Analysis - Central topic

Foreign direct investors´ motives and their place in the economy of RS

Motives for which foreign direct investors (FDI) arrive to and do business in RS often do not correspond to the development needs of Srpska, therefore it is necessary to adequately position FDI in economic policies and strategies, and also it is necessary to undertake thorough reforms of business environment as well. During last ten years, only in 2004 and 2007 there was a more significant inflow of foreign investments, which mostly came through the process of privatization of state-owned firms and in the sectors of telecommunications, trade, finance, with insufficient inflow to production and greenfield projects. Market position and access to resources were the basic motives for the arrival of foreign investors.

Motives for the arrival of FDI

Why in the first place do companies from one country move their production, buy shares or take over complete ownership over firms in other countries? Answer to this question gives the initial grounds for better understanding of their behavior in a host country. According to known findings, motives for the arrival of foreign direct investors can be grouped like this:

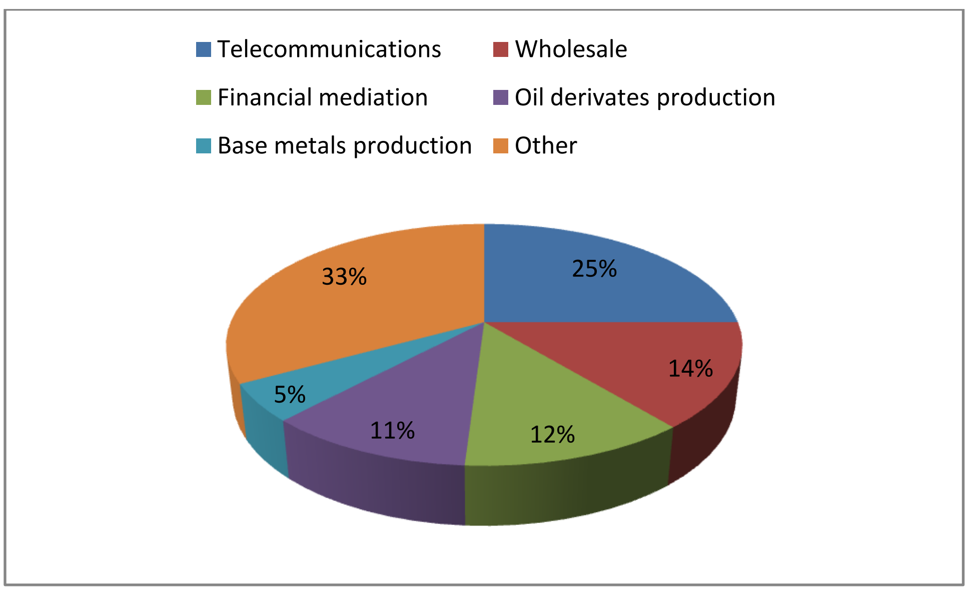
- investments which require resources – natural resources (ore, raw materials, agricultural products) or cheap labor force;
- investments which require a market – where imports of certain products are high, and investments following the movement of their buyers or the reason is penetration to other, attractive, markets;
- investments which require increased productivity and effectiveness – this implies production rationalization or joining production operations with other companies (costs reduction and/or specialization of production), as well as realization of economies of scale;
- investments requiring the existing capacities (privatization and acquisition) – so they can keep and promote long-term goals of their company, because by buying existing companies they get to keep production lines and existing market.

So, foreign investors have clear goals, which, above all, come down to making profit and making sure that their business venture realizes stable income as long time as possible. Other effects, following their presence and business operation in the host country, logically, are not primarily the subject of their interest, but they are at the focus of public policies around the world aimed at getting maximum benefit from FDI for their economies.

Positive and negative effects FDI have on a host country

Very tough global game for attracting FDI is being played in order to maximize positive effects on host economy and these effects can be multiple:

- The arrival of new technology and advancement of production, as well as application of contemporary managing and organizational knowledge in areas of marketing, finance and strategic planning;
- improving the quality of human resources through employee trainings in branch offices, as well as a possibility for the "spin off" effect, which lies in that employees in foreign investors' subsidiaries can get ideas for starting their own business;
- they can increase the pressure of competition and force existing companies to find ways for increasing their effectiveness;
- they can stimulate domestic investments if there is complementarity within the production of domestic firms. Domestic firms then have enough motives to invest additional funds in order to try and advance their business and enter the chain as suppliers, distributors or related industries;
- FDI growth in countries of eastern Europe has significantly helped financing growing deficits of current balance during transition period;
- the arrival of one investor can stimulate the arrival of other foreign investors (which are in close relation with the initial investor or due to favorable investment climate);
- experiences have shown that even newly founded subsidiaries of foreign companies have greater tendency to (re)invest during their business operation than domestic firms.



Source: Central Bank of B&H

Still, one has to be aware that, as it has been proved in practice, foreign direct investments can lead to negative consequences as well. Foreign direct investments can negatively affect economic tendencies of a host country in one of the following ways:

- there is a great risk that a foreign company, for the sake of its domination, can eliminate or displace domestic competition ("crowding-out" effect). This can lead to market monopoly, which prevents new "players" to enter;
- foreign investors can transfer the main portion of their profit to their home country (repatriation), which can cause the drawing out of domestic resources, including the situation when subsidiaries pay annuities based on loans from their headquarters;
- acquisitions, i.e., taking over domestic firms, can lead to the losing jobs, especially if those domestic firms have inherited the problem of over-dimensioned employment which "smothers" its competitiveness;
- displacing of the so-called dirty technology out of developed countries, by which foreign companies avoid polluting their own territories, and this is done often under the pressure of ever increasingly rigorous natural environment protection regulations.

Inflow and behavior of foreign investors in the Republic of Srpska (B&H)

Monitoring the flows of foreign direct investments in the Republic of Srpska is still difficult, because it is not possible to obtain a detailed structure of this data from one source. Therefore, it is necessary to use a combination of sources, such as follows.

Over a period of ten years (2001-2011), annual inflow of FDI in RS was relatively low, except for 2004 and especially 2007, when two major acquisitions through privatization were registered – Alumina factory "Birac" (465.6 million BAM) and "Telekom RS" (1.26 billion BAM) respectively. Even though it is very difficult to obtain reliable information about the inflow of FDI per business sectors in RS[1], certain trends can be perceived when viewing it together with available information for the entire B&H. According to MOFTER (period 2005 – June 2010, investments over 100 000 BAM), by value, the most of FDI came to telecommunications sector (1.28 billion BAM), and then to sectors of production (981.6 million BAM), banking (275.8 million BAM) and trade (239 million BAM). If one looks at the data from CBB&H for B&H (period 2007-2011), one gets a similar picture.

So, it can be concluded that so far the most attractive business sectors for foreign investors in the Republic of Srpska were trade and financial mediation (mostly banking), while the sector of telecommunications "earned" the first place with only one project, the afore mentioned privatization of "Telekom RS". By comparing the two sources of information in greater detail it can be found that most FDI directed to the sector of production came in 2007 (data by MOFTER), whereas, at B&H level, within this sector dominant were inflows to the production of oil derivates, meaning that this was mostly related to privatization income from selling the oil industry of RS (Oil Refinery Brod and Oil Refinery Modrica). What was also obvious here was that the majority of FDI

[1] Central Bank of B&H does not categorize FDI inflows according to business sectors in RS, while such pieces of information are available in the database of the Republic of Srpska Investment-Development Bank for period 2005 – June 2010, whose source is MOFTER.

came through privatizations and other acquisitions (taking over domestic banks), and not through greenfield investments.

FDI trends registered in the Republic of Srpska and B&H basically did not differ from those in other transition countries. Foreign investors first “took over” financial mediators and took the “controlling” position in trade sector, which enabled them to kick out competitive companies and to earn high profit over a short time period. This could be said for the monopolistic position in telecommunications sector. Access to raw materials and their processing in RS was often also confirmed as the main reason for the arrival of foreign investors, if we take into consideration the acquisitions of an iron ore mine (“ArcelorMittal in Prijedor), a coal mine (“EFT Gropu” in Stanari) and oil industry.

B&H also was not immune to high capital outflows through the account of investments[2], which was additionally encouraged by the recent global economic crisis. From 2009 to 2011, almost 970 million BAM (source: CBB&H) left the country. Also, pulling capital out of foreign-owned companies through transfer pricing “fenoms” and tax evasion was recently discovered in the Republic of Srpska, when the case of “Birca” Zvornik was opened.

Putting FDI at the disposal of developmental needs, accelerating the reform of business environment and strengthening regulatory institutions in the Republic of Srpska

In order to make full use of the potential that FDI have, they have to be included in the economic (developmental) strategy of the Republic of Srpska, i.e. to be put in the context of the realization of domestic developmental priorities. This means that activities on attracting FDI should be directed towards those sectors and projects (business sectors with identified competitive advantages, clusters as sources of excellence, strategic partnerships on the realization of big investment projects) that can activate domestic resources and potentials, that is, where it is possible to encourage the development of domestic private sector in the most effective way. FDI must not be the only support for the economy. They must be used as a means of adding or ensuring what the domestic economy lacks, so a long-term economic stability could be achieved. One should always bear in mind that the policy of attracting FDI based only on cheap labor force or abundant financial and fiscal incentives leads to “escaping” of foreign investors as soon as other countries offer even more favorable conditions.

The Republic of Srpska must urgently implement a comprehensive reform of business environment. Many international studies have continuously pointed to basic weaknesses that decrease the domestic economy’s ability to attract a more significant volume of FDI, such as the Doing Business Report for 2012, issued by the World Bank, which put B&H behind all countries in the region (127th

[2] Joze Mancinger, renowned Slovenian economist, put special emphasis on this when he dealt with perils deriving from total reliability on FDIs – Dependence on FDIs and current account balance (Zavisnost od SDI i bilans tekuceg racuna), 2008

out of 183 countries in total), or the annual progress report by the European Commission. It is pretty clear what should be done in order to create a predictable and attractive business climate for foreign and also for domestic investments – to significantly facilitate business startup and obtaining of construction permits, to advance property registration process, to strengthen the legal system and contracts implementation, to create a more effective administration as a reliable business service, to accelerate structural reforms, etc.

In order to decrease negative effects of foreign investments, i.e. to discourage investors prone to easy and quick profit making without intention for long-term business development in the domestic economy, it is necessary to strengthen regulatory institutions and ensure strict rule of law. For instance, Tax Administration must be more effective in early discovering of transfer prices manipulation and other sorts of tax evasion; Council of Competition should be more active in identifying and sanctioning monopolistic and oligopolistic behavior at the market, while regulations on the protection of natural environment should be thoroughly implemented. Also, criteria and procedures for awarding financial and fiscal incentives to foreign investors must be transparent, and the results must be measurable, with obvious benefits in regards with costs.

Nett inflow of FDI in RS (000 BAM)

Period	Amount
I-XII 2001	34 226
I-XII 2002	263 705
I-XII 2003	35 624
I-XII 2004	615 579
I-XII 2005	263 218
I-XII 2006	103 223
I-XII 2007	1 946 688
I-XII 2008	165 675
I-XII 2009	181 520
I-XII 2010	191 100
I-XII 2011	341 000
Total:	4 141 658

Source: Period 2001 to 2008 Ministry of Foreign Trade and Economic Relations – MOFTER and period 2009 to 2011. Central Bank of B&H – CBB&H

(note: CBB&H maintains statistics records in compliance with IMF methodology, while data for FDI inflows in RS prior to 2009 are not available)