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ANALYSE THE INWARD FDI POTENTIAL OF CEE REGION

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ABSTRACT

Globalization is changing the economic area into a unified market as it removes economic, political and other obstacles. Therefore, companies must ensure competitiveness and strengthen developmental capabilities. One of the ways to do that is also through foreign direct investment (FDI). The decision for FDI is a choice of individual companies, but countries have to create the right conditions for it. With it companies also increase their competitiveness and prosperity in society. In this research the attractiveness of FDI in Bosnia and Herzegovina will be assessed compared to other countries of Central and Eastern Europe. An additional contribution to the current model research will be a comprehensive overview and meaning of the factors which influence this decision in connection with factors at the national level. A factor of cultural and geographical distance from the selected country of Slovenia will also be included. There are very few similar studies in the region.

Key words: *competitiveness, FDI, globalization, countries of Central and Eastern Europe.*

JEL classification: F23, F21

1. Introduction

The internationalization of business is a term that defines the process of spreading across borders, while globalization as a concept defines the achieved status. Globalization and internationalization are complementary concepts. The concept of internationalization is more focused on the process, while the term globalization refers to the achieved cross-sectional state. Internationalization is not a process that takes place in one direction; it is by its very nature a two-way process (Dubrovski, 2006). The well-being of society and the people is no doubt the objective for which each country improves their competitiveness. Foreign direct investments (FDI) play a very significant role in this. The overview of theoretical starting points is given in the second chapter. The third chapter gives an overview of existing literature about the factors which influence FDI. The fourth chapter contains additional methodological starting points of the research. The research is done using the method of the ratings, i. e. the same way as UNCTAD did with the calculation of attractiveness and prosperity of individual countries for FDI index. The fifth chapter provides the results of the analysis of the attractiveness of Bosnia and Herzegovina for the automotive industry. The findings with recommendations for further research are listed in the sixth chapter.

2. Theoretical concepts

Traditional theories of international exchange are the oldest. This group includes A. Smith's theory of absolute advantage, Richard's theory of comparative advantages, Hekschler's and Ohlin's HO model of production factors and Leontief's upgrade of the model (Daniels, Radebaugh and Sullivan, 2007). The basic assumptions are based on the diversity of production factors, interest rates, stage of development and location factors identified as causes for international trade (Svetličič, 1996). They are all trying to answer the question of when, where, who and how companies should engage in international trade.

Porter's diamond theory of national competitive advantage (Daniels, Radebaugh and Sullivan, 2007; Hämälainen, 2003) is one of most frequently used theories these days. Determinants which affect the internationalization of business operations are: factor terms (resources, personnel, infrastructure …), entrepreneurial structural strategy and competitiveness, demand conditions, supporting and complementary industries. These determinants create an environment in which companies compete and develop. Competitiveness of national economy is based on innovation and ability to adapt and update. Intense competition is forcing companies to gain competitive advantage. Knowledge is becoming an increasingly competitive advantage, which may be provided by the state. Cultural charecteristics of a nation, the institutional framework, economical structures and other factors of the country also affect the competitiveness of businesses (Czinkota et al., 1995). Porter later added another two determinants: the impact of the government and its policies, and coincidence. Both are external and as such do not have a direct impact on the company. Coincidences relate to war, coincidental inventions, changes in demand etc. The impact of the governement reflects through tax and customs restrictions, granting of subsidies, economic and fiscal policy of the country.

Modern theories of international exchange have an ambition to supplement traditional theories of international exchange. The clarification is often explained by the technological factors (Krugman and Obstfeld, 2006). Strategic trade policy states that the pattern of international trade is affected by large enterprises with the support of their government. Here, a key role is played by politics on one hand and R & D or high technology on the other hand (Svetličič, 1996). Recent international theories are focusing on FDI as well as on international exchange. Hymer's model of specific advantages, Verno's model of international life cycle of a product and internationalization theory are also included here (Piggott in Cook, 2006).

The next group consists of theories, based on the internationalization process and not on the assumption of international trade. Here we include the theory of network approach and transnational theory (Jaklič in Svetličič 2005). Dunning presented the theory of investment development path. The largest contribution to the theory is in the dynamics of the theory itself, the clarification of FDI flows and the role of the government in these flows and in increasing competitiveness in general (Buckley in Castro 1998).

The concept and the idea of internationalization have been developed in 1937 by Coase. He concluded that the market is expensive and inefficient for certain products, which results in high transaction costs. If the transactions within a company can be held on the cost lower than market cost, the company decides to internalize (Coase, 1937 in Rojec, 1994). Buckley and Casson presented in 1976 (Henisz, 2003; Rojec, 1994) a theoretical point of departure from country-specific advantages of the factors and characteristics at companies' level and individual industrial sectors. They researched the market of halfproducts and capital market. They found that specific advantages of the company, such as hidden knowledge (also Tacit's knowledge) and innovation, lead to the internationalization of companies' operations. Today, this is the central theory which explains FDI. The basic hypothesis of the theory is that the company internationalizes its activities when the costs of such transactions are lower than the costs of transactions on the market. Internal transfer becomes cheaper. In this case the internationalization occurs due to high production of mid-phase products (Svetličič 1996).

The most significant representative is the Uppsala stage internationalization model (Jaklič and Svetličič, 2005). The model foresees four phases of internationalization; pre-export phase, exports through independent agents, the establishment of a trading branch and the establishment of a manufacturing branch abroad. Kojimo's macroeconomic theory focuses on the factors which affect the transfer of production from countries with high labor costs to those with low labor costs. He later renamed his theory to theory of tracing cycle of production and illustrated it with the flight of geese. The point is that the import of a product is followed by domestic production and export according to the changing of competitive position (Svetličič 1996).

In his eclectic paradigm and OLI model Dunning used specific strengths of the company as well as specific local benefits. Particular strengths of the company are a necessary but not a sufficient condition for internationalization. The basic idea is that the company upgrades ownership-specific strengths with the help of location advantages, therefore it decides for a process of internationalization. Better conditions, cheaper inputs or institutional strengths allow the company to exploit its advantages. The extent depends on the following conditions (Dunning, 1993): ownership-specific advantages, which may be tangible (technology, natural resources, capital and labor) and intangible (information, knowledge), the ability to maximize the profitability through different forms of internationalization (direct export, production abroad, franchising etc.) and the ability of countries to exploit locational specific advantages of the country. The implementation of all three strengths depends on compliance with the company's strategy. The motives cited above most commonly complement each other; sourcing, searching for markets, increasing efficiency and strategic reasons. Among other theories we also include The International Financing Hypothesis, The Currency Areas Hypothesis and The Hypothesis of Diversification with Barriers to International Capital Flows.

3. Literature Overview

Attractiveness of countries for foreign direct investments (FDI) is rated similarly as measuring competitiveness – we estimate the decisions on microeconomic level using macroeconomic data. And every investment decision defines the selected location on the basis of individual choice. Nevertheless, we can use the methods to calculate attractiveness with the help of selected factors. The rating that we get is relative and there are quite a few methodological and substantive concerns. Listed below are three most obvious concerns. The first weakness comes from the name itself – as a contrast between the concept and indicators of competitiveness. Competitiveness is a field of economics, where we analyze the situation and strategies with which countries create and maintain the environment. This environment allows continuous growth of added value of businesses and greater welfare of society (Garelli 2006). The foundation of the concept of competitiveness is in microeconomics, where we compare competitiveness of individual economic subjects. The country's competitiveness is about macroeconomic indicators. This leads us to the second weakness – the theoretical framework is very broad and undefined. The third shortcoming is related to the method of data acquisition, sampling method, recognizable composition of samples and method in interpretation.

The trend of FDI is a complex problem. It consists of various intertwined multidimensional variables. Most frequently used factors are an accessible market, liberal government policies, technological infrastructure, educated labor force and cultural preference to FDI (Sethi et al., 2003). World Trade Organization (WTO, 2011) recommends a mix of the new factors cited above: GDP, political stability, economic stability, infrastructure, level of trade barriers and others. The research of Buckley, Devinney and Louvir (2007) classifies the influence of various factors on accepting decisions. The most important influences are the return of investment, market growth and market size. The least important influence is cultural dimension. In addition, it was found that decision makers with more experience are less afraid of making decisions. Foster (2000) recommends a three-stage analysis. The first stage is the analysis of the target country, its culture and infrastructure, its available workforce and political risk. The second stage is the analysis of the industry if the industry already exists in the targeted country. The last stage is the evaluation of individual project value.

United Nations Conference on Trade and Development (UNCTAD) has published two indices: the index of attractiveness of countries for FDI (FDI potential index) and the index of successful acquisition of foreign direct investment (FDI performance index).

There is a lot of different literature on which factors and to what extent they influence the implementation of foreign direct investment. In the previous chapters various theoretical frameworks were presented. Certainly there are analyses of all the different models. Wheeler and Moody (1992) state that there were many significant factors when U. S. companies invested abroad – political risk, function of administration and bureaucracy, corruption and legal system. Lall and Naruja (2004) indicate the importance of openness of the countries for economic development and the importance of access to technology, knowledge transfer and access to international markets. Vadlamannati, Tamazian and Irala (2009) divide factors to macroeconomic (labor, policy, macroeconomic risk), institutional (consistency of government policy, corruption, freedom), political (regime and stability, the level of conflict) and social (literacy rate, infant mortality rate). Kinoshita and Campos (2003) define the importance of locational specific factors, such as low cost of the labor force, the size of the domestic market, infrastructure and sympathy for countries of Western Europe and the influence of institutional factors such as the policy of individual governments, macroeconomic policy and functioning of institutions in particular. Woodward and Rolfe (1993) have sought the influence on the decision of market size, labor costs and transportation costs. Barkema, Bell and Pennings (1996) emphasize the importance of the cultural dimension. This applies particularly on the case of joint venture. Henisz (2000) states that the institutions of the recipient country are extremely important. This applies particularly on the case of increased risk in the case of joint venture. Holland and Pain (1998) analyze the importance of individual determinants on foreign direct investment in transition countries. A special emphasis is on the level and method of privatization. Grabbe and Hughes (1998) define the importance of EU membership for the countries of CEE. Bevan and Estrin (2001) state that the integration of countries in EU will reduce the risk of individual countries or the risk will become irrelevant. The size of the country, labor price and distance has a significant influence in this. Janicki and Wunnava (2004) specifically indicate the importance of trade barriers and barriers whose abolition is very important for increasing foreign direct investment. Aurora, Vieira and Vieira (2004) try to define the meaning of individual factors for attraction of FDI in CEE countries. As a key reason for attractiveness they state the low cost labor, even if it is not qualified. Here we can find the efficiency factor. Basur and Tosanoglu (2006) emphasize the importance of regional connections for the recipient country. Plykinas and Akbar (2006) analyze 24 determinants, which in their opinion influence foreign direct investment. The analysis was done on the panel of countries of CEE. They divided the determinants into four groups: economic, financial, social and locational. Krugell and Mathee (2008) measure the attractiveness of regions of South Africa for FDI. They used UNCTAD's calculation of attractiveness for FDI, but chose individual categories slightly differently – they compared their results through a period of time. Numerous studies highlight all the factors which influence the process of implementation of FDI. The very nature of the process makes it impossible to connect them with the aspect of implementation of investment.

This chapter presented some starting points for the decision on selecting locations for FDI. The image of the country[57] itself affects the selection before the start of a more detailed analysis. The better the knowledge of the target location, the recipient country of FDI, is, the less likely the wrong decision will be made. In this case we can help ourselves with analyses of various organizations. These are the global competitiveness index, the index of attractiveness for FDI and the index of success in attracting FDI and analysis of the influence of various factors on existing FDI streams in the past. The sole nature of the analysis prevents the theoretical research correctness of the analysis – to analyze the decision from micro-level of the company with the help of macro-level of a specific area, country or region.

[57] The image of Bosnia and Herzegovina is more negative than the image of FYROM. Both countries have very similar economic indicators, but the value of FDI is smaller in Bosnia and Herzegovina. This is due to the »negative image of Bosnia and Herzegovina«, as an unstable and recalcitrant country in which it is always boiling (note a).

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4. Methodology

4.1. The sample and limitations of the research

The sample is intentionally chosen and consists of chosen countries in the broader region of Central and Eastern Europe. The countries are characterized by a change of the economic system over the past two decades, the process of transition and efforts to obtain direct foreign investment. The heritage also includes two important facts: extensive industrial infrastructure and low costs of existing and untapped resources. The selection of countries is dictated by the current process of relocation of production, proximity of the western market and the market of the former Soviet Union coutries. The selected countries are: Croatia, Bosnia and Herzegovina, Serbia, Montenegro, Albania, FYROM, Hungary, Romania, Bulgaria, Slovakia, Czech Republic and Poland.

Research limitations arise from the research itself and the measurement. Each investment is assessed differently and individually. There is also the assumption, that the internal rate of return of individual FDI is the same. When measuring the attractiveness of an individual country for FDI, we measure aggregate values and indices for the entire country. It would be more accurate to use the data for individual regions or areas within the countries and compare them. The competitiveness of countries for the attractiveness for FDI is very difficult to asses, because the aggregate and macroeconomic factors are compared on a level of an individual subject.

4.2. The method and calculation of results

In analysis of competitiveness, we used data obtained from the World Economic Forum (WEF 2011). We selected individual indicators on the basis of the theoretical starting points of an eclectic paradigm, of research carried out so far, factors of assessing individual investments and theoretical starting points for the aforementioned indices of attractiveness for individual countries for FDI. Using factor analysis method, we combined individual factors into a factor, to which we calculated the standard value.

Attractiveness of an individual country is calculated using the following equation:

$$IND\ (PRIV)_j = \sum K_j \times IND_j$$

where K_j represents the weight of an individual indicator and IND_j represents the value of the indicator for and individual country.

Individual values of indicators are calculated for individual countries, using the following equation:

$$IND_j = \sum Ui,_j \times Ind_{i,j} \quad ,$$

where $Ui,_j$ represents the weight of an individual indicator and $Ind\ i,_j$ the value of an individual indicator for the selected country.

The chosen indicator is calculated as follows:

$$Ind\ i,_j = (V_i - V_{min}) / (V_{max} - V_{min}),$$

where V_i represents the value of an indicator for the selected country, V_{min} the minimum value of indicator of all selected countries and V_{max} the maximum value of indicator for all selected countries.

5. RESEARCH

The research was carried out in 2011 on the results of previous periods 2009 and 2010. We used secondary data. The results of the research are presented in chart 1.

Bosnia and Herzegovina has ended up in the first half of the selected countries. Czech Republic and Slovakia are in the first two places, which is completely understandable. FYROM, which is trying to attract foreign investors with the help of intensive government policy, is in the third place. A major obstacle is the lack of industrial tradition. Inferior ranking of Hungary is very surprising. The problem in this case is macroeconomical conditions, which have become worse with the occurrence of the crisis, currency depreciation and high indebtness of the country. Right at the bottom of the list is Albania.

Chart 1: Attractiveness of individual countries for FDI in the year 2011:

Country	Place
Croatia	4.
Bosnia and Herzegovina	6.
Serbia	9.
Hungary	10.
Slovakia	2.
Czech Republic	1.
Poland	5.
Bulgaria	8.
Romania	11.
Montenegro	7.
Albania	12.
FYROM	3.

Chart 2 presents the results for individual indicators of areas for Bosnia and Herzegovina. Individual indices are composed of certain factors and are evaluated differently.

The advantages of Bosnia and Herzegovina as the recipient country of FDI from Slovenia, are cheap resources for production, available labor force and energy resources. Control of FDI is easier because of the relative closeness, cultural dimension (language, folk links, understanding ...) and common past history. The tax burden is low and the rates of customs duty for EU are 0. In addition, the macroeconomic environment is relatively stable due to the protectorate and EU cooperation. However, it can also be a potential risk due to the vagueness of political relationships. The disadvantages are arising from a complex political system and the setting system. Bosnia and Herzegovina has 14 governements – the central government, the government of entities and the cantons, the Brčko District. Financial and banking environment is relatively undeveloped, which means that financial resources are difficult to achieve.The consequences of past events have left traces on the undeveloped infrastructure (roads, railways ...) and on the technological development of the society. Their ICT structure is well developed. They have high hopes for the development of industrial zones and clusters – particularly active area is the area of central Bosnia and Herzegovina with Zenica as the center. A major obstacle is the high level of corruption, since Bosnia and Herzegovina is the worst estimated among all countries in the panel. Efficiency is very low at the moment. Lower labor costs do not necessarily mean a higher added value. However, this is the aggregate index, which can be substantially modified in the case of an individual company.

Chart 2: Values of individual indicators for Bosnia and Herzegovina and their rank in the year 2011

Indicator	Sub-indicator	Rank
Functioning of the government and the state of law	The effectiveness of laws and regulations	12.
	The strength of investor protection	8.
	The protection of intellectual property	12.
	The preference for FDI	9.
Macroeconomic environment	Inflation rate in a period of time	2.
	Economic growth 2006–2010	8.
	The balance of the budget	7.
Financial and banking environment	Accessibility of loans	11.
	Availability of local capital market	8.
	Restrictions on the movement of capital	12.
	Credit ratings	12.
Tax and customs duty rates	Total effective rate of taxation	2.
	Customs duty rate	10.
Infrastructure	Common infrastructure (roads, railways, ports, airports, terminals ...)	12.
	Infrastructure for the operation of clusters	3.
	The number of fixed telephone lines per 100 inhabitants	6.
The energy	Provision of electricity	4.
Technological environment	FDI and transfer of modern technologies	8.
	The quality of research institutions	11.
	The cooperation of educational institutions and the economy	10.
The market size	The market size	9.
Education	Rate of involvement in secondary education	7.
	The quality of business schools	6.
	The availability of specialized educational institutions	12.
Labor force	The level of trade union organization and bargaining power of trade unions	8.
	The flexibility of wage levels and other payments	4.
	The ease of hiring and firing of labor force	1.
Efficiency	The ratio between effect and pay	12.
Resource costs	Low costs of resources (raw materials, energy, labor) are a competitive advantage	3.
Management of FDI	Distance between Ljubljana and the Capital of a selected country	3.
	Linguistic and cultural dimension	1.
Various indices of the business environment	Corruption index	12.
	The degree of trade freedom	12.
	The rate of global competitiveness	12.

6. Conclusion

Globalization is the guide of changes in the world today and it is particularly tense in the last decade or two. Competitiveness of companies is the key to long-term existence. This forces the companies into a process of internationalization process by finding cheaper production sources, achieving economies of scale, finding new markets and continuous improvement of the processes in the company. The process of internationalization is particularly intense for the automotive industry where there is a migration in the countries of Eastern and Central Europe. Slovenian automotive industry is also a part of this.

We analyzed individual factors of Bosnia and Herzegovina, which influence the recipient country. We analyzed them in the context of comparison to 11 countries in the region: Hungary, Croatia, Serbia, Albania, FYROM, Montenegro, Bulgaria, Romania, Slovakia, Czech Republic and Poland. We made the comparison on the basis of existing world research and calculated indices for the attractiveness of FDI, just as the UNCTAD index of potential for FDI. We analyzed the factors of government and functioning of institutions, macroeconomic, banking and financial environment. We assessed the tax and tariff rates, the state of existing infrastructure, available energy sources, technological environment, market size, quality of education, the available labor force, today's functioning of the economy and the costs of resources. We evaluated two factors of controlling FDI, such as linguistic dimension and location proximity, the level of corruption, trade freedom index and global competitiveness of the economy.

For the objectivity of statistical sources, we used data from world trade forum's, the World Bank's and other sources' renowned researches. The biggest obstacle for higher attractiveness and better competitive ability to attract FDI in Bosnia and Herzegovina leads to an unfinished political process. This affects the stability, complexity of administrative procedures and flexibility of government's and institutions' functioning. Obstacles are also the factors of funding because the access to these resources in Bosnia and Herzegovina is very limited and with this there are also difficulties in the movement of the capital. The existing transport infrastructure needs to be updated. Bosnia and Herzegovina is intentionally investing in reassuring the necessary conditions for technological parks and industrial zones, which is a good starting point for the development of clusters. High unemployment, the ease of labor laws and low prices of available sources are all the factors, which are making Bosnia and Herzegovina unattractive for FDI.

Specific regions within the countries of Central and Eastern Europe should be explored in further researches of the potential for FDI. The research could also be carried out by comparing the competitiveness and attractiveness throughout periods of time. The decision for investing is an individual choice of the location. Every industry has its own requirements and needs. On case studies of existing FDI we could once again determine the factors that influence the decision. The form of the FDI is the next segment for further researching. Is a new investment a better choice as the renewal of existing plants, a joint venture...?

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