, otherwise ($FDI_t=0$). Dependent variable is regressed on a set of firms' characteristics, such as size, factor intensity, labour and capital productivity, export propensity, R&R intensity and sector dummies. The model is estimated for three different time periods: (1) period before 2000, (2) period 2001 and (3) period 2002-2004. For

period before 2000 set of firm characteristics for year 1996¹¹ has been used, while periods 2001 and 2002-2004 are estimated with firm level data for year 2000.

Table 14: Probability of firms' investments into SEE region in 1990-2004 (Results of probit model)

	Before 2000	Year 2001	2002-2004	2002-2004
	1	2	3	4
FDI₂₀₀₀				***1.125
				(3.07)
Size	**0.012	*0.011	0.000	-0.003
(Sales)	(2.45)	(1.91)	(0.08)	(-0.74)
Capital intensity	0.000	0.000	0.000	0.000
(Assets/employee)	(1.39)	(0.98)	(0.51)	(0.13)
Skill intensity	0.000	0.000	0.000	0.000
(Labour costs/employee)	(-0.37)	(-0.60)	(-1.00)	(-0.85)
Labour intensity	0.010	0.004	*0.038	**0.045
(Labour costs/	(0.61)	(0.18)	(1.88)	(2.11)
Labour productivity	0.000	0.000	*0.000	**0.000
(Sales/employee)	(0.98)	(0.78)	(1.70)	(2.09)
Capital productivity1	-0.0003	0.0001	0.0000	0.0000
(Profits/employee)	(-1.24)	(0.33)	(0.08)	(0.05)
Capital productivity2	0.022	-0.003	-0.006	-0.007
(Profits/assets)	(1.21)	(-0.42)	(-1.18)	(-1.32)
Export propensity	0.013	*0.020	0.000	-0.003
(Exports/sales)	** (2.00)	(1.88)	(0.07)	(-0.54)
R&R intensity	-0.991	-5.328	16.870	*15.735
(Intangible assets/sales)	(-0.10)	(-0.39)	(1.82)	(1.68)
dummy Food sector¹	**1.328	0.300	0.251	-0.338
	(2.26)	(0.29)	(0.45)	(-0.58)
dummy Commercial¹	0.248	1.361	-0.458	-0.553
	(0.39)	(1.60)	(-0.87)	(-1.06)
dummy Other services¹	-0.117	-0.249	** -1.178	** -1.150
	(-0.21)	(-0.33)	(-2.18)	(-2.12)
Constant	*** -2.943	** -3.237	** -1.698	** -2.019
	(-2.87)	(-2.43)	(-1.98)	(-2.41)
N	111	111	111	111
Pseudo R2	0.203	0.296	0.165	0.210

Notes: t-statistics in parentheses; *, ** and *** denote significance at 10, 5 and 1 per cent.

¹ Reference group is non-food producing manufacturing firms.

Before switching to results an important methodological issue should be addressed. As our sample of firms is intentionally biased toward largest Slovenian firms the results do not necessarily reflect actual pattern of behaviour of all Slovenian firms. More pronounced investment preferences to investment activity in SEE region by largest Slovenian firms may not be shared by a majority of smaller firms. In other words, a biased sample of firms may give biased estimations of coefficients. In order to control for this sample-selection bias we have used two-stage Heckman procedure (Heckman 1979), which enables us to control for these unobserved effects¹².

¹¹ Note that using firm level data sets for different years (data is available for 1994-2000) does not alter the results significantly.

¹² See more about the use of Heckman procedure in case of TFP growth and export performance of domestic and foreign firms in transition countries in Damijan et al (2001a, 2001b).

Results of probit estimations in Table 14 confirm our findings from previous sections. Common characteristics of firms investing to SEE markets before 2000 are large size, high export propensity or that they operated in food sector. Similar characteristics were found also for short run investment plans of firms in 2001. The only exception being that food producing firms have tempered their eagerness to invest into SEE region. These findings confirm that past investments and short run investment plans of Slovenian firms into exhibit mainly trade-promoting motives, i.e. large firms attempted to increase utilisation of their capacities by exporting to SEE markets. This is especially true for firms in food sector, which have found themselves competitive in SEE markets only.

Probit results for long run investment plans of Slovenian firms, however, reveal some change in investment preferences by firms. It seems that trade-promoting motive for FDI in SEE has been substituted by more distinctive efficiency-seeking motive. In the future, firms with higher labour intensity, higher labour productivity and higher R&R intensity seem to tend to relocate part of their production to SEE region in order to combine their firm-specific intangible assets with lower local labour costs.

The last model (column 4) includes a variable on existence of firms' past FDI in the region in order to capture the effects of past experience with investing into the region. Past experience with investments in SEE region may significantly affect future investment plans. Results point towards positive past experience since firms which have already had a FDI in one of the SEE countries tend to extend their investments in the future also to other countries in the region.

VI. Conclusions

As stated in the Introduction, the paper has two main objectives. The first one is to provide a macro-economic framework for analysing economic cooperation between Slovenia and SEE countries. This cooperation will be, on the one hand, influenced by general macro-economic conditions and political developments in the region, and on the other hand, by specific patterns in bilateral relationship between Slovenia and SEE countries.

Low purchasing power and high country risk will continue to influence strongly overall economic cooperation of the region with the rest of the world. While at present countries of the region are able to finance relatively large balance of payments, expressed as a percentage of GDP, either by large inflows of foreign assistance (BiH, Kosovo, Montenegro) or by privatisation-based FDI and debt-financing (Croatia), these funding sources do not seem sustainable on a long-run. As these countries have no or very limited access to international financial markets, notable exception is Croatia, they have no alternative but to significantly increase exports if they want to keep the imports on the existing or even higher levels. Only through development-oriented structural adjustment countries of the region will be able to create an environment conducive to stable economic growth that will be accompanied by sustainable current account deficits. If for

whatever reason this will not happen, countries of the region may enter into a vicious circle of low economic growth and balance of payment problems.

Slovenia's "regional" balance of payments with SEE region is in at least two respects completely different from the country's overall balance of payments. First, in contrast to overall current account deficit of the country – equivalent to between 3 to 4% of GDP in 1999 and 2000 – Slovenia registered a strong surplus – equivalent to 4% of GDP in 2000 – in its "regional" current account transactions. This surplus constitutes quite important proportion of overall current account deficits of some countries in the region. In the year 2000, for example, Slovenia's share in overall current account deficits of BiH and Macedonia amounted to 37% and 33% while in the case of Croatia this share was smaller – 22%¹³. These figures clearly indicate that Slovenia will, similarly as has already happened in its economic relations with Macedonia, sooner or later be faced with requests of these countries for a more balanced trade flows. Second, similarly as all transition economies, Slovenia is a net importer of capital from the rest of the world. In its relations with the SEE region, however, the country has become a prominent net capital exporter. This can be confirmed with the figures summarising net assets / liabilities position of the country. While at the end of 2000, overall liabilities of Slovenian entities *vis-a-vis* non-residents were \$2.3 billion larger than their assets abroad, in relations with the countries of the former Yugoslavia the investment position is completely different. In this part of the world, Slovenia's assets overpassed its liabilities for over \$800 million at the end of 2000.

As far as the second objective of the paper – to analyse current investment activity of Slovenian firms in the region in order to reveal the motivation of Slovenian firms investing in SEE – is concerned, we have tried to find out whether the pattern of trade and investment of Slovenian firms in the region tends to promote Slovenian exports to the region or whether it tends to create or restore former "multinational type" of vertical supply chain organisation. In other words, the paper attempts to uncover trade-promoting versus efficiency-seeking motives for Slovenian present increased investment activity in the region.

Anticipation of efficiency-seeking motivation of Slovenian FDI in SEE markets in the past decade, however, has been clearly rejected by the data. Trade-promoting motivation of present Slovenian FDI in the SEE region has been found to be clearly dominating over the efficiency-seeking motivation. Slovenian firms might be predominantly aimed at increasing sales to the region from their Slovenian headquarters rather than at setting up local production facilities due to comparative advantage reasons (lower costs of local labour). In the past Slovenian firms made use of investments into SEE region predominantly to secure payments for their shipments from Slovenian headquarters. So far, Slovenian firms invested mainly into representative offices and own stores with their major task to promote trade, i.e. to increase imports of goods produced in Slovenian parent firms. Only 20% of Slovenian firms that have invested into the region in the past

¹³ Calculation have been made on the basis of the following data sources: (i) current account deficits of CEE countries from *the Transition Report Update 200*, and (ii) Slovenia's "regional" current account from sub-chapter 3.1..

have established local production facilities. Major reasons for this lie in a still very unstable political and economic environment of the SEE region, in low financial discipline of local customers as well as in still under-utilised resources of Slovenian parent firms.

In addition, the paper studies the evolution of investment motivation of Slovenian firms in SEE region over the period 1990-2004. Past and planned investment behaviour of Slovenian firms vis-à-vis SEE region combined with firms' operational characteristics is studied using a simple probit model. Indeed, evidence shows a change in firms' long run investment motivation to the region relative to their past motivation. Efficiency-seeking motive has become more pronounced. In the future, firms with higher labour intensity, higher labour productivity and higher R&R intensity seem to tend to relocate part of their production to SEE region in order to combine their firm-specific intangible assets with lower local labour costs. Results also point out positive past experience with investments into SEE region since firms which have already had a FDI in one of the SEE countries tend to extend their investments in the future also to other countries in the region.

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