FDI in Bosnia-Herzegovina and Croatia - A comparable study:
Development and determinants of FDI and its effect on the
countries’ economy

Master’s Thesis in Finance and International Business

Author: Mia Kreso
Academic supervisor: Valerie Anne Rolande Smeets
Department of Economics and Business Administration
Business and Social Science

September 2014
Abstract

The aim of this thesis is to explore how the development of foreign direct investments has been in the two Southeast European countries; Bosnia-Herzegovina and Croatia. Both countries gained independence in the early 1990s which lead to the outburst of the Croatian Independence war and the Bosnian war. These factors, together with the transition process the countries were experiencing, have given these two countries an interesting position which is further elaborated in this thesis. The research design chosen is qualitative and together with the comparable study it makes the framework for this thesis. Four different research questions is discussed, all of them concerns different aspects of FDI. In the first research question FDI development in the two countries is studies. The results indicate that BiH and Croatia mainly follow the same FDI development, but that FDI in these countries will evolve differently in the future. Research question number two, concerning FDI vs GDP, did not yield any conclusive results, meaning FDI can affect GDP, but based on the data available in this thesis, the relation between these two are not clear. Question three and four deliberates on determinants associated with FDI, and indicates that there are some similarities and some differences in the main determinants for investing and that these determinants can also explain the major differences between FDI inflows. One of the major differences is discovered to be the unstable political situation in BiH, but also factors such as distance and Croatia’s EU membership have an impact. The conclusion in this thesis is drawn from data collected from second hand sources, and studies conducted on transition economies, determinants and FDI in general as well as being based on different FDI theories.

Keywords: FDI, Transitional economy, BiH, Croatia, determinants, motives, GDP
# Table of contents

1. **Introduction** .................................................................................................................. 1  
   1.1 Research questions ........................................................................................................ 2  
   1.2 Methodology .................................................................................................................. 3  
      1.2.1 Qualitative research ................................................................................................. 3  
      1.2.2 The Case study ........................................................................................................ 4  
      1.2.3 Comparable study .................................................................................................... 5  
   1.3 Research Approach ....................................................................................................... 5  
   1.4 Source reliability .......................................................................................................... 6  
   1.5 Delimitations ................................................................................................................ 7  
   1.6 Structure ...................................................................................................................... 8  

2. **Theoretical framework** .................................................................................................. 9  
   2.1 Multinational enterprises and foreign direct investments .............................................. 9  
   2.2 History of FDI .............................................................................................................. 9  
   2.3 FDI theories ................................................................................................................ 10  
      2.3.1 Vernon`s product cycle Theory .............................................................................. 11  
      2.3.2 The Internationalization Approach ...................................................................... 12  
      2.3.3 Dunning’s eclectic paradigm .............................................................................. 13  
      2.3.4 Uppsala model ..................................................................................................... 14  
      2.3.5 Other theories ..................................................................................................... 16  
   2.4 FDI motives and determinants .................................................................................... 18  
      2.4.1 Main FDI motives ................................................................................................. 18  
      2.4.2 Additional FDI motives ...................................................................................... 20  
      2.4.3 FDI determinants ............................................................................................... 20  
   2.5 Transition economies .................................................................................................. 23  

3. **Bosnia-Herzegovina and Croatia** ................................................................................ 27  
   3.1 Bosnia-Herzegovina .................................................................................................... 27  
      3.1.1 General information ............................................................................................ 27  
      3.1.2 Economy of Bosnia-Herzegovina ...................................................................... 28
3.1.3 FDI inflow into Bosnia-Herzegovina .........................................................30
3.1.4 Countries investing in BiH and sectoral distribution of FDI .........................32
3.2 Croatia ........................................................................................................33
  3.2.1 An overview of Croatia ........................................................................33
  3.2.2 Economy of Croatia ............................................................................34
  3.2.3 FDI inflow into Croatia ........................................................................36
  3.2.4 Countries investing in Croatia and sectoral distribution of FDI ...............37
4. Comparison and discussion ...........................................................................39
  4.1 FDI development and economic impact .....................................................39
  4.2 FDI determinants .....................................................................................42
5. Conclusion .....................................................................................................47
6. References .....................................................................................................50

List of figures

Figure 1: FDI inflow to Bosnia-Herzegovina from 1998 to 2013 ...............................31
Figure 2: FDI inflow by other countries (BiH) in percentage of total amount FDI ....32
Figure 3: Percentage of FDI into different sectors in BiH ......................................33
Figure 4: FDI inflow to Croatia from 1992-2013 ..................................................37
Figure 5: FDI inflow by other countries (Croatia) in percentage of total amount FDI ..38
Figure 6: Percentage of FDI into different sectors in Croatia ..................................38
Figure 7: Comparison of FDI inflow to Croatia and BiH from 1992-2013 ...............40
Figure 8: Comparison of FDI and GDI in BiH and Croatia ......................................42

List of Appendixes

Appendix A: Full overview of FDI to the countries ..................................................55
Appendix B: Some determinants for Croatia ............................................................56
Appendix C: Some determinants for BiH .................................................................58
Appendix D: Explanations for appendix B and C ......................................................60
List of abbreviations

BiH: Bosnia-Herzegovina
BRICS: Brazil, Russia, India, China, South-Africa
CEE: Central- East Europe
FDI: Foreign Direct Investment
FIPA: Foreign Investment Promotion Agency
GDP: Gross Domestic Product
GNI: Gross National Income
HDI: Human development index
MNEs: Multinational Enterprises
OECD: Organization for Economic Co-operation and Development
OHR: Office of the high representative
OLI: Ownership, Location, Internalization
PLCT: Product Life-Cycle Theory
SEE: South-East Europe
UN: United Nations
UNCTAD: United Nations Conference on Trade and Development
1. Introduction

Bosnia-Herzegovina (BiH) and Croatia are young European nations that have been independent for approximately 20 years. They share almost the same language, a long boarder and the history of being a part of Yugoslavia. Moreover, since their independence, they have both been through a war while changing from a planned economy to a market economy. The combination of all these factors places BH and Croatia in a very special position, not shared by many other countries. Still, they are two different countries, with different opportunities and challenges. The war in BiH, for instance, had a worse impact on the country than the war in Croatia. Furthermore, Croatia and BH were in 2013 ranked as number 74 and 111 respectively on the World Banks list of countries by GDP\(^1\). On the Human Development Index (HDI) for 2013 Croatia was defined with a very high HDI, ranking as number 47 in the world, while BH was defined with a high HDI ranking as number 86 (World Bank, 2014c, United Nations, 2014)

Research has been conducted on FDI in BH and Croatia, but mostly as part of a comparison of several transition economies or for the countries themselves. Generally, there is not a lot of research comparing FDI in only two neighbouring transition economies. When taking this into account, together with the aforementioned differences in list ranking, it becomes evident that BH and Croatia have had an unusual development compared to one another. It is therefore interesting to compare these two countries and see how other countries have viewed their opportunities and challenges by taking a closer look at the development of FDI and attempt to detect reasons for the potential differences.

By discussing several economic factors in addition to social factors, the goal is to shed light on why BH and Croatia differ in terms of FDI and to contribute with a better understanding of why foreign investors decide to invest or not in these two countries and to which extent this affects their economy.

---

\(^1\) When referring to GDP in this thesis I refer to GDP(nominal) per capita.
1.1. Research Questions
This thesis aim at examining two aspects of FDI in BiH and Croatia: its determinants and its development. The impact FDI has had on the countries’ economy is analysed through the development of GDP. Hence, the research questions are divided into two parts, with two questions concerning the FDI development and two questions concerning its determinants. The research questions are formulated to best identify differences and similarities as well as development and change in both countries.

Research questions for FDI development and its economic impact
- How has the development in FDI been in BiH and Croatia since they became independent nations and what kind of development can we expect in the future?
- Has FDI had any impact on the countries’ GDP?

Research questions for FDI determinants
- What are the main determinants for investing in BiH and Croatia?
- Can differences in determinants explain why some countries invest more or less in Croatia than BiH?
1.2. Methodology

1.2.1. Qualitative research

In this paper the qualitative research method will be used. The qualitative research method is an in-depth investigation of non-measurable information employed in a variety of academic disciplines, also economic research. Qualitative research can be evaluation of narrative data like interviews, pictures, video or text, whereas quantitative research examines numerical data (Easterby-Smith et al., 2012). Qualitative research often seeks to understand human behaviour and the reasons that govern such behaviour by investigating the “why” and “how” questions, not just “what”, “where” and “when”. Hence, smaller but focused samples are more often used than large samples (Yin, 2009). The investigator performing a qualitative research will use many different interpretive practices to analyse these qualitative data and thereby make the “world visible” (Denzin and Lincoln, 2011). LeCompte and Preissle (1994) define qualitative research as:

“A loosely defined collection of approaches to inquiry, all of which rely on verbal, visual, tactile, olfactory and gustatory data. These data are preserved in descriptive narratives like field notes, recordings or other transcriptions from audio-and video-tapes, other written records and pictures or films. Artifacts – consisting of products people use, objects people make, and records of what they do, say, produce or write- are also collected as qualitative data”. (LeCompte and Preissle, 1994, p141)

FDI is often performed on behalf of organisations or nations, by humans from different cultural backgrounds and with different knowledge and motivations. All these factors impact the complex process in which FDI are made. In order to investigate FDI it is therefore necessary to use a methodology adequate for such a complex investigation. Thus, I believe the qualitative methodology will give me the best opportunity to capture the many facets of FDI. The information evaluated when investigating FDI will of course involve qualitative numbers as this is an essential part of the decision making process behind FDI and a measurement of FDI level (Yung, 2007). Quantitative statistical data conducted by institutional agencies and governments, as well as secondary empirical research; will supplement the thesis. This is not contradictory to a qualitative method, but complementary and sometimes necessary in order to best answer research questions and to improve the accuracy and credibility of the conclusion drawn (Van Maanen, 1979).
1.2.2. Case study

Within the qualitative methodology, a case study approach was chosen. A case study is not limited to a certain data collection method and allows the necessary combination of qualitative and quantitative evidence (Yin, 1981). This makes it well suited for international business research with complex cross-border interactions. As a research strategy, it can be distinguished by its attempt to examine “a contemporary phenomenon in its real-life context, especially when the boundaries between phenomenon and context are not clearly evident” (Yin, 1981, p.59). Case studies can, according to Yin (2009), further be categorized as exploratory, descriptive or explanatory. The exploratory approach is applied to new research fields and to cases where the research questions have not been clearly specified and still requires data. The descriptive approach is used to portray a profile of situations and events by describing the different characteristics of a phenomenon. The explanatory approach is used in a mature research field, as it explains a phenomenon and relates events (Yin, 2009). In this thesis the descriptive and explanatory research designs will be combined. Even though information about FDI in BH is scarce for the early 1990s, FDI is a mature research field with easily available information. Some of the research questions are “what” questions, which are traditionally exploratory questions. However, these questions require the use of theory to be answered, and therefore do not qualify as exploratory. Instead, this case study is descriptive in its analysis of BH and Croatia’s economy and determinants and explanatory in its approach to explain, relate and predict the future of these.

In a case study the literature review is foremost used to sharpen the research questions. Previous findings from the developed theories therefore guide the data collection and analysis. Qualitative evidence found, will, at the end of the study, lead to a discussion of the chosen theories’ relevance to the given case and can aid in answering the research questions and conclusion making (Yin, 2009).

The case study’s particular strength is its ability to handle complex situations, making it possible to show different perspectives, while keeping a holistic as well as an in-depth view. It can also give insight into cause and effect and show how processes work over time. The case study’s limited generalizability is its most criticized aspect. According to Stake (1995) generalization is either petit (within the case) or grand (applying conclusions from one case to another). In addition, there are several other deficiencies with the qualitative research method. The data collected can become too
abundant and complex to analyse and the analysis can also be biased by both the researcher and the supplier. Therefore, the analysis depends on the analytical skills of the researcher. Furthermore, the amount of data makes the method time consuming, which in a large scale would make it expensive to administer (Yung, 2007).

1.2.3. Comparable study
The main object with a comparable study is to examine patterns of similarities and differences across different events, countries or cultures. Two or more variables are compared to learn more about the objects included in the comparison. Hence, the goal is to identify causal links and how different variables produce different outcomes across the range of cases included in a study. A comparative study is not connected with any special method, meaning that this approach is flexible and can be used in different types of studies, such as a case study. One of the problems with this type of study is that the data used in the comparison may be gathered from different sources, which might have different definition and include different aspects in their data. As this thesis deals with two different countries, the possibilities for biased data are present when data is collected from national sources (Ragin, 1989, 1994). Therefore most of the data in this thesis are gathered from the World Bank, to make the comparison more precise and reliable.

1.3. Research Approach
In accordance with the case study approach, work on this thesis started with research of existing literature on multinational enterprise (MNE) and FDI. The most relevant literature will be presented as a literature review, where the aim is to provide a theoretical framework in order to answer the research questions in the best possible manner. As this thesis is looking at FDI from a macro perspective, focus will be on FDI macro-theories. However, Dunning’s eclectic paradigm is included in this thesis even though it is both a macro and a micro theory and hence, only part of the theory will be used. As it is one of the most renowned and accepted FDI theories, I believe it will improve the reader’s understanding of FDI as well as being valuable when answering the research questions.
To increase the thesis’ validity, multiple theories will be used simultaneously for analysis. This research approach, named theoretical triangulation, allows for different perspectives on the same scenario increasing the likelihood of accurately reflecting the situation researched. However, triangulation has its limitations, which it is important to be aware of when applying it in research. Its most important limitation is the poorly defined theoretical framework (Guion et al., 2011).

The next step in this thesis was to collect descriptive and statistical data for both countries. Statistical data was, like the theories, collected in a triangular fashion as data and statistical evidence collected from several sources were compared to increase validity. These are presented in section 1.4.

The data collected will be presented as graphs throughout the thesis as well as in the appendix. For the best possible visualization, results will be presented as histograms and linear graphs for FDI and GDP development over time, which also will simplify comparison between BiH and Croatia. For a better understanding of FDI development, countries investing in BiH and Croatia will be presented in sector diagrams to visualize each country’s contribution to the total FDI. Also sectoral distribution of FDI will be presented in sector diagrams.

Lastly, all the relevant theory, together with all the collected data, will be discussed and used to answer the four research questions and to draw a conclusion.

1.4. Source reliability
The data used in this thesis are gathered from international sources such as the World Bank, UNTCTAD, Eurostat and local sources such as Central Bank of Bosnia and National Bank of Croatia. The World Bank is the most used source in this thesis as it provides information about several important variables and focus on high quality data through the use of internationally accepted standards, methodologies, sources, definitions and classifications. Furthermore, the World Bank data are presented in a way that are consistent in definitions, timing and methods, but updates and revisions can occur, which means that the data from one year does not necessarily match data form another year.
This can cause problems when using articles or rapports written a few years ago. Some of the data are also based on estimations rather than actual figures, which could lead to inaccuracies. In this thesis therefore, as recent figures as possible will be used. In cases with older data, there could be some problems with credibility, which again might affect the conclusion of the hypothesis. Using data from different sources and combining them can also lead to wrong assumptions, as the data might not be comparable.

Data from national statistics are not always in accordance with the international data. The Croatian National Bank have other variables included in their FDI calculation than for example World Bank, meaning that these numbers will not match. Numbers and information provided from Foreign Investment Promotion Agency (FIPA) should also be viewed with a critical eye, as the organization attempts to attract as much FDI as possible to BH. This could bias FIPA to present data and factors more favourable than they really are. Hence, numbers provided by Croatian National Bank and the Central Bank of Bosnia-Herzegovina will merely be used to supplement the international sources.

1.5. Delimitations

This thesis is limited through a case study’s limitations. Firstly, the thesis is limited by its timeframe and the abundance of data to be analysed during this time. Therefore, not all available data will be analysed, which could affect the final conclusion. Secondly, the discussion and conclusion is affected by the theoretical framework. Some less important theories are mentioned in section 2.3.5, but others, though they might be important to the development and history of FDI will not help answer this thesis’ research questions and are therefore left out. Determinants presented in the thesis are also a main selection made due to the time and data limitations. This selection affects the discussion and conclusion of this thesis. Lastly, generalization occurs on both a petit and a grand level. This thesis does not include an in-depth analysis, but generalise conditions and FDI in both countries to provide an overview. To decrease generalization and to increase insight, FDI to sectors within both countries are included. As determinants are described either separately or for other countries in other case studies, this thesis does a grand generalization when applying results from these as a base for the main determinants for BiH and Croatia. Therefore, microeconomic effects, making firms invest in BH and Croatia, also fall outside the scope of this thesis.
In addition, this thesis is limited due to the lack of data availability caused by the two independence wars and the chaotic post-war situations, especially in BiH. It is worth noting that FDI varies with different sources, which is probably due to the use of different variables to determine the inflow of FDI. Even though the numbers differs slightly, FDI fluctuations according to the World Bank statistics are identical to the ones found in statistics by the countries’ national banks. For instance, the Croatian National Bank, records country of origin of the final transaction even though FDI transactions are often being executed through third countries. As a result, misleading statistics are sometimes recorded. The statistics are also limited as they are not able to capture the effect of the high black-market activity in the countries, particularly in BiH (CIA, 2014). The growth rate in this thesis is calculated by three different methods; east squares, exponential endpoint, and geometric endpoint (World Bank, 2014e). This can be problematic if one method is used one year and another in another year.

Lastly, the first research question asks for the future of both countries, this will be limited to the close future of 5-10 years.

1.6. Structure
The theoretical framework will be presented in chapter 2, starting with definitions of MNE and FDI, before FDI is placed in an historical context and the different theories are presented. The theoretical framework also includes a presentation of transition economies and a presentation of motives and determinants for FDI. Chapter 3 gives a short description of BiH and Croatia with statistical data for the two countries, exploring their economies. In chapter 4 these data, together with the theoretical framework will be used to compare the two countries and the findings will be discussed in an attempt to answer the research questions. Finally, a conclusion is given in chapter 5.
2. Theoretical framework

2.1. Multinational enterprises and foreign direct investments

A multinational enterprise (MNE) can be defined as an enterprise present with facilities and/or assets in at least one other country besides their home country, where a significant part of the revenues are attained from operations conducted abroad. When an MNE conduct a direct investment in a foreign country by expanding an existing business (which is a contrast to portfolio investment) or buying a business in the foreign country, it is designated foreign direct investment (FDI). Thus, the main objective with FDI is to obtain a long-term relationship between the company conducting the investment and the business abroad, thereby giving the MNE a significant degree of influence over the management of the foreign business (Investopedia, 2010). The World Bank defines FDI as:

“Foreign direct investment is the net inflows of investment to acquire a lasting management interest in an enterprise operating in an economy other than the investor. It is the sum of equity capital, reinvestment of earnings, other long-term capital, and short-term capital as shown in the balance of payments” (World Bank, 2014e)

2.2. History of FDI

After WWII, international trade and FDI grew rapidly. At this time there were no main theories of why and how countries conduct FDI, but many studies were now being completed and theories on FDI started to emerge (Denisia, 2010). The research mainly focused on finding determinants for conducting FDI. Researchers like Robinson (1961), Deane (1970), and Forsyth and Docherty (1972) contributed to the field by studying the correlation between FDI and a variety of environmental factors. The results varied slightly from study to study, but generally political stability, market growth and arrangement in the existing market were found to be some of the major determinants for FDI.

The research on FDI continued and one of the first models for FDI, the Kemp-MacDougall model, was developed in 1962 (revised 1966). The model was based on the neoclassical model by Heckscher-Ohlin from 1933, which considered FDI a part of international capital movement, where the capital between two countries moves freely from the abundant country to a capital country, ending in equalization between the countries (Faeth, 2009).
Some scholars criticized the neoclassical trade theory as limited and claimed it did not explain FDI flows well enough due to its assumption of perfect markets. Hymer (1976) and Kindleberger (1969), who believed that FDI should be analysed in connection to imperfect markets, were among the first critics. They claimed that no market advantages could be created in a perfect market, and for the company to engage in FDI they should be able to achieve ownership advantages to balance out the disadvantages of entering foreign market. Furthermore, critics argue that advantages such as product differentiation, economics of scale, managerial expertise can only be achieved if the market is imperfect. Two important assumptions underlying this view is that it is cheaper for the company to use these advantages abroad than in the home country and that these advantages are so valuable to the company, that they, if possible, will prefer an FDI over other selling them. (Faeth, 2009)

2.3. FDI theories

There has been several discussions concerning what drives MNEs to invest in foreign countries, and the two most common perspectives in this discussion were the micro- and macro perspective. The micro environmental perspective tries to explain motives from the companies’ or the investors’ perspective, while the macro perspective explains FDI as a capital flow between countries. Thus, the micro factors can be related to the company itself such as ownership advantages, cost reduction and economies of scale, while the macro factors looks at market specific factors, such as barriers to entry, availability of resources, political stability, good infrastructure, market size and country risk (Faeth, 2009, Assunção et al., 2011). In the last 15 years companies have started looking at FDI as an important factor in capital collection and development of the country’s strategies. Countries have therefore started to compete for FDI (Te Velde, 2006). The amount of research on FDI has helped countries to understand what makes a company conduct an FDI, and what countries can to do attract more of these types of investments. In the latest years it has become commonly accepted that FDI cannot, and should not, be explained by a single theory, but by a combination of several. This FDI approach has been strengthened by a variety of empirical evidence which found that the various FDI theories does not necessarily replace each other, therefore all of the theories can be relevant in explaining the determinants behind FDI (Faeth, 2009).
In the next paragraphs, a variety of macro FDI theories will be reviewed. Not all of these theories are of great importance to this thesis, but they are included in order to provide the reader with the best overview of FDI macro perspective. Since this paper focuses on the macro perspective for investing in two specific countries, it is more relevant to look at the macro determinants. A selection of determinants will be reviewed through empirical data collected from other studies.

2.3.1. Product Life-Cycle Theory

Product Life-Cycle Theory (PLCT) was developed by Vernon (1966) who related investment theory with trade theory and claimed that the investment decision was a decision between investing and exporting. Furthermore, he argued that these decisions change according to the product’s life cycle stage. The theory states that there are three stages a product will go through; new, matured and standardised. In the first stage the product is in the developing phase where it is being introduced to the market and where a lot of the costs come from innovation. This phase can be very demanding and expensive for the company. As a result, this phase usually starts in a developed country like U.S where it is easier to establish a good connection between the producers and the market. Here it will be easier to access new capital and the risk and uncertainty can be minimized by starting with small a production, until it is known whether or not the product will become a success. At the end of this phase, the company can also begin exportation of the product. In the maturing stage, the demand will grow, and the export sales become more important. By now the product and the production process are usually stable, providing the company with some economies of scale. As export to other countries increases, the company will, in some cases, be better off by starting a production facility abroad. Producing abroad can give lower costs, especially labour costs, and the company will increase competitiveness as well as avoid certain import restrictions set by foreign governments. In the standardized stage, the product is standardized and the company can enable further economies of scale. Skilled labour is not needed any longer, giving the company the opportunity to conduct an FDI in less developed countries with lower labour costs. The main critique towards PLCT is the implicit claim that all products follow the same path and that some products are of such a shape that the will never be considered a cheap and standardised product (Storper, 1985).
2.3.2. The Internalization approach

Buckley and Casson (1976) extended the concept of internalization introduced by Coase (1937) into one of the major theories of FDI, the Internalization Theory. Coase’s theory is based on the concept of market imperfections; the market was often inefficient due to market failure and comparing the efficiency of various forms of transactions between firms, showed that firms were better off internalizing transactions. By using a market which brings high risk and uncertainty, the enterprise could end up with high transaction costs such as information-, enforcement- and bargain-costs. Coase himself did not focus on MNEs, but Buckley and Casson claimed that his theory could be applied to MNEs as well. Instead of engaging in joint ventures and contracts with a company, Buckley and Casson’s findings suggests FDI should be incorporated into the already existing enterprise. Critical factors which have an impact on the internalization decision can be divided into firm-, industry-, region- and nation-specific factors. Firm specific factors reflect the ability of the management to organize an internal market, while industry specific factors are related to the nature of the product and the structure of the external market. Geographical and social characteristics of the region-linked by the market are denominated region specific factors and factors relating to the political and fiscal relations between the nations involved are denominated nation specific factors (Faeth, 2009, Rugman and Verbeke, 2003).

Several other scholars have later added other aspects to the Internalization approach or in other ways developed it further. There are too many changes and scholars to mentions all of them, but two of the best known will be mentioned here. Rugman (1975) stated that one of the motivations for conducting an FDI is that it allows companies to spread their risk. This risk diversification would be achieved through FDI as a product might be forced to change in a new market. Since these two versions of a product might differ, a problem in one market will not necessarily manifest in both markets, and the foreign market might react differently than the home market. Hennart (1982, 1991) focused on horizontal and vertical integration. He argued that internalization advantages could be due to know-how or goodwill, which would lead to horizontal integration. Lack of competence in other markets would lead to vertical integration. By making an MNE hierarchy, whether it is a horizontal or vertical, instead of using the price market, the company could eliminate transactions costs and become more efficient.
All the additions to the Internalization Theory were provoked by critiques and helped the development of the Internalization approach. A very important critic was the lack of localisation advantages, identified by Dunning that led to the OLI paradigm presented in the next section.

2.3.3. Dunning’s eclectic paradigm

OLI eclectic paradigm is a framework developed by Dunning (1977, 1979) where he tried to integrate the existing FDI theories in an eclectic model that was supposed to explain the extent and pattern of international production. The main variables in the OLI-paradigm are the Ownership (O) advantages from firm-related theories, location (L) advantages from host-country related theories, and internalization (I) advantages from theories on market imperfection. These variables can be applied in trade, international production and international organisation, allowing the OLI framework to cover internalisation modes such as FDI, exports, and licensing. According to the OLI-paradigm the composition is context specific, meaning that the economy, political features and the industry in the home and host country will have an impact on the internalization decision. Moreover, the three variables are interrelated and consequently one has to focus on all of them simultaneously rather than individually. Dunning also stated that the paradigm is not prescriptive, but rather an explanation of how internalisation is taking place (Dunning and Lundan, 2008).

The O refers to the competitive advantages a company have in their local country. The higher the advantage is, the more likely the company is to engage in foreign countries as it increases the company’s possibility to generate positive profit. If these ownership advantages are strong, the company should exploit the opportunity to conduct an FDI. Hence, ownership advantages explain why companies go abroad. The company can achieve ownership advantages by controlling specific assets which are not easily available for competitors. Different types of ownership can advantages include intangible assets, such as product innovation, knowledge and production management (Dunning and Lundan, 2008).
L in the OLI answer the question of where the company should go as the host country must possess some locational advantages. The foreign country/countries with the highest location advantages will add value to the MNEs by undertaking new activities and will therefore be chosen as the host country for an FDI. Examples of locational competitive advantages are resource endowments, market size, cultural relations, social and political framework and low taxes, wages and transportation costs.

Lastly, the I explains how the company should enter a foreign country. Companies can, in many cases, profit from establishing their own production facilities in foreign country instead of producing through more indirect arrangements such as licensing. Without the advantage of internalization, much of the foreign direct investment would probably be replaced by contracts between the home country and the new foreign country. Other reasons to internalise are avoidance of entry barriers set up by the local industry and restrictions on import and export as well as the gain of more control in countries with weak and unclear rights. Internalization is also closely linked to the theory of transaction costs where the option of outsourcing versus completing the in-house decision, is made on cost and ease of transaction.

Even though the eclectic paradigm is renowned and much used it has been criticized for the lack of explanations, being too general and being difficult to use since it is not a formal theory that can be proved in a scientific way. Despite the criticism, the paradigm is a good framework and has remained one of the dominant analytical theories for determining MNEs activities and their use of FDI. After his first article introducing the OLI paradigm in 1979, Dunning has written several articles about OLI with several new suggestions, alterations and tried to explain unclear matters(Dunning and Lundan, 2008).

2.3.4. The Uppsala model

The Uppsala model was suggested by Johanson and Vahlne (1977), and is based on research performed on Swedish manufacturing companies, attempting to explain the process companies go through early in the internalization process. The main finding from this research was that companies slowly and gradually expand as their knowledge about the foreign market and operations increase. An increase in market knowledge was believed to have a direct impact on the commitment to the foreign market and
the commitment gained would increase the business activity in that market. According to the model, companies’ expansion is also closely related to physical distance between two markets and companies therefore expand to countries with a market close to the domestic one before expanding further away. Factors such as language and culture are believed to lower marked uncertainty, which is the main reason for expanding to similar markets. Based on these thoughts the Uppsala model can be divided into four stages, where the first stage is when the company develops in their home country and slowly starts exporting to neighbouring countries. In stage two the company export via agents and in the third stage the commitment is believed to be strong enough for the company to establish sales units. As the knowledge of the market increase, more resources will be invested, which will lead to step four, which is to establish a manufacturing unit. In this last stage, the country will conduct an FDI, in contrast to the first stage where exporting, licensing and joint ventures were the preferred choices. The Uppsala model was revised several times and there were also conducted a great deal of empirical research on the theory. Bilkey and Tesar (1977) and Fina and Rugman (1996) were among the researchers who found support for the theory in their research, while researchers such as Sullivan and Bauerschmidt (1990) and Melin (1992) reported little or no support for the Uppsala model.

Even though the model gained some popularity in the field it was also heavily criticized. Some of the critics argue the model was not valid for large MNEs (Björkman and Forsgren, 2000). Nordström (1991) wrote an article that criticized the Uppsala model on several levels. His believe was the model did not match the world’s development, as markets have moved toward homogenization where information is easier to access. The criticism lead to a revision of the model in 2009, by the researchers, in the article “The Uppsala internationalization process model revisited: From liability of foreignness to liability of outsidership”. There were no great changes to the model, but some important modifications were made, making the model more accurate.
2.3.5. Other theories

Several different FDI theories exist, next to the ones already mentioned, and it is almost impossible to mention all of them. Still, there are some other theories worth mentioning as they might provide more insight in this thesis. One of these is the institutional approach, which believes that companies operate in a complex environment which is uncertain and confusing. Consequently, a company’s decision will depend on the institutional forces that influence its environment (Francis, 2009). Which strategies the company decide to use, is largely determined by the foreign countries’ institutions and policies (Peng, 2009). Policies which have an impact on the decision are tax regimes, subsidies, access to capital, and other fiscal and financial incentives. All of these factors can influence whether a company choose to export, license or to conduct an FDI.

Another macroeconomic perspective FDI theory was developed by Kojima (1973) and later further developed and complemented. The neo-classical based trade theory is built on a comparison between Japanese and American FDIs and Kojima argues that the Japanese type is “pro-trade FDI” (FDI complements trade), while the American type is “anti-trade FDI” (FDI substitutes trade). He focuses on the differences in the home structure (institutional and social) in which firms operate as well as the strategic goals and industrial policies of the home governments. Kojima claims FDI will improve production, the industrial structure (on both sides) and facilitate trade if investment flows from a comparatively disadvantageous industry in the investing country compared to the recipient country; transferring capital, managerial skills and technology. In contrast, investments from an industry with comparative advantage in the investing country to a country in a disadvantageous position would block the reorganization of international trade leading to loss of efficiency. Kojima supported the Japanese effort to invest in developing countries in industries where these countries are gaining or are expected to gain. Thus, he advocated Japanese investments in natural resources, as Japan is at a disadvantage and developing countries in an advantage in this field. Generally, Kojima claims industries chosen in the developing country should not only serve the benefit of the investing country, but be export oriented. Furthermore, Kojima stated that trade barriers should be liberalized and argued for a free trade policy in order to make cost similar (Dunning and Lundan, 2008).
Either (1986) criticized the theory for over-focus on factor endowments and states that the larger part of MNEs are between countries with relatively similar factor endowments. Dunning (1988) also criticized Kojima theory on several accounts such as the theory’s ignorance of FDI prompted by the desire to rationalize international production and market failures and he found the dichotomy between Japanese and American MNEs artificial.

Most FDI theories are built on the idea that trade occurs due to comparative advantages between countries and unlimited free trade. The “new trade theory” suggested an alternative framework for analysing FDI and MNE activity. Several economics contributed to this theory (initiated by Krugman in the 1970s), recognizing that trade and gains from trade can arise independently of comparative advantages as firms pursue strategies of product differentiation and exploit economies of scale. (Faeth, 2009, Markusen, 2002). The theory suggests it might be in a country/firms best interest to import a good although there may be no disadvantage for a country to produce it. This way, the trade of such goods is protected and the country/firm can better specialize in other products and attain economies of scale. Following this logic the theory suggests that monopolies or oligopolies might not be negative for the world market, neither for consumers nor businesses. Because this new trade theory correlates ownership and location advantages with technology and a country’s characteristics it can be used as a complement to Dunning’s eclectic paradigm (Markusen, 2002).

Several empirical studies have been published on this theory, but a critique against the new trade theory is their view of a firm as nationally-owned production facility, meaning an organization that produces one good, in one location. However, multi-plant production is generally excluded from new trade theory analysis, even though industries characterized by scale economies and imperfect competition are often dominated by multinationals. (Markusen, 2002).
2.4. FDI motives and determinants

2.4.1. Main FDI Motives

In order to examine why companies engage in FDI, we have to understand the motivation behind the decisions. Using and extending the taxonomy developed by Behrman (1972), Dunning (1993) found four main categories of motives; natural resource seekers, market seekers, efficiency seekers and strategic asset and capability seekers. He argues the market and natural resource seekers primarily motivate new FDI, while efficiency and asset seekers primarily motivate subsequent investments. Today many MNEs might have more than one motivation to persuade an FDI. Separating MNEs into categories is therefore not always feasible. To complicate matters further, MNEs are today often involved in different types of markets, where the changes can be rapid. The motivation when planning an FDI is therefore not necessarily the same when the company has come further in the development process in the foreign country. Nevertheless, the four main FDI motives will be presented in the following paragraphs according to Dunning’s taxonomy (Dunning and Lundan, 2008).

**Natural resource seekers** can be divided further into three categories. The first one is those MNEs that seek physical resources, either because there is a lack of the resources in their home country or because it might be cheaper to acquire in other countries. These resources include natural resources like metals and minerals as well as agriculture products. In the latest years companies also invest in service activities such as tourism, car rentals, oil drilling, construction and medical and educational service. These investments are of course locally bound, which might involve a higher risk. The second category is those MNEs seeking cheap and well-motivated unskilled or semi-skilled labour. Such FDI usually involves a country with high labour costs investing in countries with low labour costs. Finally there is the MNEs need for expertise they cannot get in their home country, or which might be cheaper abroad. Technology, marketing and organizational expertise are some examples.

**Market seekers** invest in particular countries to supply goods or services to markets in these countries. Their main objective is to exploit or promote a new market. Four additional reasons for seeking new markets can be identified. Firstly, if a supplier or customer has established a facility abroad companies might not be able to retain cooperation with these suppliers or customers if they do not follow. Secondly, companies want to adapt the service or product to the new country, especially in the food
industry, where it is normal to change the tastes on different products. Thirdly, production and transaction costs might get lower by having a production facility in a foreign country instead of the home country. The government in the host country might also prompt companies to move the production facilities to another country. Countries that are geographically far away from their potential market are also more interested in engaging in market seeking. Fourthly, and maybe most importantly, MNEs consider it crucial to have a physical presence in a market served by their competitors.

*Efficiency seekers* seek to gain benefits from economies of scale or/and scope. Their motivation can also be to diversify risk. Taking advantage of economies of scale and scope commonly takes place between countries that have similar economic structures and income levels. Those seeking risk of diversification take advantage of differences in the relative cost and availability in different countries’ traditional factor endowments.

*Asset seekers’ objective is to promote long-term strategic objectives, especially that of sustaining or advancing their global competitiveness. They achieve this through increasing their global portfolio of human competences and physical assets, which they perceive to weaken competitors’ advantages or increase their own. Asset acquirers aim to benefit from imperfections in the intermediate product market and may even add to these. Especially highly-technological industries are motivated by acquiring assets, but FDI motivated by assets are increasingly undertaken by MNEs from emerging economies.*
2.4.2. Additional FDI motives

In addition to the main FDI motives, there are some motivations that do not fit in under any of the four categories described in the former paragraphs, which should be mentioned. These can be divided into three groups; escape, support and passive investments (Dunning and Lundan, 2008).

*Escape investments* are performed by companies wanting to escape certain legislative restrictions or other restrictions in their home country, though escape is a determining factor, it is rarely the only motivation behind a foreign investment. Companies motivated this way are concentrated to highly regulated sectors (such as the service sector) and countries.

*Support investments* are made to support activities that the rest of the enterprise engages in, and these types of investments are rarely self-contained. It is especially used for monitoring the parent company and to help promote and run the exports from the parent company, in the foreign market. These investments are often trade and financial related and has gained more recognition in the latest years.

*Passive investments*, as the name indicates, involves passive instead of active management and are usually portfolio investments. For an investment to be considered passive it results in less than 10% financial equity interest. Passive investments is undertaken to gain capital appreciation or to earn profit and expresses faith in the existing management and organization of a company.

2.4.3. FDI determinants

FDI theories mentioned earlier in this paper, attempts to explain why companies conduct FDI in particular locations, based on several determinants. Locational determinants such as market size, infrastructure, labour cost, inflation rate and other types of determinant can be controlled by the local government. This also includes fiscal and financial policies, such as tax-rate, which can measure the business climate and the ratio of trade that can indicate a country’s openness (Botrić and Škuflić, 2006).
The literature and empirical evidence concerning FDI determinants are substantial (Blonigen, 2005) and the empirical work is generally based on investor surveys and econometric in-depth case studies (Mottaleb and Kalirajan, 2010). As determinants depend on several country, industry and company specific characteristics, these studies mainly focus on specific regions and countries such as Sub-Saharan (Asiedu, 2006), China (Cheng et al., 2008), BRICS² (Vijayakumar et al., 2010) and South Eastern European countries (Botrić and Škuflić, 2006). Due to the complexity of identifying determinants and the lack of wide range studies, it is difficult to review any general determinants for investment. Still, it is possible to identify some similarities between the different studies, even though some scholars disagree. These similarities, using the most important determinations, will be discussed further in the subsequent paragraphs, although the different studies mentioned not necessarily include BiH or Croatia.

*Infrastructure*, such as communication network, power supply and transportation system is believed to be one of the determinants to attract FDI, as it will be easier for the company to produce and distribute their goods with a developed infrastructure (Vijayakumar et al., 2010). There have been conducted studies on this determinant, but the results vary, giving inconsistent conclusions. Some authors found a significant positive relation between FDI and infrastructure (Biswas, 2002, Asiedu, 2006, Vijayakumar et al., 2010, Mhlanga et al., 2010) while others found no evidence of infrastructure affecting the FDI (Cleeve, 2008).

*The stability* of the economic and financial circumstances is also believed to be an important determinant for FDI. Countries with this stability are believed to have more stable prices, low unemployment rate and a balance of payments equilibrium which again has a positive effect on the FDI inflow (Cleeve, 2008). It is possible to measure these determinants, for example by using the inflation rate, which reflect the price stability in the country. A high or volatile inflation rate is usually connected with an unstable economy, meaning that the FDI in such a country is presumed to be lower than in countries with stable inflation rates (Botrić and Škuflić, 2006). One of the more surprising conclusions concerning the unemployment rate was made by Botrić and Škuflić (2006) when they discovered that this factor had a positive effect on the FDI, and not a negative as first expected.

---

² BRICS is a collection of five emerging national economies; Brazil, Russia, India, China and South Africa (economy watch)
Dunning and Lundan (2008) explained these results, by stating that the stability of an economy often are ignored by the company, since these countries often have lower production and labour costs, which makes the countries attractive for FDI anyway. This effect was later confirmed by two other studies as well (Botrić and Škuflić, 2006).

*Political instability* can be seen as a determinant for why countries chose not to invest in a country. It is a common though that political instability has a negative effect on FDI, which is also confirmed in several studies. Schneider and Frey (1985) and Biswas (2002) measured the political regimes’ impact on FDI, and discovered that left-wing regimes usually affect FDI in a negative direction. This was especially true if the foreign investor considered the country as a great risk. However some researchers did suggest an insignificant relationship between political factors and FDI activity (Swain & Wang, 1997, Zhang, 2002, Andreosso-O’Callaghan and Wei, 2003 cited in Wiessala et al., 2009). Countries with high degrees of political instability usually also have a significant amount of corruption, which affects the quality institutions and limits its development (Cleeve, 2008). Most analyses found corruption to have a negative effect on FDI (Asiedu, 2006, Cleeve, 2008, Mohamed and Sidiropoulos, 2010). The resources, which are distributed unequally, can feel unfair and lead to revolts, and thus restrict FDI.

*Financial and fiscal incentives* can also affect an FDI decision. Different tax rates in different countries, will affect which country the investors choose. Whether corporate taxation affects FDI in a positive or negative manner is not entirely conclusive; using one type of proxy for financial and economic incentive concluded that it does affect FDI decision, but using another type of proxy resulted in the opposite (Root and Ahmed, 1978, cited in Assunção et al., 2011). Cleeve (2008) could not prove that taxation had any effect on FDI, while Bellak and Leibrecht (2009) conclude that a lower tax rate attract more FDI (cited in Assunção et al., 2011). Although it is now proven to have some significance, tax has had no exceptional influence compared other determinants. Research on exchange rates has also shown mixed results. Exchange rate is not of the most important FDI determinant and some researchers like Blonigen (2005) believed that FDI, more than any other type of investment, is unaffected by the volatile exchange rates.
Market size and market growth are two factors associated with the “New Trade theory”, also affecting FDI. There are believed to be more opportunities in a bigger market with more customers and a growing market presents possibilities for company/operation expansion later on. Even though the results on market size are not conclusive it is commonly accepted to have a positive relation with FDI (Vijayakumar et al., 2010). The study of Botrić and Škuflić (2006) is not too reliable, as the sample of countries was too small. With the market growth, the results are even more mixed. Most of the results have found a positive relation between FDI and market growth (e.g., Schneider and Frey, 1985, Cleeve, 2008, Mohamed and Sidiropoulos, 2010), while Mhlanga et al. (2010) and Vijayakumar et al. (2010) achieved inconclusive results.

An open economy is considered more attractive than a closed economy, as it gives foreign investors more opportunities. By implementing more reforms to liberalize their economy, like making trade agreements, the country will increase their attractiveness to foreign investors (e.g., Asiedu, 2006; Vijayakumar et al., 2010). This is one of the determinants where most studies agree on its effect on FDI. Even though not every study could prove it to have a significant effect, they could not deny it either as their results were not conclusive.

2.5. Transition economies
Croatia and BiH have since their independence changed their economy from a planned economy to a market economy. This change in a country’s economic system is referred to as a transition economy. This designation is also used for economies switching from patrimonial relationships to a rule based systems of market relationships. This second transition economy definition includes countries such as Indonesia, Philippines, Cambodia and Russia³ (ADBI, 2014). This paper, however, will focus on the first definition involving countries from Southeast Europe (SEE)⁴ and former Soviet countries (CIS countries). When Central-European countries (CEE)⁵ are mentioned in this thesis, it includes all the countries that are or have been a transitional economy, minus the countries which are also SEE

³ Russia can be placed in both definitions.
⁴ Transition economy SEE countries: Bosnia-Herzegovina, Croatia, Serbia, Montenegro, Albania, Macedonia,
⁵ Transition economy CEE countries; Slovakia, Slovenia, Hungary, Czech Republic, Poland, Estonia, Latvia, Lithuania
countries. The reason for this division is that several studies have found a major difference in FDI between the SEE and the selected CEE countries. (Estrin and Uvalic, 2014)

Changing from a planned economy to a market economy requires several structural transformations. Economic liberalization (where prices in the market are set by market forces rather than by central planning organization), removal of trade barriers and simplifying trade with foreign countries are examples of these transformations. Another important alteration is privatising several former government owned enterprises and resources, while establishing a financial sector that will facilitate macroeconomic stabilization and movement of private capital. Still, the processes can be slow and time consuming. The lack of market orientated infrastructure and low integration in the world economy only makes problems worse. Nevertheless, it is commonly accepted that by strengthening the private sector and emerging market-economy behaviour, FDI have aided the adjustments of vital economic structures. This is mainly due to the elimination of distortions in the macro economy from the former centrally planned system (Åslund, 2007, Kalotay, 2010).

Even though there are similarities between the transition economies, the development in the SEE countries have been different from the CEE countries. Differences within these two groups complicate matters further, making it almost impossible to talk generalizing about transition economies. Even so, some general tendencies do exist for the transnational countries. Firstly, FDI to these countries will be less integrated in the beginning of the transition process than in the following transitional phases. Therefore, the market seeking investors will be more interested in conducting an FDI early in the process. Efficiency seeking investors will dominate later in the process as they depend on a higher stability in the market (which is lacking in the beginning of a transition process). The start phase also includes structural changes determined by demand and supply of the market and their integration into the international division of labour. Secondly, a study shows that many of the transition economies follow the Uppsala model path, by receiving investments from countries in close physical distance (Campos and Kinoshita, 2002).
Several SEE countries experienced high political and economic instability in the beginning of the 90s (due to events such as wars) which partly explain why economic recovery has been slower in this part of Europe. The high political and economic instability and the troubled image investors have about war and conflict, is in some studies referred as the Balkan effect. It is believed that this effect can be one of the reasons the FDI inflow are lower than expected to several SEE countries. (Estrin and Uvalic, 2014) It is evident that future EU members was doing better than other transition economies as several of these countries are no longer considered transition countries (Kalotay, 2010). From 1992 to 2008 the FDI inflows to economies in transition had maintained a strong upward trend. The growth followed a chronological sequence, spreading from the West (the future EU members) and down to the SEE. Nonetheless, these regions did not cut clear from the Financial Crisis, so by 2008 these countries were also affected. Both before and after the Financial Crisis it appeared FDI was strongly influenced by the relationships transition economies have with EU. Indications for this can be seen by the structural changes being less pronounced in Southeast Europe, followed by CIS being a bit more pronounced and lastly CEE countries with the most pronounced changes in an inverse relation to FDI. At the time, none of the Southeast European transition economies were member of EU, and the same goes for CIS. With Croatia entering the EU in 2013 and several countries negotiating membership, it is possible that the structural changes will become evident in these countries as well (Kalotay, 2010).

Many determinants for conducting an FDI, observed in transition economies overall, have through the years been identified. Determinants such as the level of technology, tax and the industrial structure in the country receiving FDI are important examples. There are also indications for a higher flow of FDI to more open transition economies, where the trade has fewer restrictions. In contrast, political and economic instability, lack of protection for private property and poor quality of the bureaucracy might influence FDI in a negatively. The empirical prove for this was found by Lankes and Stern (1998) (cited in Tøndel, 2001). Their analysis conclude the major determinants for not engaging in an FDI in transition economies were corruption and high taxes/regulations, followed by policy instability, crime, theft and costs of regulations. This research was mainly conducted for CSI countries, but there are no other evidence clearly stating these results are not valid in other countries. Several studies have been conducted to see if the main determinants of FDI differ between transaction economy countries and
several have so far been identified, but with contradictory results. Market access is a determinant commonly seen as the most important and with the most conclusive result (Tøndel, 2001).

Another important question, concerning the transition economies, has been whether FDIs have had any effects on economic growth or GDP. The results are not clear. Campos and Kinoshita (2002) conducted a research based on 25 transition countries, between 1990 and 1998, which indicated that FDI had a significant positive effect on the economic growth of the each of the selected countries. Borensztein, De Gregorio and Lee (1998), empirically examined the relationship of FDI and economic growth in developing countries and based on conditions in the transition economies of Europe, the result could also apply for these countries (cited in Lyroudi et al., 2004). Their study shows a positive relationship between FDI and growth in the respectable countries. Other studies, such as Carkovic and Levine (2002), however, have not found a significant relationship with economic growth for transition countries and foreign direct investment (cited in Lyroudi et al., 2004). These conflicting results could be explained by different countries having different determinants for conducting an FDI in transition countries, but also by differences between the transition countries themselves, both in culture, legislative and political systems and also in how predictable and stable the country is (Lyroudi et al., 2004).
3. Overview of Bosnia-Herzegovina and Croatia

3.1. Bosnia-Herzegovina

3.1.1. General information

Bosnia-Herzegovina is a country situated in the Southeast part of Europe, bordering to Serbia, Croatia and Montenegro. The country has a short coast, approximately 20 km long. Bosnia and Herzegovina are the country’s two main regions, but they have no finely defined border. Bosnia, the northern and biggest region, occupy approximately 80% of the country with big forest areas and very fertile agriculture land. Even though the country is situated close to the Mediterranean Sea, the Dinaric Alps make the climate cold in the winter, but fairly mild in the summer, especially in Bosnia. Herzegovina on the other hand has a milder climate, with very dry and hot summers, and mild, but rainy winters. Agriculture is also present in this region, but the karsk topography, covering a lot of the region, makes it harder to make good off all the land (TAFBiH, 2014, CIA, 2014). BH has many natural resources in varying quantities. Some examples of these are coal, iron, bauxite, manganese, wood, copper, chromium, lead, zinc and hydro power (UN, 2014).

On the 3rd of March 1992 the country declared independence from Yugoslavia and was admitted as a Member State of the United Nations on the 22nd of May 1992. The declaration of independence would be the start of the worst war in Europe since WWII. Three years would pass, before the Dayton Agreement was signed, putting an end to the bloody war. More than 100 000 people were killed, thousands of women were raped and more than 1 million people fled their homes. The infrastructure was destroyed and many cities had to be completely rebuilt (IP, 2014). The great number of land mines was also problematic. Following the war, their locations were unknown and many people died or were injured after coming in contact with them. This has of course affected the amount of usable land, but work to locate and remove mines was steadily progressing until a flood in the northern part of the country in May 2014 dislodged many mines and deposited them in new locations (Associated Press, 2014).

In December 1995 the Dayton agreement was signed, ending the war. One of the agreement’s main elements was the division of BiH into two entities; the Federation of Bosnia and Herzegovina (51% of territory) and the Republika Srpska (49% of territory). The Federation of Bosnia and Herzegovina and
the Republika Srpska have their own constitutions, which have to be in conformity with the Constitution of Bosnia and Herzegovina. These entities each have authority over their own army, police force, and social services as well as separate banking supervisions. Directly after the war ended the Office of the High Representative (OHR) was inserted, making most of the country’s decisions. The OHR is responsible for implementation of the Dayton agreement, making the office’s Representative BH’s ultimate authority. OHR is still working towards the point where BH can take full responsibility for its own affairs (OHR, 2014b). This two-entities structure with OHR in charge was not an optimal one, but it was necessary at the time. Even though it was a right decision in 1995 it has led to difficulties for both the governance of the country and for foreign investors (Schake, 1999). Since 1996 both of the entities have given more power to the state government, but have still kept some control inside the entities (UN, 2014). Another important element of the Dayton agreement is the rotation of the Presidency of Bosnia and Herzegovina between three members of the big ethnic groups, Bosniaks, Serbs and Croats. Each member sits for 8 months at a time, over a four year period. The Bosniak and Croat member are elected directly by the people within the Federation while the Serb member is elected in Republika Srpska. In 2000, the city of Brcko was proclaimed a self-governing administrative district after several disputes inside the country. It consists of land from both entities and although the population here is diversified, it is believed to be one of the places in Bosnia-Herzegovina with the lowest tension between ethnic groups (OHR, 2014a).

3.1.2. Economy of Bosnia-Herzegovina
Before the war, BiH had a strong industrial sector mainly focusing on hard metals and the electro energetic sector. They hosted a large amount of industrial companies, where some of these worked with famous world brands such as Coca Cola, Pepsi and Marlboro, but also several big local companies. After the war, 45% of the industrial plant was destroyed and the production was cut down to a minimum in the remaining industry, as was seen in the electricity and coal production which only produced 10% of the pre-level standard. Overall the industrial production was only 5% of what it had been before the war. This has of course affected the country’s GDP, which in 1994 had dropped to less
than 20% of the pre-war level and by 1999 it was still merely 60% of the pre-war level\(^6\). By 2000, most of the housing, schools, water supply systems, roads, telecommunications and electricity grid were reconstructed, but the old industry areas were still abandoned or in ruins and many of them are still not operable. Comparing the industry sectors today to the industry before the war reveals a slight change and today, wood-process, metal work, tourism, agriculture and energy production from water, sun and wind is considered to be the most important industries (World Bank, 2014e).

The country has struggled to raise their GDP, but between 1998 and 2008 BiH did manage to increase their GDP significantly. As a result, the country’s poverty rate dropped from 20% down to 14% (2013) and the unemployment rate for the well skilled labour force has dropped from 50 % to 28% (2012) (World Bank, 2014e). Although the unemployment rate has decreased, it is still one of the highest in Europe and among youth it is over 60 % (World Bank, 2014d). In addition to a high unemployment rate the wages in BH are low with an average wage at approximately $600 and a GDP per capital of $4655. BH has a VAT rate of 17%, and a tax rate of 10% (CBBH, 2014).

Because of the slow growth in GDP and the industry itself, in 2000, the World Bank was one of the main actors attempting to strengthen governance, by building up the fiscal and monetary policies, reform the tax system and privatize some of the state owned enterprise. The work of the World Bank was partly successful with the implementation of the PFSAC (Public Finance Structural Adjustment Credit) and PFSAC II. (World Bank, 2014a). Today BiH is considered an upper middle economy as they have a Gross National Income (GNI) between $4,740 (June 2013) (World Bank, 2014e). BH today has a major problem with corruption and is ranked as number 72 on the CPI rankings. This has also affected the FDI inflow and the negotiation with the EU, so the government has set up the 2009-2014 Strategy for the Fight against Corruption cases, which still has not showed any positive result (UNODC, 2011).

---

\(^6\)The numbers for Bosnia-Herzegovina existed also before the war, as it was considered a republic inside of Yugoslavia (world bank, 1997).
As mentioned, tourism is again starting to become an important source for income. Already from 1995 to 2000 there was an annual growth of 24% in this sector. There was also a solid growth of 20% in 2007. This increase is due to both nature tourism (winter skiing and summer countryside) and city tourism with people visiting the capital Sarajevo and the UNESCO heritage-list city Mostar. Following the fall in tourism due to the Financial Crisis, the country again experienced growth in this sector by a 9,4% increase of overnight stay, where 58,6% of these were foreigners (World Bank, 2014e). Another facet to the tourist industry is the diaspora population, which comes home to visit during the summer months. As these have more money to spend this result in an increase in retail sale and food service industry. It is also worth mentioning that the World Tourism Organization have estimated BiH to have the third highest growth in tourism between 1995 and 2020, meaning there still are lot of potential in this sector.

3.1.3. FDI inflow to Bosnia-Herzegovina

According to The World Bank, the total flow of FDI into BiH was $7,54 billion, from 1994 to 2012\(^7\). Because of the war, the first FDI was not registered until 1997, and was a sparse $1 million. Only one year later, FDI had increased to $67 million. The period from 1999 to 2007 FDI generally increases, reaching an FDI inflow of $1,8 billion in 2007, which is the highest amount recorded since the war. The increase in FDI inflow in 2007 contributed to hold the 2008 FDI inflow high as well. However, as shown in figure 1, BiH had a fall in FDI in 2009 to the same level as in the early 90s. Despite a good prognosis from FIPA and the Bosnian national bank, FDI decreased again in 2012 after a small increase. The 2007 increase is due to the privatization of several large state owned enterprises that year (World Bank, 2014e, FIPA, 2012).

---

\(^7\) The number acquired stated the FDI to BiH from 1994-2012, even though the first FDI inflow to BiH was recorded in 1998.
The country has received less FDI than would be expected, especially compared to their neighbouring countries, despite the fact that BH has made significant efforts to attract foreign investors by passing a liberal foreign investment law and uniform trade, corporate tax and customs policies. Several steps has therefore been taken to minimalize the macroeconomic vulnerabilities in the country and thereby increase FDI inflow. These steps include the establishment of the FIPA, increasing privatization and changing the political, economic, legal and social variables to make the country more stable. FDI inflow has improved in the last 10 years, compared to the 1990s, implying some of these changes were effective. BiH is also working towards becoming a member of the EU. A membership in the EU is believed to make foreign investors more interested as it will lead to fewer barriers and better market access (Serin and Çalışkan, 2010). BiH has already signed the Stabilization Association Agreement with the EU, which is a step towards membership. They have also signed the Central European Free Trade Agreement which will make it easier to trade with countries in central Europe, as it creates a free trade zone.

---

\footnote{For exact numbers see Appendix A}
3.1.4. Countries investing in BiH and sectoral distribution of FDI

90 different countries have been recorded to have invested in BiH 1994 and 90% of investments came from European countries. The main investors in BiH from 1998 to 2011 were Austria, Serbia, Croatia and Slovenia. In 2011 a significant change can be recorded in the inflow of investments, as the Russian Federation was the country with highest level of FDI to BH this and the following year. At the same time, investments decreased from countries which used to be high investors, while FDI inflow increased from countries such as Saudi Arabia and Kuwait. However, Austria and Croatia were still the second and third largest investors in 2012 (FIPA, 2012).

![FDI inflow by countries (BiH)](image)

**Figure 2:** FDI inflow by other countries (BiH) in percentage of total amount FDI

As we can see in figure 3 the highest amount of FDI was made in the manufacturing sector followed by banking and telecommunication. The country’s well developed industry with a good reputation is believed to account for the high FDI within manufacturing, since this might make it easier to invest in this area. BiH’s currency “Bosanska Marka” was pegged to the Euro, making the financial environment safer and more stable, which has given foreign investors more confidence in both the currency and the banking sector of the country. Today, therefore, banks from Western Europe control most of the banking sector in the country (FIPA, 2012).
3.2. Croatia

3.2.1. General information

Croatia is a country situated in Central and Southeast Europe and was a former republic of Yugoslavia. The country borders to Hungary to the northeast, Bosnia-Herzegovina to the south and east, Montenegro to the south, Serbia to the west and Slovenia to the north. It has a 1773 km coastline to the Adriatic Sea where the 1246 islands of the country are situated. The country consists of three major geomorphological parts, the Pannonian Basin, the Dinaric Alps and the Adriatic Basin. The Adriatic Basin is situated in the south of the country, while the Pannonian Basin dominates the north. Thus, the main topography of Croatia is lowland, with elevation less than 200 meters, usable for agriculture purposes. The Dinaric Alps can be found to the northwest and are dominated by karst topography. The climate in Croatia is mostly moderately warm and rainy, but snow is not unusual in the Dinaric Alps and at elevations above 1200 meters. Along the Adriatic Coast and in the south the climate is typically Mediterranean, and can be very warm. The country is a republic, where the president is directly elected to a five-year term and no president can be in office longer than two terms (Crljenko et al., 2014).

Croatia declared their independence in June 1991, but the declaration was not effective until the 8th of October 1991 and in 1992 Croatia was recognized as a country by the European Economic Community and the United Nations. It was also around this time that the Croatian War of Independence started,
which lasted until 1995. Between 10 000- 20 000 (the number differ between different sources) were killed and it is estimated that around 500 000 became either refugees who had to move to different parts of the country or abroad. The war caused damages to the country’s infrastructure, cities and industry. Especially the textile, leather, metal and timber industries were affected by the war, and several companies in these branches were forced to close down. The country is not rich on mineral resources and the few mines the country had, were closed down in the 1970s and 1980s (Crlijenko et al., 2014).

3.2.2. Economy of Croatia

Even though Croatia is considered one of the most stable countries in its region, the country is facing several problems. Some of these problems include a weak competitiveness and poor business climate as well as widespread corruption, high country debt and an inefficient legal system. The corruption is still a problem with the country ranking as number 57 on the CPI ranking. However the corruption in the recent years have decreased as it was one of the major impediments to Croatia’s EU accession in 2013 (GAN, 2014). In spite of these problems, the country experienced a strong economic performance from 2000-2008 when the GDP growth rate was annually around 4%. The global financial crisis hit Croatia hard, making the GDP decline in 2009 and 2010, while in 2011 there was zero growth. (World Bank, 2014e) Croatia is now in its 6th year of recession, with the GDP estimated to fall in 2014 as well. It is possible to see this recession in the unemployment rate, as this has doubled from 2007, and was around 17% at the end of 2013, while the youth unemployment rate rose to over 40%. Before the recession, the poverty rate was under 10%, now 6 years later it has increased to around 20% (World Bank, 2014e). Consequently, the government was forced to make large budget deficits, causing demonstrations and riots in the latest years, signalizing the people’s dissatisfaction (Prug, 2011). Even though Croatia is in the EU, the country has not yet joined the Schengen Area (expected to join in 2015) or changed to Euro. Therefore, their main goal is further integration with the EU, and to switch the currency to Euro as soon as the Croatian economy meets the criteria of inflation, public finances, exchange rate stability and interest rates (World Bank, 2014b). In 2013 Croatia had a tax rate of 20% and a VAT of 25%
(except for some special goods\textsuperscript{9} which has a reduced VAT of 5\% or 10\%). Croatia is considered a high income country with a GNI of $13\ 290 (June 2013) and a GDP per capita of approximately $13\ 500 (2013) (World Bank, 2014e).

Today, Croatia’s tertiary sector accounts for 70\% of the GDP and is dominated by manufacturing and tourism, which each generates approximately 15\% of the country’s GDP. Food, drinks and tobacco are the leading manufacturing industries, generating the highest revenues. 10 million tourists are drawn to Croatia every year, largely due to the country’s beauty. Almost 50\% of Croatia is specially protected and conserved areas and the country has a total of 19 National Parks. Tourism is highly seasonal, peaking in the summer months, when around 3 million tourists visit. Historically the main tourist groups have been from Austria, the Czech Republic, Germany and Italy, but lately there have also been an increased number of tourists from Scandinavia, France, The Netherlands and Great Britain (Cr\ljenko et al., 2014).

The Petrochemical industry and Shipbuilding are two other major industries, with shipbuilding accounting for over 10\% of exported goods. Because of the varied climate and soil there are a diverse production of agriculture products, such as lavender, wine and Continental and Mediterranean fruit and vegetables. In the recent years the country has also become famous for its olive oil. The long coastline has resulted in a well-developed fishing industry (Cr\ljenko et al., 2014). Blue fish (sardines, mackerel) are most common and in the latest years it has become a big export good, especially to countries such as Japan and South Korea (BD, 2013). There are still a lot of potential in Croatia and the country was, in terms of international competitiveness, ranked at 75 out of 148 (2013) by the World Economic Forum (World Ec\nomic Forum, 2013).

\textsuperscript{9} Real estate has a VAT of 5\%, while hotels, newspapers, cultural events and special groceries have a VAT of 10\%. 

35
3.2.3. FDI inflow to Croatia

According to the World Bank, Croatia’s FDI inflow have been 33.9 billion from 1992 to 2013, which is 60% of the amount invested in western Balkan. As presented in figure 4, FDI was rather low until 1995 due to the ongoing war in the region, but after the peace agreement was signed in 1995, there is a clear increase in investments into the country. Since the independence the main source of FDI has been privatization of strategic government-owned assets, such as utilities and banks, which can be considered “big companies”, resulting in high inflow of FDI (U.S. Department of State, 2012). The surge in FDI inflow to Croatia, especially after 2000, was driven largely by the economic recovery, a better investment climate and the start of accession negotiations with the European Union (EU) in 2005. In 2003 the increase was doubled and even though FDI fell slightly in 2004 it thereafter increased until it peaked in 2008. Like many other counties, Croatia was affected by the financial crisis, making the FDI investment fall in 2009. FDI has not increased significantly since then, as Croatia, as well as the countries investing in Croatia, has experienced an economic recession. Another reason for the fall is the emerging structural problems within the economic sector. These structural problems are mainly caused by corruption and complex bureaucracy. Some actions have been made in order to change this, but the long-time results of the efforts are still not visible. The juridical system in Croatia is known to be inefficient and unpredictable, which is a major concern for investors (World Bank, 2014b).
Despite these issues, Croatia is considered to be an open and liberal economy for FDI where foreign investors do not need to seek investment approval. The country is trying to be even more open to foreign equity ownership, and the only place where restrictions on FDI are implemented is in the transportation section (FAO, 2012).

To attract more FDI the country has also made it easier to get credit and register property and also made it less costly to pay taxes, by reducing the health contribution rate. Furthermore, Croatia has signed several legal trade documents to ease trade, such as; the Trade Act (2008), the Act on Trade companies (2009), Act on Excise Duties (2010), the Law on Customs (2009), the Customs Tariff Act (2010) (Bank, 2014).

3.2.4. Countries investing in Croatia and sectoral distribution of FDI

The countries investing in Croatia have mainly been Austria, the Netherlands and Germany. Austria has contributed with 25,2 % of the total FDI since 1993, Netherland with 14,9 %, and Germany with 12,1 %. European Union countries are responsible for around 90% of FDI (2011), but countries such as the U.S, Israel and Russia have also conducted FDI in Croatia (UNCTAD, 2012).
FDI have mainly been conducted in Croatia’s financial sector, followed by manufacturing, wholesale and retail trade. The financial industry on its own accounted for 37% of the inward FDI stock at the end of 2011 and more in-depth analysis showed that the majority of the invested capital is mainly invested in large Croatian companies, while the small and medium entrepreneurship only received around 4% of the total FDI (UNCTAD, 2012).
4. Comparison and discussion

4.1. FDI development and economic impact

As we have seen previously in this paper, there are a wide range of theories for internalisation and FDI and determinants for these. FDI determinants and theories can be applied when trying to explain the companies’ main reasons for conducting FDI in BH and Croatia and how these investments affect the countries. It is believed that FDI can bring certain advantages to the receiving country, such as initiation of new production, unemployment reduction (due to the creation of new jobs), increased knowledge and gain of new technology. However, it is important to emphasise that FDI can have a negative impact on the receiving country, which for example, can lose control of certain assets (Kersan-Škabic, 2004). The two countries’ economic and political situation, together with the theory of transitional economies, can help us explain the development in these countries and give an indication of a probable future. Based on the information gathered for this thesis, it is evident that the FDI inflow into BH and Croatia generally follows the same development, but with individual differences which will be discussed in the following paragraphs.

An important factor when comparing the FDI development in BiH and Croatia is the major negative effect the Bosnian-War had on BiH, with many fatalities, a broken infrastructure and unstable economic, political and legislative systems. Consequently, FDI inflow into BiH did not start until 1997 and it is hard to collect good and/or reliable data from the years prior to 1997. On the other hand, FDI inflow to Croatia started in 1992 as their war had a less devastating effect, giving Croatia a 6 years head start over BiH. Despite this advantage, the FDI conducted up until 1997 had no significant positive effect on Croatia’s local economy (Derado, 2013). Assuming year one for Croatia to be 1992 and year one for BiH to be year 1997, the FDI fluctuations does not differ much. Some of the changes in the FDI flow can be explained easily, for instance there was a fall in FDI around the Financial Crisis (2008) and an increase in FDI to BiH in 2007 due to the sale of several government owned companies. Following the Financial Crisis, a trend of decreasing FDI was seen worldwide with a global FDI fall of 50% in two years. This trend can be seen in both Croatia and BiH with a fall in FDI of approximately 50% and 80% respectively (World Bank, 2014e). The FDI inflow to both Croatia and BiH have still not recovered and there are no indicators suggesting a change in the close future (Estrin and Uvalic, 2014).
However UNCTAD projections for global FDI in the next years show an increase in FDI which we might see in BiH and Croatia as well (UNCTAD, 2013)

<table>
<thead>
<tr>
<th>Years</th>
<th>BiH</th>
<th>Croatia</th>
</tr>
</thead>
<tbody>
<tr>
<td>1992</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1993</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1994</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1995</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1996</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1997</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1998</td>
<td></td>
<td></td>
</tr>
<tr>
<td>1999</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2000</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2005</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2006</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2007</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2008</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2009</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2010</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Figure 7:** Comparison of FDI inflow to Croatia and BiH from 1992-2013. FDI is given in million US$.  

It is difficult to know the future for FDI inflow to these two countries, because it is impossible to know if there will be a new financial crisis or other type of FDI changing disasters. Still, it is possible to predict a likely development by making assumptions based on FDI inflow in the recent years, different types of economic indicators and how CEE countries have developed, even though the Balkan Effect has to be considered. Analysing the situation today it is reasonable to assume that the two countries will develop differently in the close future. First of all, Croatia is in the EU and is expected to join the Schengen in 2015 and adapt to the Euro before 2017. Thus, market opportunities will open, resulting in an increase of the market size, which might lead to new types of investors investing in the country. Botrić and Škuflić (2006) have discussed some of the reason for Croatia’s low FDI and concluded that Croatia would have been more attractive if the export as a percentage of GDP was higher. BiH on the other hand will probably continue to struggle with high unemployment and a complicated government structure. Still, the country has a lot of potential and recent data indicate that there has been some improvement since the Financial Crisis. Based on some positive trends in the recent years, FIPA and the National Bank of BiH expect a further increase in FDI inflow in the future, which seems legit based on the development the country has had since the war. If these calculations and assumptions are correct, BiH might join the European Union in a couple of years (FIPA, 2012).
The major flood (May 2014) in north Bosnia and south-east part of Croatia might impact the countries’ economy. Particularly BiH was severely affected, with destruction costs estimated to over 1 billion US$. Several people were killed, a lot of agriculture land was flooded and several land-slides destroyed the roads and houses (Milativic, 2014). This was a major hit on an already fragile economy and it will be interesting to follow its effect on the FDI inflow to BH. This event is so recent, that good data still does not exist, which makes it harder to analyse how and if this has any context to the future of FDI.

GDP is a good measure of the economic output and by comparing GDP from year to year it can measure economic growth. The impact FDI have on the countries’ economic growth can therefore be measured by comparing FDI and GDP. In BiH GDP per capita have had a steady growth since the war with periodically higher growth rates. FDI to BiH have a similar trend. The rise of GDP from 2002 to 2008 is higher than previously, which correspond to those years when the FDI inflow is highest. In 2009 the GDP fell, and the same happened with the FDI inflow, before both stabilised (with some fluctuations for GDP). These results indicate that FDI might have an important impact on GDP, even though the two economic indicators do not follow each other exactly. In Croatia on the other hand it is not that easy to find a connection between GDP and FDI. GDP in Croatia, mainly increase up to 2008, while FDI fluctuate until 2005 when it increases significantly. The GDP decreased in 1999, probably due to the problems in banking sector, which also led to a short recession in the country (Krznar, 2011). This does not seem to match FDI for the same years. However, GDP and FDI both decrease greatly around 2009, when the financial crisis hit, whereupon the trend is less visible. These findings make it plausible that FDI have some influence of the GDP in Croatia. Still, it is hard to determine how strong this connection is as the change in GDP can be due to several other economic factors also affected by the financial crisis. Nonetheless, a connection between GDP and FDI would be in accordance with several studies conducted on both developed and undeveloped countries as well as transitional economies, showing a direct relation between the FDI flows and the growth of GDP. According to these studies, FDI is important in transitional economies because FDI leads to an increase in manufacturing that will help these countries to produce more better-quality goods, which is crucial for this type of economies. Other have found the link between FDI and GDP to be weak or seen only when the state promotes its own policies. Based on studies arguing a direct connection between FDI inflow and economic growth rates, IMF and the World Bank recommends countries to create favourable
conditions for FDI as FDI is believed to be the safest and most efficient way to integrate into the world economy, which is crucial for the formerly closed transitional economies (Hansen and Rand, 2004).

![GDP and FDI for BiH (1994-2013)](image1)

![GDP and FDI for Croatia (1992-2013)](image2)

**Figure 8:** Comparison of FDI and GDI in BiH and Croatia. For an easier comparison GDP is given in US$, while FDI is given in million US$.

### 4.2. FDI determinants

According to the Dunning’s taxonomy investors have four different motivations for seeking an FDI, market, efficiency, asset and resource. In the early years of transitional economy, one of the main motivations were market seeking. This motivation is closely linked to market size and growth, but even though BiH and Croatia are rather small countries, this motivation was important for investors choosing transitional economies. Although the markets are small, the foreign investors will still expand their business by investing in these new unexplored markets. (Lank and Venables, 1996 cited in Tøndel 2001). The efficiency motivation is also relevant for Balkan as these investors are seeking lower manufacturing costs, which is something BiH and Croatia can give them, as they have lower labour costs. Asset seeking investors are not interested in the Balkans as asset seeking investments normally are conducted between advanced economies, something that neither BiH nor Croatia have become yet. Resource seeking investors are not that interested in Croatia, expect those investors who are investing in tourism, which can be considered a resource (Estrin and Uvalic, 2014). However BiH have more natural resources and also tourism(in a smaller degree) which means that resource seeking investors have more investment opportunities here (FIPA, 2012).
Location advantages are one of the main elements of Dunning’s eclectic paradigm. Dunning stated that all three advantages (OLI) had to be present for the company to choose an FDI over another internalisation approach such as export. Having a location advantage is consequently not enough, but location advantages are the only conditions governments can influence directly. Thus, by being aware of location specific determinants and exploiting these, a country can increase FDI inflow.

One of the determinants discussed in the literature reviews, market size, can be eliminated as a major determinant for both countries. Croatia with a population of 4,2 million and BiH with a population of 4,6 million does not offer a strong consumer market. Market size is one of two factors associated with new trade theory the other factor is market growth. Neither BiH nor Croatia have a high birth rate and with a low immigration the market in not expected to expand much in the recent future. Historically GDP growth rates have been higher in BiH than in Croatia which could give them an advantage, but as discussed earlier, this is probably an after effect of the Bosnian-War.

The economic growth is believed to depend on several factors, and one of these factors can be identified as trade agreements with other counties. Trade agreements are positive for a country as they can make is easier to trade with other countries. Liberalization of trade was also discussed by Kojima, where he believed it was necessary to make transactions between countries easier. Both BiH and Croatia have signed several of these types of agreements in recent years and as described in this thesis, an open economy will boost FDI. The highest amount of FDI that BiH received was when the country gave foreign investors permission to buy former government owned companies. The process to a more open economy is important in transitional economies and both Croatia and BiH have made incentives to make the economy more attractive to foreign investors, mainly by giving them the same opportunities as local investors. In BiH some of these incentives include free trade agreements, tax agreements, and the Law on the Policy of Foreign Direct Investment from 1998, ensuring foreign investors the same rights and obligations as national investors. Croatia do not have a foreign investment law, but they have other legislative acts, such as the 1995 Company Law ensuring equal rights and protection of foreign investors. The Law on Free Trade Zones (1996) and Investment Promotion Law (2000 and 2006) make it easier to invest in the country. However, as long as the company conducting
the FDI do not have the needed asset knowledge, they will choose export over FDI, whether or not the conditions in the BiH and Croatia are good.

In BiH, the infrastructure has suffered severely from the war and the low economic growth compared to Croatia. Approximately 30% of BiH’s roads and 40% of its bridges were destroyed during the war and their electricity-generating capacity was reduced by 80%. Today Croatia has three times more railway than BiH and significantly more air traffic, both domestic and international. Both countries have a less developed telecommunication network and worse internet access than the rest of Europe (World Bank, 2014e, IP, 2014).

It is believed that political instability is an important determinant, as it can affect several factors in investing. The uncertainty of not knowing what to expect from a country and their government can possess a high risk for companies. Therefore, BiH would probably gain more FDI, by having a more stable political structure. An unstable political environment usually also contribute to a high corruption level. As already mentioned, BiH are more unstable than Croatia and this is also reflected in the corruption statistics where BiH is ranked lower than Croatia. The impact of corruption is a factor closely related with the institutional approach, where it is believed that a low level of corruption is more attractive. This is also valid when comparing BiH and Croatia as Croatia has a higher FDI rate and less corruption. The political complexity and instability in BiH might explain why the country has receives less FDI than expected, and also strengthen the theory of a Balkan effect. To a smaller degree, the same is true for Croatia. Even though Croatia has some degree of political instability and corruption they have less corruption than BiH as well as a functioning government structure. Still, the level of FDI is lower than expected. Croatia might still be facing post-war consequences, as the economy in the early 1990s was fragile and this fragile reputation might be present today as well. Both countries and especially BiH have tried to stabilize the political situation, but only with some luck. By going back no further than 2013, we discover riots and demonstration in several Bosnian cities against the government and the system, so the future prospect is not too bright. The political instability has also led the negotiation process with EU to a standstill.
Economic stability is also an important factor when considering an FDI. Inflation rates and unemployment rates are some of the main factors that have to be considered. Researchers believe there will be less FDI conducted in a country where the inflation rate is high, and the economy unstable. Yugoslavia was in the late 1980s and early 1990s experienced high inflation, which followed BiH, when they gained independence. The inflation developed into hyperinflation, reaching its peak month of inflation in June 1992, with a monthly rate of 322%. A strict fiscal policy and pegging of convertible mark to euro, have given BiH a stable inflation rate. After the hyperinflation, BiH has had an extremely low inflation rate for several years and between Q3 2006 and Q4 2007 it dropped below the Euro Zone inflation. That the inflation rate was lower than in the Euro Zone is very surprising, with the local currency in BiH is attached to the Euro. However, the inflation rate increased considerably from 2007 to 2008, probably as a consequence of the financial crisis. The generally low inflation rate can have contributed to FDI inflow, but based on the low level of FDI BiH has received, it does not seem like the inflation rate is a big enough incentive to invest in the country. Nevertheless, it is possible that FDI would be even lower had the inflation rate been higher and more unstable (Raifesen, 2014).

Croatia also inherited the hyperinflation from Yugoslavia and the greatest inflation was measured to 1616 %, but in the late 1992 the Stabiliisation Programme based on nominal exchange rate was introduced, which made the inflation rate more stable (Vizek and Broz, 2009). However, the inflation rate in Croatia has evolved unsteadily and in 2008, following the Financial Crisis, it peaked again. The growth rate and FDI also peaks in 2008. As a result, it appears valid to suggest the inflation rate is affecting the economy in this case, which in turns affects the FDI.

The unemployment rate has been and still is very high in BiH, whereas in in Croatia the unemployment rate is not as high, although it has been increasing since 2008. Some studies state that unemployment has a positive effect on FDI, because it might contribute to lower labour costs in the receiving country. This is also partly in accordance with PLCT, where Vernon argues that companies, after a certain amount of time, will invest in countries with low labour costs. Both Croatia and BiH have low labour costs, BiH even more so than Croatia. Labour costs have not risen noteworthy in recent years and there seems to be no reason to suspect a change in the close future. Therefore, labour costs seem to be a major location advantage for both countries and should be considered a major determinant. However,
the FDI inflow to BiH is dominantly to the infrastructure while in Croatia is to financial intermediation. This might suggest that labour costs might be more important for BiH FDI.

The tax rate in a country is also believed to have an impact on FDI, but studies on tax rate have not showed conclusive results. Although most studies indicates that corporate tax does not influence FDI, it is widely believed that a low corporate tax rate will attract FDI only if the fiscal policy of the country in general is considered a friendly business environment (Göndör and Nistor, 2012).

When comparing BiH and Croatia in this matter it becomes evident that Croatia has attracted the highest level of FDI, although BiH has a corporate tax rate of only 10% while the tax rate in Croatia is 20%, which is a considerable difference. Using the aforementioned studies might help explain the discordance; BiH has lower tax rate, but since the business environment is unstable and problematic, the tax rate will not give the country a substantial enough advantage, and will therefore not be an incentive for foreign investor.

According to the Uppsala model factors such as language and culture decrease the market uncertainty, meaning countries first invest in other near-by countries. Croatia and Serbia are one of the major investors in BiH. In Croatia the major investors are countries such as Austria and Netherland, meaning that in this matter the differences between the countries are noteworthy. BiH’s diversified population, where around 50% of the population are either Croats or Serbs, might be one of the reasons for the difference. Croatia and Serbia might have incentives for to investing in the part of the country where their ethnic group are in majority. The reason the Netherlands is a large investor is probably due to the fact that the country is used as a pass-through for investments from multinational corporations. This means that even though companies from other countries are the ones actually investing in Croatia, it will be recorded as it is from the Netherlands. (Galeza, 2011) Austria might be a big investor as they are usually motivated by market and efficiency seeking motives, which is a motivation for investing in Croatia. Another reason is probably that Croatia is close to Austria, and Austria is known to be a country that invests mostly in Europe and in countries close to home (Hunya, 2008). Western European countries could also be more afraid of investing in BiH because of their reputation or because the market is considered too unknown. While Croatia can also be considered an unknown market, the infrastructure and a stable government, can make a significant difference.
5. Conclusion

BiH and Croatia are two neighbouring Southeast European countries, in a very special position. The goal of this thesis was to present an overview of these two counties and compare their FDI inflow. In the following paragraph I will attempt to answer the research questions by combining the theories and data presented earlier in the thesis and discussed in the previous section.

As the countries gained independence around the same time and have both been a transitional economy, we would expect them to have the same development in FDI inflows. This thesis found BiH and Croatia to generally have similar fluctuations, with some individual differences due to different events inside the countries. Even though the fluctuations in FDI are similar, we observe that the FDI to Croatia are significantly higher than to BiH, a trend that is seen from their independence and until today. BiH did however start off with a higher FDI inflow than Croatia in the first years, which can probably be explained by Croatia still being a war zone when the first FDI to the country were conducted. We also observe that the major decrease in FDI was around the Financial Crisis, which is in accordance with the global FDI trend. Since the Financial Crises both countries have struggled to increase their FDI to a pre-crisis level. In fact, Croatia today in sixth year of recession, something which is seen in increased unemployment and poverty.

Predicting the future is nearly impossible but based on the available data and previous research the future is not optimistic. Uvalic (2014) even argued that the prognosis of return of FDI is too optimistic, given the present unfavourable global climate for FDI and unsettled political issues on Balkan, especially in BiH. FDI could therefore be increased by improved government policies, but this it difficult to achieve. In addition Croatia’s EU membership can and will make new opportunities for the country, which might lead the country out of recession.

The GDP have mainly increased in both countries since their independence, with a few exceptions. Croatia experienced recession in 1998-1999 which caused drop in GDP in 1999. Later both countries had a fall in GDP due to the Financial Crisis, where Croatia had a considerably greater fall than BiH. Comparing GDP and FDI development does not give a conclusive connection, even though some similarities can be detected, more so for BiH than Croatia. The fluctuations in FDI are not visible in GDP, except during the Financial Crisis, but the general trend is similar for both indicators.
Furthermore, FDI inflow to Croatia is higher than to BiH and the same is true for GDP. Hence, FDI’s effect on the countries’ economy is inconclusive, since it is obvious that the GDP is affected by other factors that have not been included in this thesis. FDI can however give a slight indication on development of GDP.

As stated previously in the thesis, FDI investment to the two countries differ, both in amount of FDI, which type of industry receive FDI and also in investing countries. These differences can partly be explained by different motivations from foreign investors as well as locational advantages BiH or Croatia might possess.

It is difficult to isolate one determinant for why countries chose to invest in BiH and Croatia, as the data gathered in this thesis does not give a conclusive result. However, by analysing the different determinants mentioned earlier in this paper, we can identify some negative and some positive or neutral determinants the countries have. Reviewing the main determinants investors have for investing in BiH and Croatia discussed in this thesis shows that distance and market size influence FDI negatively. Even though the new market might have been positive for FDI around the late 1990s, the population is now decreasing in both countries and the market is well established. Neither BiH nor Croatia are located centrally as none of the major European economies are situated close by. Another determinant affecting FDI negatively in BiH is political instability.

The other mentioned determinants are either positive or not of importance for FDI, but separating the main determinants from other determinants with a positive effect on FDI is difficult as our information is limited. Determinants with a positive impact on FDI differ some between the two countries. In European standards, both countries have low labour costs giving investors the opportunity to reduce expenses. They have managed to achieve a reasonably stable and open economy, with a low inflation and several trade agreements. In BiH, the tax rate is low, which could affect FDI in a positive manner. Because Croatia has entered the EU a potential economic growth could affect FDI positively.

From the previous paragraph a few differences in FDI determinants can be detected. Inflation rate in the two countries do not differ much, while the tax-rate differs it does not seem to have a major impact on the FDI (studies shows that tax-rate are not a good indicator for FDI). Labour costs are also lower in BiH than in Croatia. Based on these determinants, we should expect BiH to have a higher level of FDI,
as the opposite is true, these determinants do not provide a good explanation for the differences in FDI. The market size and growth are also relatively similar and therefore these determinants do not offer a valid explanation for the differences. Croatia’ higher FDI can in my opinion be based on three factors, distance, political stability and EU-membership. The political stability in BiH is fragile, with a lot of disagreement, changes and high corruption rate that affects the FDI negatively, while Croatia have a more stable situation. Croatia is also member of the EU, which means that the investors will see them as more interesting and with greater opportunities. In the distance perspective we can include types of countries that invest in BiH and Croatia. While BiH mostly receive FDI from neighbouring countries, Croatia received more from West European countries, such as Austria, the Netherlands and Germany. This can be explained by the fact that the aftermath off the Bosnian-War have contributed to a negative reputation, meaning countries hesitate to invest while Croatia is closer to Western Europe and also have a better reputation.

As this thesis indicates BiH and Croatia have some major differences both economically, politically and in terms of FDI. Almost 20 years after the war and 23 years after their independence, the situation have not changed as much as expected in BiH and the country still has a lot of work to do, mainly with the special political situation in the country, before they reach their main strategic goal, which is to become a member of the EU. Croatia on the other hand progressed a lot, even though the country has had their problems, which has become evident in the last six years with the country’s recession. The EU membership and a relatively stable political situation still make the situation in Croatia much more optimistic than BiH. To attract even more FDI and strengthen their economy Croatia should focus on factors that determine competitive production such as corporate taxes, exchange rates and productivity. Based on this information it will be interesting to follow the development in these two countries in the future.
References


ASIEDU, E. 2006. Foreign direct investment in Africa: The role of natural resources, market size, government policy, institutions and political instability. World Economy, 29, 63-77.

ASSOCIATED PRESS. 2014. Bosnia floods trigger 3,000 landslides and unearth mines. The Telegraph.


UNCTAD 2012. FDI inflow in brief: Croatia. unctd.org.


