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UDK 339.727.22 (497.5)
JEL Classification F21, P33
Prethodno priopćenje

THE IMPACT OF FOREIGN INVESTMENT FLOWS ON CROATIAN ECONOMY - A COMPARATIVE ANALYSIS

The aim of this paper is to analyze and compare foreign investment trends in the countries of the last wave of accession to the European Union. The analysis is made on the basis of foreign direct investment and foreign debt flows in those countries for the period 1989-2006. The comparative analyses of both flows suggest that there was a wide difference in efficiency of those flows, which is partly explained by the character of foreign direct investment (Greenfield versus equity investments). The main conclusion of the paper is that regardless of the volume of inflows, the national investment policy might have considerable impact on the real growth of the economy.

Keywords: foreign direct investment trends, transition, foreign debt, investment policies

1. Introduction

The aim of this paper is to analyze the progress in the transition of Croatia comparatively with other transition countries, the recent members of the EU, and the effects of foreign direct investment (FDI) inflows on the economy. The first section presents the transition process in Croatia. The second section deals with

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The paper was presented on the 7th Global Conference on Business and Economics, Oct 13-14, 2007 in Rome, Italy, organized by the International Journal of Business and Economics and the Association for Business and Economics Research. For the purpose of publishing in *Ekonomski pregled*, the paper was peer-reviewed

the progress in transition achieved in the new EU member states of Central and Eastern Europe after the democratic changes in those countries. The third section analyses the FDI flows in new EU countries, the fourth section deals with external debt in transitional countries, while section five is focused on motivational factors and general investment climate as one of the very important factors in the country and region.

2. Transition Process in Croatia - Main economic trends

EU accession negotiations with Croatia began on October 3rd, 2005 and are continuing. The first phase of the accession process, the analytical examination of the *acquis* was completed in October 2006. Implementation of the Stabilisation and Association Agreement has largely continued without major difficulty. The country should be able to cope with competitive pressures and market forces within the Union in the medium term, provided that it strongly implements its reform programme to remove the remaining weaknesses. Inflation is low, the exchange rate stable, fiscal consolidation has continued and growth has accelerated. Private investment has risen, the banking sector has continued to grow and unemployment has declined.

The real GDP growth in Croatia reached an estimated 4,3 per cent in 2005. However, due to heavy losses in GDP in the period from 1989 to 1993, the level of GDP per capita in the year 2005 reached the level from 1989. The Croatian economy grew at an average rate of 6,4 per cent annually from 1994 - 1997. In 1998 GDP growth amounted to only 2,5 per cent, while a negative growth rate of -1 per cent occurred in 1999. After the year 2000, GDP growth rate was 4,4 per cent a year. An overview of the situation is presented in Table 1.

The economy has recovered in the past three years. The economy is estimated to have real GDP growth of 4,8 per cent in 2006 and forecasted growth of 5,5 per cent for 2007. The improvement was driven primarily by a strong increase in investment activity and consumption. It is expected that the most propulsive branches of the economy will be industry and construction. However service sector will mostly contribute to total economic growth. Croatia, with such dynamic growth, is narrowing the gap between the levels of GDP per capita with EU. It is, of course, still wide, but the tendencies are to bridge this gap in two decades. The growth rate in the period 1994 - 2006 was obtained with low and declining inflation rate. Croatia has a high level of price stability, and relatively low inflation (2 per cent in 2006) despite pressures on the supply side (record oil prices, higher excises on tobacco and cars and growth of administratively regulated prices of gas and water).

Table 1.

THE MAIN ECONOMIC INDICATORS OF THE CROATIAN ECONOMY

	1999	2000	2001	2002	2003	2004	2005	2006
GDP (EUR billion.) current prices	18,7	20,0	22,2	24,5	26,2	28,6	31,2	34,2
Real GDP growth rate (in per cent)	-0,9	2,9	4,4	5,6	5,3	4,3	4,3	4,8
GDP per capita current prices (EUR)	4.100	4.560	4.997	5.507	5.905	6.461	7.038	7.706
Current account balance (as per cent of GDP)	-7,0	-2,4	-3,7	-8,6	-7,1	-4,9	-6,3	-7,7
Retail prices (% change , real)	4,2	14,4	9,5	12,6	3,7	2,6	2,8	2,1
Producer prices, per cent (end of period)	2,6	11,2	-3,1	2,3	1,0	4,8	2,7	1,9
Consumer prices, , per cent (end of period)	3,5	5,5	2,4	1,8	1,7	2,7	3,6	2,0
Unemployment rate (registered in percent)	20,8	22,6	23,1	21,5	19,1	18,5	18,0	17,0
Unemployment rate (ILO)	13,6	16,1	15,8	14,8	14,3	13,8	12,7	11,8
Consolidated general government balance (in per cent of GDP)	-7,1	-7,5	-6,8	-4,9	-6,2	-4,8	-4,0	-3,0
Public debt (as percent of GDP)	-	48,2	49,4	48,6	48,6	48,9	49,2	46,6
Export of goods and services (billion EUR)	7,5	9,3	10,8	11,1	13,1	14,2	15,3	16,9
Import of goods and services (billion EUR)	9,3	10,6	12,1	13,8	15,2	16,2	17,5	19,6
Balance (EUR billion)	-1,7	-1,3	-1,3	-2,7	-2,1	-2,0	-2,2	-2,7
Foreign direct investment, EUR millions	1.369	1.139	1.502	1.197	1.785	990	1.425	2.838
External debt (EUR million)	10.101	12.109	13.458	15.055	19.811	22.781	25.541	29.032
External debt, as percentage of GDP	54,1	60,6	60,7	61,5	75,5	79,4	82,4	84,8
Exchange rate, HRK: 1EUR (end of period)	7,5818	7,6339	7,4710	7,4070	7,5642	7,4957	7,4000	7,3228

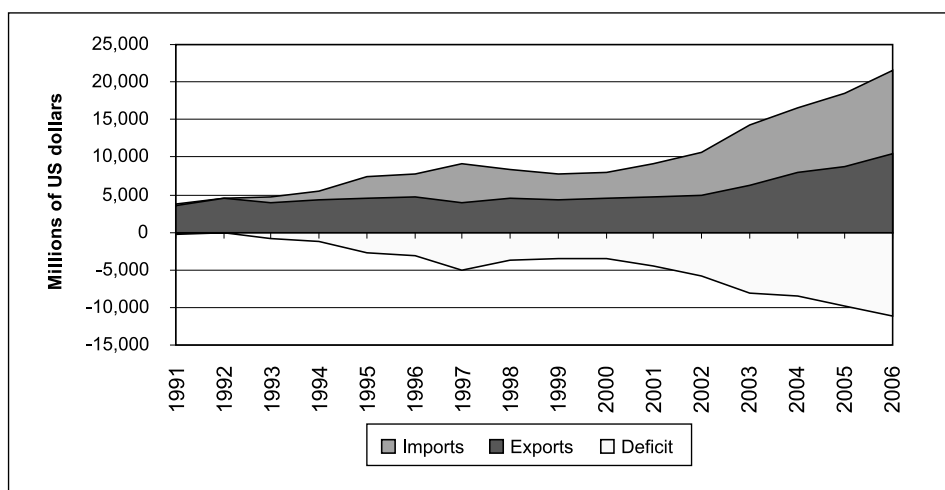
Source: Croatian National Bank; and RB Analize, No.25/04, 2007.

In foreign trade, there was an exceptionally high increase in imports of goods, whereas exports have remained stagnant. The export segment of the economy determines only about one fifth of the aggregate demand for domestic products and services. The coverage of imports by exports was below 50 per cent in 2004-05.

The data from balance of payment shows that Croatia had a permanent deficit in trade. The trade deficit has continuously grown since 1994 and reached a high level in 1997 (\$5.4 billion) and after that it has been shrinking for a short period of time. It continued to be a burden with slow decrease, but primarily at the expense of low imports (see figure 1). In 1993 the deficit in foreign trade was below USD 1 billion; after the year 2001 the trade deficit is growing from USD 4,1 to 10,5 billion in 2006. Exports of goods stagnated around USD 4,5 billion during the period 1994 to 2002. After that period improvement with the rising tendency is visible – exports grew from USD 6,2 billion in 2003 to 10,4 billion in 2006, with imports growing to almost USD 22 billion in 2006 (preliminary data of the CNB). A part of this trade deficit was covered by a surplus in services: the main credit receiver is tourism (travel). The foreign currency inflows from the export of services in tourism amounted to USD 2.5 billion in 1999 (two thirds of the total receipts from services) and reached USD 7,9 billion in 2006.

Figure 1.

THE VISIBLE TRADE OF CROATIA, 1993- 2006
 (MILLION US DOLLARS).



Source: CNB statistics

There is also a link between remittances and trade deficit. Namely, the remittances have impact on large trade deficit while mainly finance the consumption of imports. Remittances are relatively stable source of inflows and are mainly used to finance private consumption of poorer families.

The current account deficit has also grown significantly until 1997 when it reached 2.5 billion dollars (Stipetić, V., Jovančević, R., 1996). After 1997 and a short tendency towards its decrease the deficit related to GDP decreased from 7,0 per cent in 1999 to 3,7 per cent in 2001 and it is estimated to be 7,7 per cent of GDP in 2006. That current account deficit of balance of payment in 2006 could - to a great extent - be covered with FDI, as a result of significant inflows at the end of the year after pharmaceutical company Pliva takeover, and continuation of privatising the oil company INA. Significant and rising imbalances in the trade and current accounts and a rising external debt constitute potential risks to macro-economic stability.

3. Croatian FDI inflows

Beginning with 1997, Croatian FDI inflows reached EUR 13,5 billion in 2006. Equity investments are the most substantial component accounting more than two third of total investments. In 2003 and 2004 there is considerable capital withdrawals related to changes in ownership. Those transactions entered the country in the form of loans and later used to buy equity capital in another domestic firm. Reinvested earnings account for only around 20 per cent of total FDI and demonstrated constantly growing trend from 2004. Partly it is a result of higher profits earned by enterprises. Other capital, including debt transaction between affiliated companies contributes with 20 per cent of total FDI. It included mainly loans in the form of debt in the banking sector and trade credits in wholesale and retail sector. Most FDI in Croatia was directed towards existing companies, as a mode of the privatisation process. However, in the last two years there is a tendency towards new production facilities (Jovančević, 2001). Table 2 presents the FDI inflows in Croatia between the periods 1997 to 2006. by sources of investments.

Table 2.

FOREIGN DIRECT INVESTMENT IN CROATIA, 1997-2006
 (IN MILLION EUR)

	Equity investments		Reinvesting earnings	Other capital		Total
	Claims	Liabilities		Claims	Liabilities	
1997	0.0	322.1	35.9	-7.1	125.6	476.6
1998	0.0	575.5	63.9	-12.8	216.3	842.8
1999	0.0	1,208.3	44.6	-0.6	116.9	1,369.2
2000	0.0	748.3	87.3	0.0	302.9	1,138.5
2001	0.0	899.4	188.4	0.1	414.5	1,502.5
2002	0.0	712.1	161.8	-0.3	323.3	1,196.9
2003	0.0	756.2	588.9	-1.5	440.9	1,784.5
2004	-2.8	316.4	291.4	-17.4	402.7	990.3
2005	0.0	793.0	570.5	1.5	59.9	1,424.9
2006	-0.1	1,785.0	701.7	16.4	334.5	2,837.5
Total	-2.9	8,116.3	2,734.4	-21.7	2,737.5	13,563.7

Source: Croatian National Bank Statistics

The sources of FDI in Croatia between 1993 and 2006 is analysed by countries in table 3. Most of the FDI inflows to Croatia came from the developed countries - around 90 per cent. European Union (15) participated with 73,2 per cent and 2004 new member countries participated with 11,8 per cent in the period from 1993 to 2006 (CNB). The largest sources of FDI in Croatia between 1993 and 2006 were Austria, Netherlands, Germany, France, Italy, Luxemburg, Hungary, Slovenia, Switzerland and UK. However, USA inflow of FDI in Croatia was negative in this period since Croatian firm Pliva invested in USA, but that resulted in losses. The three leading countries, from which FDI inflows have originated during the 1999 to 2003 period, were Austria (28,4 per cent), Germany (22,8 per cent) and the USA (14,7 per cent). In the 2004 to 2006 period the first rank has Netherlands (42 per cent), followed by France (around 20 per cent) and Italy with 10 per cent.

Table 3.

**FDI IN CROATIA 1993. – 2006- COUNTRIES OF ORIGIN
(IN MILLION EUR AND IN PER CENT)**

	1993-2003			2004 - 2006			1993-2006		
	Total	In %	Rank	Total	In %	Rank	Total	In %	Rank
Austria	2423,31	28,35	1	337,09	6,42	7	2.760,4	19,39	1
Netherlands	471,39	5,52	7	2157,04	41,07	1	2.628,4	18,46	2
Germany	1843,84	21,57	2	359,48	6,84	6	2.203,3	15,48	3
France	120,45	1,41	12	1044,99	19,89	2	1.165,4	8,19	4
Italy	519,85	6,08	5	548,64	10,44	3	1.068,5	7,50	5
Luxemburg	517,71	6,06	6	471,10	8,97	4	988,8	6,95	6
Hungary	528,18	6,18	4	393,58	7,49	5	921,8	6,47	7
Slovenia	331,39	3,88	8	229,29	4,37	8	560,7	3,94	8
Switzerland	132,97	1,56	11	303,94	5,79	9	436,9	3,07	9
UK	170,66	2,00	9	144,87	2,76	10	315,5	2,22	10
EBRD	143,30	1,68	10	90,37	1,72	11	233,7	1,64	11
United States	1343,37	15,72	3	1126,06	-21,44	12	-217,3	1,53-	12
Total	8984,80	100,00%	-	5252,7	100,0		14.237,5	100%	-

Source: Croatian National Bank statistics

Inward FDI by economic activity in Croatia shows that the inflows are highly concentrated in three industrial sectors that received almost two-thirds of total FDI (see table 4.). Financial intermediations was the target of strong FDI inflows for the whole period (EUR 3.6 billion) followed by manufacture of chemicals and chemical products (EUR 1,7 billion) and the telecommunications with EUR 1,5 billion. Most of these inflows in the first period of our analysis are privatisation related. After the year 2001, they also experienced several greenfield projects.

A large privatisation in the telecommunications sector, the establishment of the second GSM provider and the inflow of foreign capital to several small ISP providers, had a positive impact on employment, as well as on the price and quality of the telecommunication services provided. The effects of FDI in the banking sector seem to have been positive in terms of employment, quality of services and the reduction of the average interest rates. Foreign investment in banking helped

maintain the stability of the financial system, which is a necessary precondition for the improvements in business environment (Jovančević, 2002b).

Foreign direct investments into manufacturing accounted for 31.8 per cent of total or 2.1 bn EUR. Almost 90 per cent of total investment in manufacturing was recorded in five sectors - Chemicals and chemical products (EUR 1.7 billion), manufacture of coke, refined petroleum products (EUR 544 million), extraction of crude petroleum and natural gas (EUR 464 million), non-metallic mineral products (EUR 461.9 million), food products and beverages (416,8 million), and radio, TV and communication equipment (103,4 million).

Foreign investments into wholesale and retail sale account only 4 per cent of total FDI during the observed period. Share of this sector in total FDI became significant in 1997 because of an increased presence of the international wholesale and retail chains in the Croatian market (like Metro, Billa, Spar, Marks&Spencer, Benetton, DM, Baumax and Bauhaus). Retail prices of the imported goods decreased significantly and the real turnover in retail trade increased.

The first generation of foreign wholesaling and retailing firms entered the Croatian market in the 1990s using less risky market entry strategies such as franchising, joint ventures, acquisitions, agency/distribution contracts and direct investment into small-specialised stores. Since the end of 1999 a new wave of trade operations has started with greenfield investments in food retailing. The growth in employment proves the thesis that those companies are able to contribute to additional employment in Croatia. The Survey of foreign managers' perceptions of Croatia as FDI destination suggests that the most important success factors are: close relationship with suppliers, attractive pricing, financial control and monitoring, and store design. Those factors give them the edge over local domestic companies. We find that the major factors in attracting FDI to Croatian trade sector are geographical proximity, stable macroeconomic policy, relatively underdeveloped market, labour supply and its quality (see Anić, and Jovančević, 2004).

Table 4.

FOREIGN DIRECT EQUITY INVESTMENT IN CROATIA - INVESTING
ACTIVITIES (IN MILLION EUR AND PER CENT)

Activity	1993-1999		2000 -2006		1993 - 2006
	Total	In %	Total	In %	Total
Financial intermediation, except insurance and pension funds	340,9	11,66%	3.245,0	37,74%	3.585,9
Manufacture of chemicals and chemical products	759,3	25,97%	952,8	11,08%	1. 712,1
Telecommunications	837,5	28,64%	716,7	8,34%	1. 554,2
Manufacture of coke, refined petroleum products	0,0	0,00%	543,7	6,32%	543,7
Wholesale trade and commission trade	55,4	1,89%	417,6	4,86%	472,9
Extraction of crude petroleum and natural gas	93,4	3,20%	370,6	4,31%	464,0
Manufacture of other non- metallic mineral products	220,0	7,52%	241,9	2,81%	461,9
Manufacture of food products and beverages	133,2	4,56%	283,5	3,30%	416,8
Retail trade, except of motor vehicles and motorcycles	15,0	0,51%	388,4	4,52%	403,4
Hotels and restaurants	57,7	1,97%	268,1	3,12%	325,8
Sale, maintenance and repair of motor vehicles	43,0	1,47%	136,7	1,59%	179,7
Real estate activities	23,8	0,81%	155,7	1,81%	179,5
Other business activities	16,7	0,57%	151,5	1,76%	168,2
Insurance and pension funding	33,4	1,14%	85,2	0,99%	118,6
Manufacture of radio, television and communication	40,9	1,40%	62,5	0,73%	103,4
Total	2924,2	100,00%	8.597,5	100,00%	11. 521,7

Source: CNB statistics

4. Transition results in the new EU member states and Croatia

The new member states are catching up with the major advanced Western economies from 2000 on. The new EU member states are benefiting from their integration with the European single market, by opening up new trade and investment opportunities and by anchoring macroeconomic and institutional reforms. Over the past 8 years, GDP growth in these countries has averaged around 5 per cent, supported by fast increases in total factor productivity and raising per capita income (EBRD, 2007).

Croatia also benefited from the EU status of candidate obtained in 2004 and accession negotiations began on October, 2005 and is continuing. Croatia continues to meet the Copenhagen political criteria and the political situation is still improving. A clear view of performances of the accession countries is presented in figure 2.

Real GDP growth held up dynamics in most accession countries in 2006, although the pace of economic expansion decelerated in some countries in Central and Eastern Europe. Growth in emerging Europe is projected to slow moderately to 5.5 per cent in 2007, reflecting the cooling of the expansion in Western Europe (World Economic Outlook, 2007).

Table 5.

REAL GDP GROWTH IN NEW EU MEMBER STATES AND CROATIA

Country	1994-1995	1996-1998	1999-2001	2002-2004	2005-2006
Czech R.	4,1	0,8	2,6	3,1	6,1
Estonia	1,5	6,6	4,9	7,2	11,0
Hungary	2,2	3,6	4,6	3,9	4,1
Latvia	0,7	5,6	6,1	7,3	11,1
Lithuania	-3,3	6,3	3,1	8,1	7,6
Poland	6,1	6,1	3,3	3,5	4,7
Slovak R.	6,0	5,0	2,4	4,9	7,1
Slovenia	5,4	4,0	4,1	3,5	4,6
Bulgaria	2,4	-3,7	3,9	5,0	5,9
Romania	5,5	-2,3	2,0	6,1	5,9
Croatia	6,4	5,0	2,1	4,4	4,5

Source: EBRD, Transition Report, May 2006; IMF, World Economic Outlook, April 2007.

As a factor that contributes to GDP growth we should consider the employment growth rate in those countries. The available data for 2000-2005 show that the average annual employment growth rate was not sizable contributor to GDP growth (EU Commission, Competitiveness Report, 2006). Total employment rate for the analyzed period was the lowest in Poland (-0,6%), which was significantly below the EU-25 average. Baltic countries recorded higher employment growth rate at annual level - Latvia (1,6%), Estonia and Lithuania (1,1% each of them); while the other NMS had faced the same employment growth rate or below the EU-25 average (0,6%).

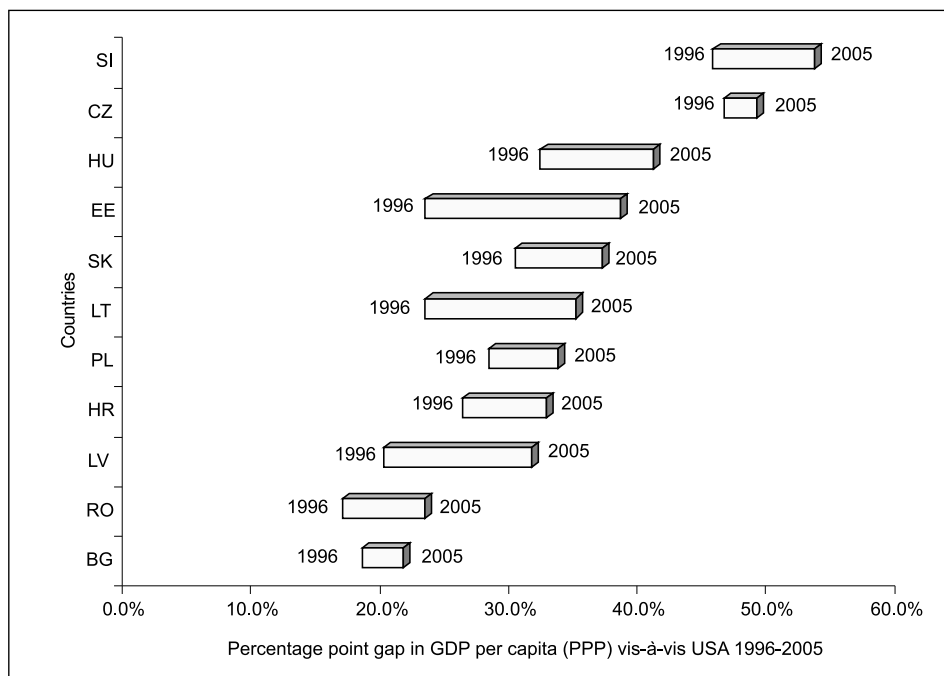
However, data on employment rates need to be complemented by data on average working hours per worker. The data suggest that annual labour productivity growth accelerated in the most of the new EU member states. Strong labour productivity growth rates during the analyzed period were present in Estonia and Lithuania (6,5% each), Latvia (6,4), while other countries were faced with slower growth rate.: Slovakia (4,0), Hungary (3,9), Poland (3,6), Slovenia (2,8) and Czech Republic (2,4). Analyses show that workers in Central and Eastern European countries tend to work longer hours. However, results change when we compare worker and hour productivity. Old EU member states experienced higher hourly productivity while the reverse is true in Czech Republic, Estonia and Poland (SEC, 2006, 1467/2). Some of these new member states have a stronger contribution from capital accumulation and this could also explain the differences in growth.

The progress, which has been made, is graphically presented in figure 2. It represents the narrowing gap in per capita GDP (expressed in PPP) in 1996 and 2005 for analysed country. The length of marks represents progress which a given country has achieved in that decade in catching up with the USA.

The convergence has been particularly remarkable in Lithuania, Estonia and Latvia. Beside other reasons, this is due to their strong commitment to an attractive business environment (including lower tax burden) and sound macroeconomic policies. Slovenia shows favourable progress in bringing down inflation and so far is the first country, which has met the Maastricht criteria and joined the euro area. Slovenia is also catching up in GDP per capita relative to USA, as well as Croatia, while Bulgaria and Romania are doing the same with slower pace. This is partly due to the raising current account deficits in these countries (see figure 3).

Figure 2.

GAP IN GDP PER CAPITA RELATIVE TO THE US (USA = 100)

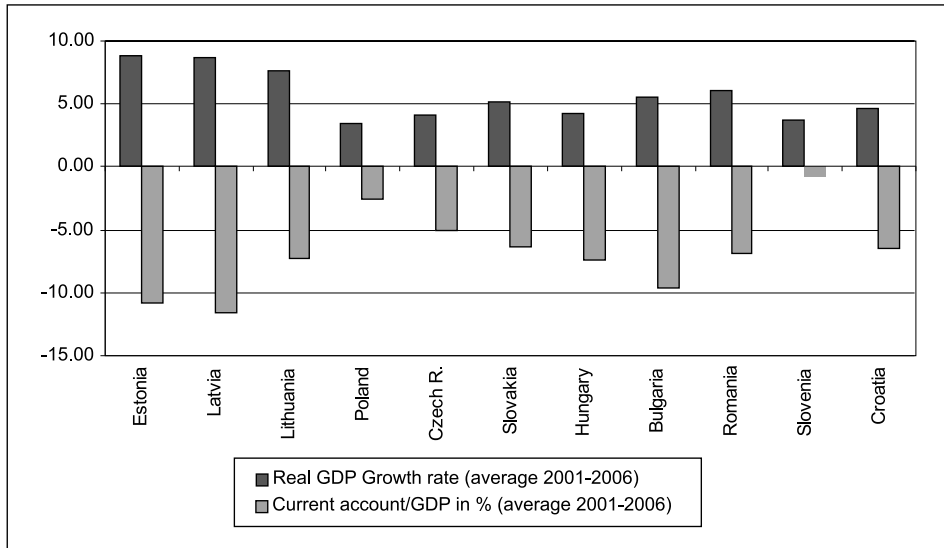


Source: Based on figures from Eurostat Yearbook 2006-07.

How is current account deficit related to absolute and relative growth of GDP? In figure 3, we correlate the current account deficit (as percent of GDP) with real GDP growth rate for the period 2001-2006. They are linked: the higher the share of current account deficit in a country, the higher its GDP growth rate (see figure 3). In Estonia, Latvia and Lithuania, current account deficits were financed by a combination of FDI inflows, bank's long-term borrowing and growing EU funding. In Poland, Slovak Republic, and Bulgaria, the large part of current account deficits being financed through FDI and other private capital inflows. However, in most new EU member states, FDI contribution was scarce to bridge their current account deficits, which have built up into foreign debt (Mencinger, J., 2003). The principal risk for emerging Europe depends on financial conditions that might reduce investor's willingness to continue financing its large current account deficits.

Figure 3.

CURRENT ACCOUNT DEFICITS BY COUNTRIES AND REAL GDP GROWTH RATE, 2001-2006.



Sources: Eurostat, CNB and central banks' web sites

5. The FDI flows in new member states (NMS)

In Central and Eastern Europe (CEEC), FDI inflows have continued to grow since transition and liberalisation began in the early 1990s. But, in real terms it still represents a low portion of the total FDIs. This is an indicator of the sensitivity of multinational companies and other capital entries into this market. The conditions of the world economy after 2000 have intensified competitive pressures, forcing multinational and other companies to search for locations that are more profitable. Central and Eastern European Countries (CEECs) and China in overall fall of FDIs were the only bright spots: FDIs there rose by 15 per cent (UNCTAD 2006).

FDI inflows into the EU accession countries (previously classified under Central and Eastern Europe) rose in 2005 to 36,3 billion dollars (with leading Poland, the Czech Republic and Hungary). The main motives for market-seeking foreign investors to invest in the new EU members are a strong economic growth

of these countries. For efficiency-seeking investors, competitive labour costs are especially important.

We shall concentrate on the FDI trends in NMS countries, which in the 1990s started to reform their former socialist economic systems (see table 6).

Table 6.

FOREIGN DIRECT INVESTMENT IN NEW EU MEMBER STATES
 AND CROATIA, 1994-2006 (IN US MILLIONS OF DOLLARS)

Country	1994	1996	1998	2000	2001	2002	2003	2004	2005	2006*
Czech R.	749	1,276	3,591	4,943	5,476	8,276	1,895	3,960	10,135	4,616
Estonia	212	111	574	324	343	153	763	781	2,250	561
Hungary	1,097	3,335	3,070	2,151	3,573	2,722	479	3,542	5,412	3,055
Latvia	279	379	303	400	114	250	256	596	497	840
Lithuania	31	152	921	375	439	715	142	510	680	803
Poland	1,846	4,445	6,049	9,327	5,804	3,901	4,284	12,097	6,578	9,656
Slovakia	236	199	374	1,897	1,520	4,130	737	1,403	1,951	3,500
Slovenia	129	167	221	71	226	1,508	-174	281	-88	-377
Bulgaria	105	138	537	998	803	876	2,070	2,777	2,298	5,016
Romania	341	415	2,079	1,051	1,154	1,080	2,156	6,368	6,587	11,430
NMS countries	5,026	10,616	17,718	21,536	19,451	23,610	12,609	32,314	36,299	39,100
Croatia	110	486	836	1,080	1,182	582	1,926	877	1,548	3,516

Source: EBRD Transition Report, 2007.

As a general rule, we might conclude that FDI flows have grown faster since 1994: the volume of it was in 2006 in Poland (5,2 times higher), in Czech Republic (6 fold) and Slovakia (14,8 fold), Croatia (32 fold) and so on. However, considering that the countries are of different sizes, the absolute amount does not indicate the importance of FDI for those economies. So, it is necessary to measure relative importance of FDI for those countries by looking on per capita basis and as a source of gross capital formation (refers to table 7). FDI represents a considerable proportion of their GDP – between 2,8 and 15,9 per cent. The “wealthy” Slovenia, with better economic performance is more outward oriented (with a 189 US \$ outflow per capita in 2006 or 0, 9 per cent of GDP in 2006. A low percentage FDI inflow was also recorded in Lithuania (2.7 per cent of GDP). Both countries are characterised by a high growth rate and a substantial export expansion. Therefore, a successful economic policy depends not only on the size of FDI, but also on the broader development strategy of a country.

The FDI inflows have shown that for the period 1989-2006 NMS countries had an inflow 2.672 US dollars per capita. The most attractive countries for FDIs were, based on per capita inflows, the Czech Republic, Hungary and Estonia (see table 7). In the years 2005-06 things have changed: the countries with the lowest FDI inflows were Poland with USD 214 yearly, Lithuania (USD 218) and Latvia (USD 291). Estonia was on the top by inflow of FDI (USD 1.044 yearly).

Table 7.

CUMULATIVE FDI INFLOWS IN NEW EU MEMBER STATES
AND CROATIA, 1989-2006 (MILLIONS OF DOLLARS)

Country	Cumulative inflows (in US\$ mln)	Cumulative inflows per capita (US \$)	FDI inflows per capita US \$		FDI inflows (in per cent of GDP)	
			2005	2006	2005	2006*
	1989-2006	1989-2006				
Czech R.	56,498	5,512	989	450	8.1	4.2
Estonia	6,857	5,098	1,670	417	16.1	3.4
Hungary	45,738	4,545	537	304	4.9	2.7
Latvia	5,054	2,203	216	366	3.1	4.4
Lithuania	5,676	1,669	199	236	2.6	2.7
Poland	80,687	2,123	173	254	2.2	2.8
Slovak Republic	17,246	3,194	363	648	4.1	5.1
Slovenia	2,652	1,333	-44	-189	-0.3	-1.0
Bulgaria	17,168	2,230	298	652	8.5	15.9
Romania	35,550	1,636	303	526	6.7	9.4
NMS countries	273,127	2,672	355	383	5.6	5,0
Croatia	14,113	3,177	349	792	4.0	8.3

Sources: EBRD; *- estimates

6. External debt in transition countries

The external debt might be an important source of economic growth. Croatia's foreign debt tripled during the period under analysis, growing from EUR 10, 1 billion in 1999 to EUR 29 billion in 2006 (see Table 1). External debt rose in Hungary (reached 90 per cent of GDP), as well as in Slovenia (reached 80.6 per cent of GDP in euro terms in 2006). In Croatia, this growth is mostly a result of bank debts with a significant increase share of corporate debt, due to the Central bank decision to

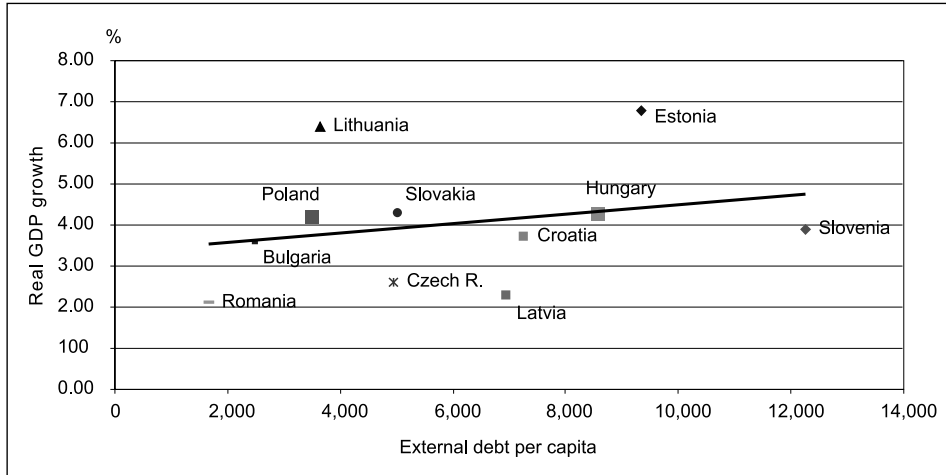
limit foreign borrowing by banks. The public sector foreign debt decreased since the government has increased the proportion of domestically sourced financing. Gross external debt of Croatia corresponds to about 85.5 per cent of the country's GDP in euro terms at the end of 2006 (it was only 21 per cent in 1994). This international criteria on debt is acceptable in the case when foreign funds are used for expansion of exports. In that case liabilities towards foreign creditors (principal and interest payments) can be paid. However, a large part of these foreign loans in Croatia were invested in infrastructure projects (roads, bridges etc.). The main risk to growth stems from the strong expansion in domestic credit and the growing commercial bank external indebtedness. These may have a negative effect on the already high foreign debt levels and may create appreciation pressures.

For this analysis, however, the most important conclusion is that the level of total foreign inflow of capital is not correlated with the economic growth, as it can be seen from the figure 4. Estonia has got much higher GDP growth rate (6,8 %) for the period 1996 - 2006 than Slovenia (3,9%) in spite of high inflow of foreign capital. The growth of Slovakia economy was almost twice as high as the economy of Czech Republic, regardless of the almost same inflow of capital. High rate of Lithuanian economy (with 6, 4 per cent) occurred in spite of the under the average inflow of foreign capital.

External debt service burden is measured as the ratio of debt repayments to goods and services exports (in per cent of exports and goods and services). Measured by this yardstick Croatia is most heavily burdened by debt repayments, in 2006 (29, 2) followed by Bulgaria (24, 9), Romania (19,5), and Slovenia (18,4). Croatia is a country heavily burdened with external debt repayments since it allocates almost one third of its total goods and services export revenues for external debt services (see EBRD Report 2007).

Figure 4.

REAL GDP GROWTH (1996-2006) AND EXTERNAL DEBT PER CAPITA (2005) IN CROATIA AND PEERS (IN MILLIONS OF US DOLLARS)

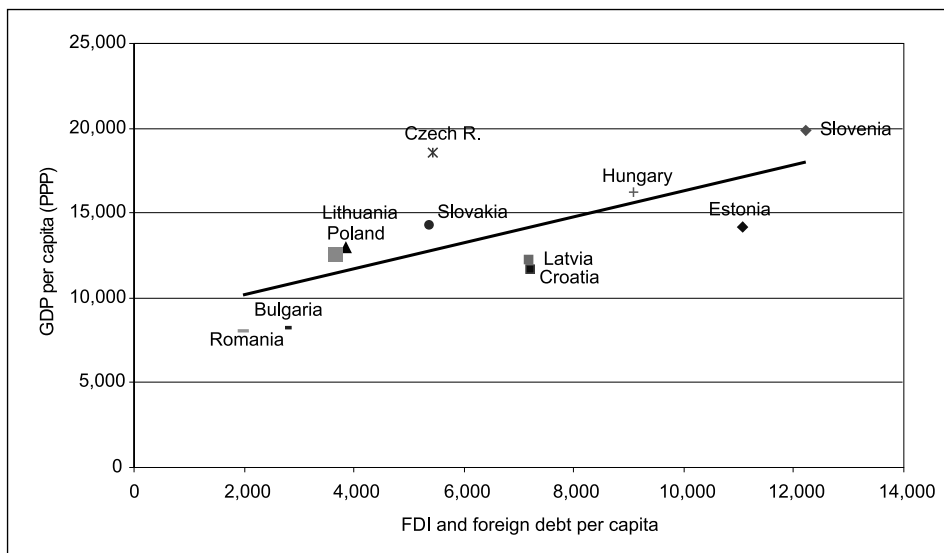


Sources: EBRD Transition Report 2007; World Investment Report 2006

Summarizing the figures for FDI and foreign debt, we are obtaining the total inflows of the foreign capital per capita in transition countries in the year 2005. Data for all analysed countries are shown in figure 5. The total inflow of foreign capital in those countries for the year 2005 varies considerably: from very low (Romania only USD 1.972 per capita) to very high flow of these sources to Estonia (USD 11.062) and Slovenia (USD 12.215 on per capita basis). Also, the pattern of capital inflow differs considerably for the whole period 1991-2005: in Slovenia 87 per cent of the total came in the form of credit, only 13 per cent as FDI. Opposite is the case with Czech Republic: it obtained 51 per cent of the inflow from FDI (EBRD Report 2006).

Figure 5.

REAL GDP PER CAPITA AND FOREIGN CAPITAL AS A SOURCE
OF GROWTH IN CROATIA AND PEER COUNTRIES, 2005



Sources: EBRD Transition Report 2007; World Bank World Development Indicators, 2007.

Let us conclude: the rate of growth of those transition countries can't be explained only by the volume of inflow of foreign capital. It is much more influenced by the economic policies of those governments and entrepreneurship existing in those countries.

That forced me to enter into the field of business surrounding that are prevailing in transition economies with considering motivational factors for investment. In order to increase FDI many countries reduced corporate taxes. The ones with lower taxes increased their level of FDI and capital was flowing out of the countries with high corporate taxes. According to the survey corporation tax rates show a declining trend (See table 8).

Table 8.

CORPORATE TAX IN 2004 AND 2007

The highest corporate income tax			The lowest corporate income tax		
Country	2004 (%)	2007 (%)	Country	2004 (%)	2007 (%)
Germany	38.3	38,34	Cyprus	10/15	10
Malta	35	35	Ireland	12.5	12,5
Belgium	n/a	33,99	Lithuania	15	15
Italy	37.3	33	Latvia	15	15
France	33,8	33,33	Hungary	16	10/16
Japan	42	30	Slovakia	19	19
Austria	25	25	Poland	19	19
China	n/a	33 15/24	Estonia	0/26	22

Source: <http://www.worldwide-tax.com/>

Ten NMS (who joined EU from 1 May 2004) already have much lower rates than the old EU members generally. Five of them have reduced their corporate tax rates significantly in 2004 (Czech Republic, Hungary, Latvia, Poland and Slovakia). As a result, the average rates for these ten countries, which were at the level at 23,6% in 2003, will be reduced further. This has an effect on the EU as a whole (the average corporate tax rate was reduced from 28,5% in 2003 to 27,4% in 2004).

A simple comparison of a tax rate is not adequate for assessing the relative tax burdens in each country. Many other elements need to be taken into account including the cost of labour, as well as education level, corruption in the country etc.

7. FDIs Motivational Factors

The general investment climate in a country and a region is a very important factor that is closely related to the perception of political and country risks. Regional stability and reputation is a very important supra-national factor. It is necessary to create an encouraging environment in which FDIs will be launched. Effective legal system and effective judiciary are important, but there are many other factors that are equally as important. Foreign investors like to have stability in a country and to see consistency in government policy. We were interested in the investment-related perceptions of the foreign managers in Croatia. Managers

were asked to assess the current macro-economic position of Croatia, and their judgements were not very generous in marking government performance in the year 2002 when the survey was done (Jovančević, and Šević, 2006).

More than half of the managers gave a high mark (median value 5) to the Tax / or excise system. They assess that the system is not comprehensive. There is a lack of predictability on what will happen, and year by year adjustments have to be made on short notice. A tax system that focuses on labour taxes and consumer taxes is not inductive for foreign investors. An equally high mark was given the Customs system, and the Foreign exchange system. However, the public administration is far too bureaucratic and inefficient in dealing with logistic issues. More than half of the managers consider the access to external finance in the local market extremely good (median 5).

Table 9.

MACROECONOMIC SITUATION IN CROATIA

Factor	Median	Mod	Standard Deviation
Croatian macroeconomic position	4.00	4.00	0.95
Political and social environment	3.0	3.0	1.31
Geographical & cultural proximity	7.5	8.0	1.50
Country Inflation rate	7.0	8.0	1.86
Labour regulation	5.0	5.0	1.45
Favourable legislation to FDI	4.0	5.0	1.54
Government's ability to influence the economic reform in a significant manner	3.50	3.00	1.22
Country legal system efficiency	3.0	3.0	1.33
Legal environment with respect to FDIs	4.00	5.00	1.09
Comprehensiveness of the Tax /excise system	5.00	5.00	1.19
Comprehensiveness of the Custom system	5.00	5.00	1.32
Comprehensiveness of the Foreign exchange System	5.50	6.00	1.09
Employability of the locally recruited staff	6.00	5.00	1.68
The access to external finance in the local market	5.00	5.00	1.99
Quality of financial services provide by domestic banks	6.00	6.00	1.67
Quality of financial services offered by international banks	6.00	6.00	1.58
Croatian Government efforts in promoting FDIs	4.00	4.00	1.64
Croatian government regional policy	4.00	4.00	1.13
Protection of intellectual property	3.0	3.0	2.11
Competition	4.0	3.0	2.02
Opportunity to enter new markets	5.0	5.0	1.33
The quality of accounting services offered in Croatia	6.00	7.00	1.53
The Quality of legal services offered in Croatia	6.00	6.00	1.38
Assistance by their own Government - in country	5.50	3.00	2.24
Assistance by Croatia (the Croatian Government)	4.00	4.00	1.73
Rate of questionnaire	7.00	5.00	1.78

Source: personal Survey : on the scale from 1 (appalling) to 10 (excellent)

The lowest mark was given the Government's ability to influence economic reforms in a significant manner (median value of 3.50). More than half the managers gave a low mark to Croatia's current macroeconomic position (median value of 4.00). Also, a low mark was given to the "legal environment with respect to FDIs" and the efforts of the Croatian Government in promoting FDIs. Managers think that frequent change of laws and the lack of a constant economic policy is not good for investors. Although the government was not highly regarded, the managers believed that accounting and legal services offered in Croatia are of good quality and can support the foreign business endeavours in Croatia. The managers believed that both domestic and foreign banks provide very good financial services, which is rather surprising as the vast majority of them (over 90 per cent) admitted that they favoured foreign-owned banks, believing that they are more professional and easier to deal with.

However, it should be noted that direct tax benefits are usually not crucial for making a decision as to whether to invest in a particular country or not. It is generally believed that a worldwide decline in corporate tax rates is certainly a direct consequence of competition in tax rates on corporations. Managers of smaller firms operating in Croatia believe that further corporate tax reductions would help in attracting additional FDIs, but we also believe that there is a personal motive which influences their attitude. Managers in low-tax countries have bigger leverage when it comes to new profits, which makes them successful in comparison to those operating in higher-tax countries.

Croatia scores relatively poorly in the law enforcement indicators. It seems that the legal processes are too long, overly complicated and certainly the attitude of the judicial system can be described at least as relaxed. Corruption still presents an important impediment to greater inflow of FDIs. As has been already stated, investors are interested in relatively stable countries, where they can command high levels of return with reasonable risk.

The usual problem that face FDIs in transitional countries are those linked with the restrictions on FDIs in certain sectors of the economy. The government of the day should consider easing the remaining restrictions and eliminating the specific privileges offered to foreign investors. Often tax concessions given to foreign investors are example of discriminatory policy against domestic investors. A successful government will also look to develop special niche to promote some special advantage that will make its country a distinctive FDIs destination.

Many international investors refer to the Heritage Foundation study and the index of Economic Freedom when deciding whether to invest in a particular country. The degree of economic freedom is not perfectly correlated with investment desirability; however the annual study does provide a good overview on the overall economic situation of 157 countries (Heritage foundation; 2007). Each one of the 10 freedoms is graded using a scale from 0 to 100, where 100 represent the

maximum freedom, according to the methodology. A score of 100 signifies an economic environment or set policies that is most conducive to economic freedom.

Table 10.

INDEX OF ECONOMIC FREEDOM IN TRANSITION COUNTRIES

Country	2007 score	Regulation	Trade	Fiscal	Gove't	Monetary	Investment	Property Rights	Corruption	Labour
Bulgaria	62.2	66.9	60.8	91.3	65.6	75.7	60	30	40.0	71.5
Czech R.	69.7	61.2	76.6	79.9	52.7	86.2	70	70	43.0	77.2
Estonia	78.1	80.0	76.6	89.7	66.8	83.0	90	90	64.0	51.2
Hungary	66.2	71.2	76.6	79.2	41.8	76.7	70	70	50.0	66.1
Latvia	68.2	76.8	76.6	89.3	69.2	74.1	70	50	42.0	64.1
Lithuania	72.0	86.4	76.6	91.0	76.6	81.2	70	50	48.0	60.1
Poland	58.8	56.1	76.6	79.1	55.3	80.3	50	50	34.0	56.2
Slovak Republic	68.4	71.0	76.6	93.0	60.8	76.7	70	50	43.0	62.5
Slovenia	63.6	74.2	76.6	69.7	56.8	79.0	70	50	61.0	48.7
Romania	61.3	70.9	74.0	91.7	74.9	69.7	50	30	30.0	61.4
Croatia	55.3	53.8	77.8	79.9	36.5	79.3	50	30	34.0	52.0

Source: Heritage foundation; 2007. Scale graded from 0 to 100.

According to the Heritage Foundation's assessment for 2007, Croatia's economy is 55.3 percent free, which makes it the world's 109th freest economy. According to the scores, Croatia is ranked as 37 of 41 countries in the European region. Croatia scores well in trade freedom and monetary freedom. Freedom from government, investment freedom, property rights, and freedom from corruption are still low scoring. The complex and administrative procedures required to start, and operate a business discourage FDI inflow. The overall freedom to start, operate, and close a business is restricted by the national regulatory environment. Starting a business takes an average of 45 days, compared to the world average of 48 days. Although the top income tax rate is high, the corporate tax rate is low (20 per cent).

Among the selected countries, regarding corruption, Estonia has the significantly highest score followed by Slovenia and Hungary. In other countries, corruption is still the most important problem facing their countries.

The factor property rights scores the degree to which private property rights are protected and the degree to which the government enforces law that protects private property. Table 11 shows that protection of property rights is most assured in Estonia and in Czech Republic and the lowest in Bulgaria, Croatia and Romania. A modern pro-active government has to facilitate doing business rather than harassing it, with the provision of an effective legal framework for FDI that will promote best practices in both the legislative and law enforcement domains (Jovančević and Šević, 2006). The most important issue for newly EU member states, as well as for Croatia, is to effectively address issues of corruption. This sort of action by the government creates an especially positive response from the investment business community. An underlying factor is the existence of an effective and efficient system of property rights. Different forms of property rights have to be guaranteed and enforced. Without a well functioning property rights regime there is very little that one can do to attract FDIs. If the property rights regime is accompanied by an increased transparency and a rule based system, then it is certain that a country is a welcome FDI destination.

8. Conclusion

The analyses of the impact of foreign investment flows to the transition economies and Croatia for the past sixteen years have shown us that there was a significant inflow of foreign capital (including foreign debt) in those countries. As a result these economies experienced high growth rate in the past 8 years, narrowing the gap in GDP per capita with developed countries. The volume of inflow varied considerable from country to country, as well as the pattern of it (FDI versus foreign debt; greenfield against equity investments and so on). The long term performances of these economies are correlated with the amount of inflow of foreign capital and increasing foreign debts, but very important components were motivational factors of entrepreneurship in those economies (the existing managers in their ability to adjust to the market economy), country legal system efficiency, protection of intellectual property and efficiency in the battle against corruption.

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UTJECAJ IZRAVNIH INOZEMNIH INVESTICIJA NA HRVATSKO GOSPODARSTVO - KOMPARATIVNA ANALIZA

Sažetak

Cilj je rada analizirati i usporediti tendencije inozemnih direktnih ulaganja u zemljama članicama posljednjeg proširenja EU. Analiza se bazira na tijekovima inozemnih direktnih ulaganja i inozemnih dugova u navedenim zemljama u periodu 1989 do 2006. Komparativna analiza inozemnih tijekova kapitala sugerira da postoji ogromna razlika u efikasnosti tih tijekova što se djelomično objašnjava karakterom inozemnih direktnih investicija (Greenfield nasuprot equity investicijama). Zaključak je rada, da bez obzira na volumen pritoka kapitala, nacionalna investicijska politika može imati presudan utjecaj na realni sektor gospodarstva.

Ključne riječi: izravna inozemna ulaganja, tranzicija, inozemni dug, investicijske politike