

# THE FOREIGN DIRECT INVESTMENTS ENTRANCE AND ITS IMPACT INTO COUNTRIES IN TRANSITION (CASE OF BOSNIA AND HERZEGOVINA)

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## *Abstract*

FDIs are very often the most glorified way of high and rapid economic development into transitional countries. Bosnia and Herzegovina has to catch up the significant higher level of real economic convergence before its entrance into European Union membership. So, in that way Bosnia and Herzegovina will be able to meet with a foreign competition on a huge common market of EU. The neoclassical concept of economic growth (famous as "Washington Consensus") which has been applying into Bosnia and Herzegovina emphasizes the FDIs entrance as the main actuator of B&H economic development. That concept supposes that FDIs entrance and comparative advantages could bring the optimal economic growth and development for all countries in the conditions of foreign trade and capital movement's liberalization, monetary stability (without inflation and with stable exchange rate) and fiscal stability (balance of budget).

The subject of this paper is the analysis of theoretical vindication of such macroeconomic policy and real role of FDIs in economic development concerning existing economic and political situation in Bosnia and Herzegovina and historical experiences of today developed economies.

JEL classification: O16, P45, F21, F37

**Key words:** Bosnia and Herzegovina, Washington Consensus, Foreign Direct Investments, Keynesianism, real and nominal convergence, European Union.

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## **1. The macroeconomic policy frame of B&H economy development and its main macroeconomic indicators**

The role of FDI into B&H economic development can be analysed only within the B&H macroeconomic development policy as a whole. Bosnia and Herzegovina has started its economic development process in 1996. Because of impossibility to create its own macroeconomic development way, B&H has applied the neoclassical macroeconomic development framework (known as "Washington Consensus")<sup>60</sup> which couldn't bring good results in the case of

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<sup>60</sup> Originally, the term «Washington Consensus» refers to 10 recommendations for the countries wishing to reform their economies. The author of the recommendations is the British economist

B&H economic situation. This economic schedule supposes that free market competition (A. Smiths invisible hand) and FDI's (Foreign Direct Investments) entrance are main actuator of economic grow and it will bring optimal allocation of factors of production resources. But, Bosnia and Herzegovina is weighted by many economic and non-economic problems and such macroeconomic policy which is based on neoclassical political economy theory is not appropriate for B&H economy.

**Table 1.**

Indicators	2000	2001	2002	2003	2004	2005	2006	2007
Nominal GDP (billion EUR)	5,5	5,9	6,6	7,4	8,1	8,7	9,8	11,6
GDP per capita (EUR)	1,660	1,786	1,958	2,214	2,388	2,561	2,873	3,412
Real GDP growth rate (%)	5.5	4.5	5.5	3.0	6.3	4.3	6.2	8.0
Industrial production growth rate (%)	8.8	12.2	9.2	4.8	9.0	10.0	11.0	10.0
Average net wages (EUR)	190	209	228	247	258	275	300	322
Annual inflation rate (%)	4.8	3.1	0.4	0.6	0.4	3.7	6.1	4.9
Annual unemployment rate (%)	39.7	40.3	40.9	42.0	43.2	31.1	30.0	28.0
Currency reserves (million EUR)	522	1,379	1,270	1,428	1,779	2,160	2,787	3,420
Trade balance (billion EUR)	-3.00	-3.31	-3,52	-3,67	-3,68	-4,01	-3,41	-4,14
Total FDI (million EUR)	159	133	282	338	567	478	564	1,628
FDI contribution to GDP (%)	2.9	2.2	4.3	4.6	7.0	5.5	5.8	14.0
Deposits of households in Commercial Banks, mill EUR	267	740	829	985	1,273	1,629	2,097	2,641
Population (in million)	3.30	3.32	3.35	3.35	3.38	3.38	3.40	3.40

Source: Agency for Statistics of B&H; Central Bank of B&H, FIPA

John Williamson (1989). They concern fiscal discipline, modification of public consumption, tax reform, financial liberalisation (interest rate liberalization), introduction of a single foreign exchange rate, trade liberalisation, eliminations of all obstacles to direct foreign investments, privatisation of state-owned companies, deregulation and competitiveness of the market, and inviolability of property rights.

The best confirmation of unsatisfactory macroeconomic policy is huge and sustained trade balance deficit which according to its definition means domestic population poverty enlargement. If foreign trade deficits are based on the import of capital equipment and new technology which are going to be used in new productive investments (“green field investments”) which open new job opportunities and especially if domestic industry is also connected with those investments on the principle of “industry clusters”, than it can function positively. But, if deficits are based on the imports of consumption, but not capital goods, than the national income is spent on the goods produced abroad and multiplicative effects of domestic industry growth are decreasing. Unfortunately, the foreign trade deficits in Bosnia and Herzegovina are mostly based on the imports of consumption goods and the exports of lower staged processing goods (raw materials) which are a direct consequence of the overly liberalized foreign trade.<sup>61</sup>

In the case of Bosnia and Herzegovina, FDI entrance can be only additional source for economic development, but not the main. Free market competition and capital flow liberalization and all another items of “Washington Consensus” macroeconomic policy are inconsistent according to existing B&H economic and political situation. According to economic theory and historical experiences of all today developed countries, the much appropriated policy is *Keynesian* type of economic policy (the combination of state budget deficit, moderate inflation which can be under control of central bank and gradual depreciation of national currency) where the state economic role should be focal. Some measures of foreign trade protectionism (custom protection, subventions) are also very important to protect the most sensitive sectors (for example agricultural sector).

## 2. The amount and a structure of FDI stock into B&H economy

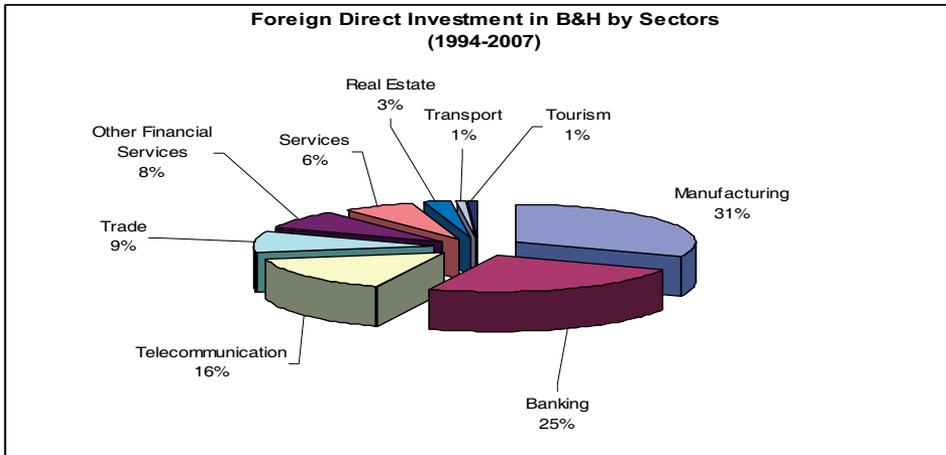
Foreign direct investments can influence economic growth in two ways - positively and negatively. It primarily depends on which type of FDIs is about and is it connected with other domestic firms on the principle of “clusters industries building”. There are two main types of FDIs: *green field* investments and *take-over* investments. While *green field* investment means the new production initiation, the *take-over* investment means the buying of existing domestic firms. The green field investments are much more important than take-over, because they primarily influence on unemployment decrement, but take-

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61 In consideration of export structure B&H is in unfavorable situation because the coverage of imports by exports is only about 30-40%. B&H records the largest coverage exactly by the import and export of primary raw-materials, respectively that the deficit in the foreign trade exchange is realized only by following groups of products: wood and wood products, wood coal, iron and steel products, aluminium and aluminium products, lead and lead products.; Source: FIPA (2008), Investment Opportunities in Bosnia and Herzegovina, p. 18

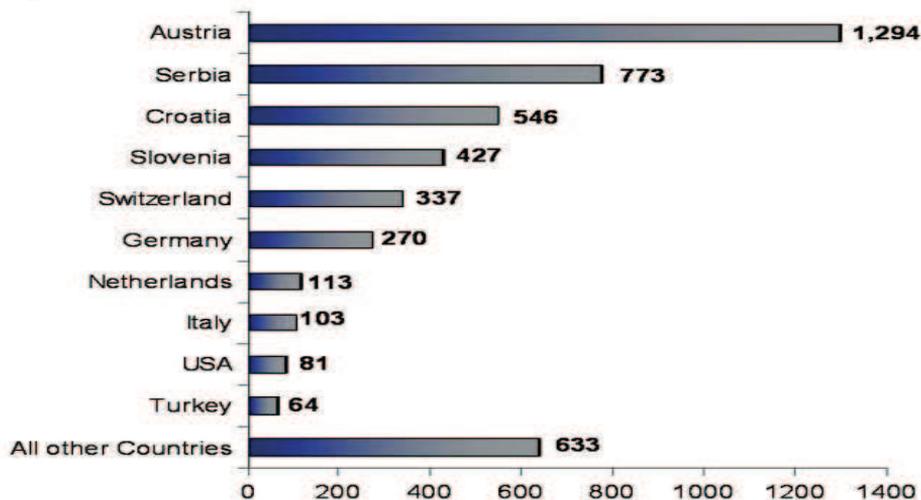
over investments usually influence on unemployment increment, because of labour cost reduction. So, the FDI entrance should be directed through green field investments (for example by tax reduction, or effective tariffs protection) which form new producing companies and “*industrial clusters*” which connect domestic industry. In that way, the domestic production can substitute the import goods in a long term. Great bottoming on foreign capital entrance of multinational companies which conquers domestic market and export and without planned domestic industries development, it can happen that GDP of the country grows and GNP decreases in a long term. That causes pauperization of domestic population because profit gained in the country (through foreign capital - FDI of multinational companies) will go abroad.

**Figure 1.**



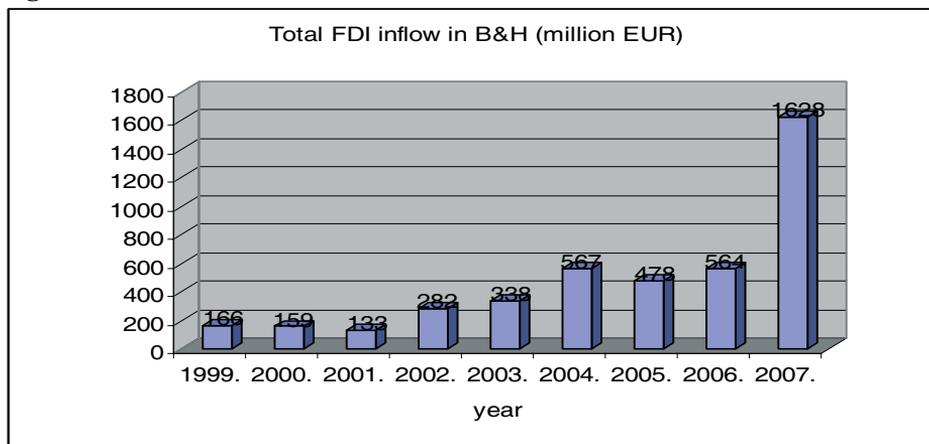
Source: B&H Central Bank, MoFTER, FIPA

**Figure 2.**



FDI Stocks by Country, mill EUR (May 1994 - December 2007)<sup>62</sup>  
 Total amount 4.6 billion EUR

**Figure 3.**



Source: Central Bank of B&H, FIPA

<sup>62</sup> Source: <http://www.cbbh.ba/>

From the very beginning of B&H development process, the FDI entrance has been done mostly through take-over investments (in banking sector<sup>63</sup> and telecommunication sector before all), so the macroeconomic consequences of that haven't given good result that is visible from the some macroeconomic indicators (unemployment, foreign trade deficit, grow rate, ...). But, in 2007, the FDI inflow was a record year, and it was tripled comparing with 2006. Greenfield investments were participated with 40% in total FDI and FDI contribution in GDP was 14% in 2007. It was very significantly improving investment climate in B&H, but FDI entrance is still extremely sensible on uneconomic problems that Bosnia and Herzegovina has been affected by (corruption, political instability, complex bureaucrat procedures etc.). Besides that, singular B&H market is too small and disconnected with a small purchasing power which also isn't favourable for FDI entrance.

### **3. The most attractive fields for FDI entrance into B&H**

There are too many attractive economic fields for investment opportunities into Bosnia and Herzegovina. We can underline the following sectors as the most attractive for foreign investors: energy sector, infrastructure, the construction industry, agriculture and food production, beverages production, forestry and wood products, telecommunications, manufacturing of clothing, textile and leather goods, production and processing of metals, and production and processing of wood. All those sectors offer many advantages and opportunities for doing business. Besides that, foreign investors can use domestic skilled workforce with experience in manufacturing as well as in management.

The energy sector is placed on the first place, because it is well-known that Bosnia and Herzegovina owns with a relatively huge sources of primary energy (hydro-power before all, coal energy, wind energy,<sup>64</sup> solar energy ...).<sup>65</sup> So, there are too many possibilities for foreign investors to invest into construction projects on the Drina, Neretva, Bosna, Una, Trebisnica and Vrbas rivers and in the development of more than 200 small hydroelectric power plants on other sites is enormous.<sup>66</sup>

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<sup>63</sup> The banking sector, which has been completely reformed, has proved especially attractive to investors seeking new market opportunities. Currently, foreign banks own 86% of the B&H banking sector, ensuring employment for almost 9,000 people.; Source: <http://www.cbbh.ba/>

<sup>64</sup> According to recent research conducted by domestic and international experts, wind potential of Bosnia and Herzegovina has a 30% higher utility coefficient than the EU average and the highest potential in the Balkan region.; Source: <http://www.fipa.gov.ba/>

<sup>65</sup> The theoretical potential of hydropower in Bosnia and Herzegovina is calculated at 8000 MW, the technical potential 6800 MW and the economic potential 5600 MW. With an installed capacity of 2052 MW (53% of the total electricity generated), hydropower is highly significant in Bosnia and Herzegovina, although its potential is far from being fully exploited yet (37% of its economic potential).; Source: FIPA.

<sup>66</sup> Source: <http://www.fipa.gov.ba/>

Bosnia and Herzegovina has also relatively high agricultural potential.<sup>67</sup> Unfortunately, the B&H agricultural sector is much more underdeveloped toward EU. Agriculture sector in Bosnia and Herzegovina employees about 40% of B&H labour force, but in the case of EU it is about only 3-4%. It is sufficient proof that foreign investors can remarkably improve agricultural production through new technology introducing and labour productivity increment. Foreign investors have already recognized the value of this sector, but the advantages of investment opportunities in the agriculture sector still remain to be utilized.

The following sector which offers many opportunities for investments is tourism. B&H is a country with a large fortune in the sense of different cultures, religions, traditions and architecture where investment opportunities (for example: hotels, spas, restaurants, recreational, natural, historical, and cultural attractions) can be very attractive. Practically, the each tourism types (for example: cultural tourism, mountainous tourism, ecological tourism, religious and historical tourism, hunting, fishing and river tourism, health tourism ...) offer possibilities for investing. Very related with a tourism development, as well as industry, are the infrastructure and traffic roads. Up to the middle of 2003, when it was built the first 11 kilometres of modern highway, B&H was the only Southeast Europe state without any highway kilometre. At the beginning of 2009, B&H has had only 20 kilometres, probably the least kilometres per capita in Europe. All traffic types (roads, highway, railway infrastructure, airports) require urgent renovation.

There are also other types for foreign investing, such as: automotive industry,<sup>68</sup> banking and financial services, construction industry, forestry and wood industry, telecommunications, mining industry<sup>69</sup> ...).

#### **4. The measures for FDI entrance encouragement**

The market size is one of the most important factors for the higher level of FDI inflow from outsiders. The larger market size has the positive effect on FDI entrance. In that sense, the CEFTA enlargement on Western Balkan countries (CEFTA 2006 agreement) could bring a significant impulse for higher FDI level.<sup>70</sup>

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<sup>67</sup> Although much of the country is mountainous, there are over 1.5 million hectares of agricultural land in Bosnia and Herzegovina, both for crop growing and livestock rearing.

<sup>68</sup> B&H has tradition in the automotive industry, especially in production of auto components. The Volkswagen Group has recognised this tradition, so B&H's companies are connected in this way into the international automotive cluster which is looking for investment partners to expand production into wider international markets.

<sup>69</sup> The major companies in this sector are Mittal Steel Zenica and Aluminij Mostar, which are export-oriented enterprises and connected in wider international mining clusters.

<sup>70</sup> At the end of 2008. the parties of the CEFTA agreement are: Albania, Bosnia and Herzegovina, Croatia, Macedonia, Moldova, Montenegro, Serbia and Kosovo.

**Table 2.**

State	Accession	Population	Area (km <sup>2</sup> )	GDP in millions (PPP)	GDP per capita (PPP)
Albania	1 January 2007	3,619,778	28,748	19,920	6,300
Bosnia and Herzegovina	1 January 2007	4,590,310	51,209	28,166	7,100
Croatia	1 January 2003	4,491,543	56,542	68,980	15,500
Macedonia	1 January 2006	2,061,315	25,333	17,350	8,500
Moldova	1 January 2007	4,324,450	33,843	9,821	2,900
Montenegro	1 January 2007	678,177	14,026	6,135	10,600
Serbia	1 January 2007	7 400 000	88 361	77,280	10,400
Kosovo	1 January 2007	2,126,708	10,908	4,000	1,800

CEFTA 2006 membership.<sup>71</sup>

Criteria for CEFTA 2006 membership (World Trade Organisation membership *or* commitment to respect all WTO regulations, any European Union Association Agreement and Free Trade Agreements with the current CEFTA member states)<sup>72</sup> enable creation of free trade and unique market on the area of Southeast Europe.<sup>73</sup>

So, the closer relationship between Bosnia and Herzegovina and EU, that concerns introducing of market laws and institutions will enable her to access into wider international markets and membership into WTO. Cooperation between Bosnia and Herzegovina and its neighbours on economic principles and fulfilling of " *Stabilization and Association Agreement* " conditions and CEFTA integration will bring her a status of " *Acceding Country* " of EU.<sup>74</sup> All those factors will be very attractive for higher FDI entrance into B&H.

<sup>71</sup> [http://en.wikipedia.org/wiki/Central\\_European\\_Free\\_Trade\\_Agreement](http://en.wikipedia.org/wiki/Central_European_Free_Trade_Agreement)

<sup>72</sup> The current criteria for CEFTA membership were determined at Zagreb meeting in 2005.

<sup>73</sup> B&H also has free trade agreements with Turkey, as well as preferential export regimes with USA, Japan, Canada, Switzerland, Australia, Norway, New Zealand, Russia and Iran. According to the Interim Agreement, the preferential export regime with the European Union is in force, which provides that all goods of B&H origin that fulfill EU technical-technological standards and conditions, can be imported to all EU countries without any quantitative restrictions and without paying customs and other similar duties. Source: Foreign Investment Promotion Agency of Bosnia and Herzegovina.

<sup>74</sup> B&H foreign trade is concentrated on its neighboring countries and EU 27 members (93.1% of import and 76.9% of export).; The EU is Bosnia and Herzegovina's biggest trading partner, with total trade of around 5 billion euros in 2007. In 2007, imports coming from the EU made

## 5. The restrictions for higher FDI entrance into B&H

FDI entrance is extremely sensible on uneconomic problems that Bosnia and Herzegovina has been affected by (corruption, political instability, complex bureaucrat procedures etc.). That is a consequence of the three major transition processes (transition from war to peace, transition from a socialist command economy to a market-oriented economy and transition from being a part of a large nation to become an independent country with its own institution).

Besides that, Bosnia and Herzegovina is too small and disconnected market with a small purchasing power which also isn't favourable for FDI entrance. Bosnia and Herzegovina has very complicated state system (unknown in world history and legal science), and the direct consequences of that are many restrictions for foreign investors in Bosnia and Herzegovina. The best confirmation of that can be seen through World Bank's the Doing Business project.<sup>75</sup> The Table 3 shows the B&H position among 178 countries which were analysed by comparing regulation in their economies.

**Table 3.**

Ease of Doing Business	Doing Business 2008 rank	Doing Business 2007 rank	Change in rank
<b>Doing Business</b>	<b>105</b>	<b>105</b>	<b>0</b>
Starting a Business	150	147	-3
Dealing with Licenses	150	150	0
Employing Workers	114	115	+1
Registering Property	144	143	-1
Getting Credit	13	12	-1
Protecting Investors	83	81	-2
Paying Taxes	142	143	+1
Trading Across Borders	53	67	+14
Enforcing Contracts	126	125	-1
Closing a Business	61	69	+8

Doing Business project (B&H position among 178 countries).<sup>76</sup>

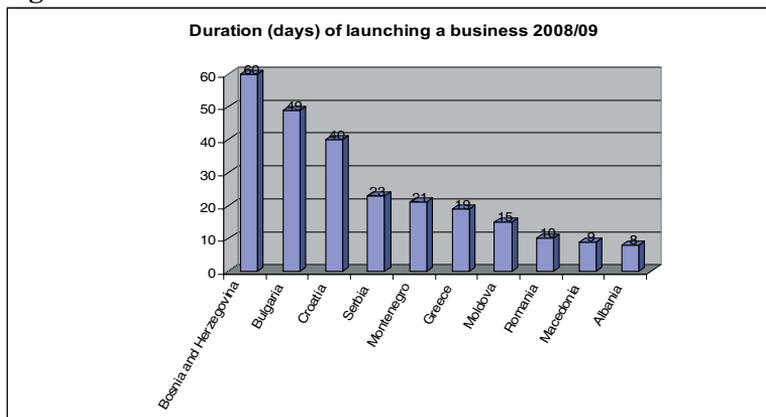
So, the starting a new business in Bosnia and Herzegovina takes the longest duration in relation to another countries in the region.

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up 66.7% of total imports by Bosnia and Herzegovina, while exports to the EU accounted for 71.4% of its total exports. Source: Ministry of Foreign Trade and Economic Relations.

<sup>75</sup> The Doing Business project provides objective measures of business regulations and their enforcement across 178 countries. The team works closely with thousands of professionals around the world. <http://www.doingbusiness.org/Documents/CountryProfiles/BIH.pdf>

<sup>76</sup> Source: <http://www.doingbusiness.org>

**Figure 3.**

Source: <http://www.doingbusiness.org>

B&H government has to simplify the procedures for doing business and grow the financial security for foreign investors as well as the number of their investments projects.<sup>77</sup>

## 6. Conclusion

Bosnia and Herzegovina is a transitional country which has applied the neo-liberal concept of economic development where the FDI entrance is one of the main items. But, Bosnia and Herzegovina is burdened with a many non-economic problems (for example: complex state system, corruption, duration of launching a business ...) and economic problems (for example: disconnected market, overly foreign trade liberalization, inappropriate macroeconomic policy as a whole) which restrain higher foreign investing activities. But, relatively high amount of natural resources which is owned by Bosnia and Herzegovina and its good geopolitical place can offer very attractive location for green-field investment. But, that should be followed with an appropriate macroeconomic policy in the sense of clusters industries creating and simplified procedures of launching a business. In that way, Bosnia and Herzegovina can significantly improve investment climate and become one the most attractive country for investing in the region of Southeast Europe.<sup>78</sup>

<sup>77</sup> The number of investment projects in Western Balkans was (1997-Q1 2006): Croatia 84, Serbia and Montenegro 70, Bosnia and Herzegovina 40, FYR Macedonia 11, Albania 8.; *Attracting Investment to South East Europe – Survey of FDI Trends and Investor Perceptions*, FIAS – The Multi – Donor Investment Climate Advisory Service – The World Bank Group, Washington, DC, November 2007. p.14

<sup>78</sup> The top Southeast Europe priorities for investing climate improving are: political stability, EU integration and infrastructure improvements.; Source: South East Europe Investor Perceptions Survey.; <http://www.worldbank.org/>

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