

# **SLOVENIAN INVESTMENT ACTIVITY IN SEE: TRADE-PROMOTING OR EFFICIENCY-SEEKING MOTIVATION?**

**Jože P. Damijan**

University of Ljubljana, and  
Institute for Economic Research, Ljubljana

## **1. INTRODUCTION**

After a decade of wars and economic destruction in the region of South-Eastern Europe (SEE) most of the successor states are far from their economic performances before 1990. Most heavily harmed has with no doubt been Serbia with manufacturing output in 1999 decreased to only 22% of that in 1989, while on the other edge Slovenian manufacturing output in 1999 reached 75% of the 1989 level. Suspension of bilateral trade links following the introduction of protectionistic trade policies by individual republics of former Yugoslavia at the end of 1980s<sup>1</sup> can be listed as one of the key reasons for consequent tremendous output fall in the region. For illustration, in only three years (1990-1993) Slovenian sales to former Yugoslav markets decreased from \$6,662 mill. to \$965 mill. (Damijan and Majcen 2000). The decline of Slovenian purchases from this region occurred in the same magnitude. After 1993 there is observable slightly increasing trend in Slovenian exports as well as imports with the region of former Yugoslavia. From the Slovenian point of view, the markets of former Yugoslavia before 1990 served as a base for the necessary inputs, such as deficient raw materials, semi-manufactured products and agricultural products for Slovenian manufacturing sector. After processing either in Slovenian headquarters or in local affiliates of Slovenian firms, final products were then sold further to western markets as well as in the former single Yugoslav market.<sup>2</sup> The crucial part in these patterns of Slovenian purchases in the region was the vertical supply-chain organisation of production as well as intra-firm trade – the organisation that is characteristic for multinational companies (MNCs). In fact, this MNCs pattern of trade has also formally been based upon appropriate ownership framework with Slovenian firms being the major “foreign” acquirers and greenfield investors in the region. Leaving aside negative political connotations this pattern of production and trade has provoked in the past,<sup>3</sup> it is ultimately true that in the period before 1990 it helped to stimulate economic growth and to sustain a

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<sup>1</sup> Starting in 1988, the former Yugoslav single market began to fall apart due to impositions of some quasi import taxes between republics. After the official break-up of Yugoslavia in 1991, additional barriers on bilateral trade were created followed by war in Croatia and Bosnia, and the trade embargo against Serbia and Monte Negro.

<sup>2</sup> On the other side, a lot of exports of final products from other parts of the region were directed through Slovenian trade firms which were licensed for foreign trade operations.

<sup>3</sup> At the end of 1980s, there was given rise to the political accusations in other republics of Ex-Yugoslavia that Slovenian firms do “exploit” other republics of the region through exploitation of their economic resources.

kind of economic and social stability in the region. Fidrmuc (2000) shows that according to the above pronounced pattern of intra-firm and inter-republic trade the volume of bilateral trade flows between republics of former Yugoslavia was about 24 times higher than that predicted by gravity model which is based on normal trade flows between EU countries.

Recently, the key role of Slovenia to promote economic stabilisation in the SEE region could be again based on a kind of trade reintegration and on creation of new or restoration of former supply-chain organisation. Current trends in Slovenian aggregate trade flows as well as outward FDI flows already reflect the tendency towards increased trade and investment activities in the SEE region. Are we, in fact, witnessing the restoration of pattern of trade and production specialisation that was characteristic for this region before 1990? The aim of this paper is to analyse current investment activity of Slovenian firms in the region in order to reveal the motivation of Slovenian firms investing in SEE. We are suspicious that at present rather trade promoting than efficiency seeking motives are a driving force behind present increased investment activity of Slovenian firms. Slovenian firms might be predominantly aimed at increasing sales to the region from their Slovenian headquarters rather than at setting up local production facilities due to comparative advantage reasons (lower costs of local labour). The reasons for this belief lie in a still very unstable political and economic environment of the SEE region, in low financial discipline of local customers as well as in still under-utilised resources of Slovenian firms. Trade promotion might be a short run strategy of Slovenian firms, in the longer run, however, efficiency seeking and comparative advantage reasons might prevail.

Present and planned trade and investment behaviour of Slovenian firms vis-à-vis SEE region is analysed using a specially for these purposes conducted survey among 115 largest Slovenian companies, which is combined with their income statements and balance sheets. In first step present trade and investment activities in the region are observed. In second step, then, planned investment activities of Slovenian firms together with their operational characteristics are analysed. Simple probit model is used to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004.

## **2. FIRMS' STRATEGIES FOR PENETRATING SEE MARKETS**

Following usual international business literature there are two basic approaches for a firm to penetrate exports markets. Firm can either choose regular export mode or an investment (FDI) mode of market entry. Decision for one of the two depends on many factors such as entry costs (tariffs, distance and transportation costs, etc.), technology (in case of important internal and external scale economies relative to entry costs it does not pay off to divide production among many locations) comparative advantage reasons (differences costs of labour and resource abundance between home and foreign country), country risk, etc.

Major advantage of export mode of foreign market penetration over the investment mode is in lower funds needed to start selling in foreign markets. Major disadvantages of export mode, however, are lower efficiency in case of high entry costs, low financial discipline in exports markets, etc. The advantages of investment mode over the export mode are in possibility of avoiding high entry costs, possibility to make use of cheaper local labour and materials, in the possibility of influencing local authorities and getting subsidies, tax exemptions, etc. for starting operations, etc. Major drawbacks of investment mode lie in

large funds required for setting up local production, distribution networks, etc. and in a potentially higher risk of operations in foreign markets. In subsequent section we shall analyse above entry modes of Slovenian firms when penetrating SEE markets.

### 3. OVERALL PATTERN OF TRADE AND INVESTMENT BETWEEN SLOVENIA AND SEE COUNTRIES

#### 3.1. Pattern of trade

After 1993 a slight upward trend in Slovenian exports to SEE region can be observed with total exports expansion amounting to near 80% from 1993 to 2000 when measured in € (US\$ based figures show, however, an expansion by 40% in the same period<sup>4</sup>). Major part of this export expansion is made on the account of rapid expansion of exports to Bosnia (BiH) and FR Yugoslavia (FRY). Exports to Croatia, which account for half of the total exports to SEE region, however, has stagnated over the period. After 1999 when free trade agreement between Slovenia and Croatia became effective one can also observe slightly upward trended exports.

**Table 1: Bilateral trade between Slovenia and SEE countries 1992-2000 (€mill.)**

<b>Exports</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2000 (%)</b>
<b>Croatia</b>	736	633	624	690	683	741	727	630	747	7.9
<b>Macedonia</b>	103	170	184	146	136	133	144	166	172	1.8
<b>BiH</b>	18	17	58	92	211	255	285	341	406	4.3
<b>FRY</b>	309	7	14	7	77	99	92	80	155	1.6
<b>Total SEE</b>	<b>1167</b>	<b>826</b>	<b>880</b>	<b>935</b>	<b>1106</b>	<b>1228</b>	<b>1247</b>	<b>1217</b>	<b>1480</b>	<b>15.6</b>
<b>TOTAL</b>	<b>5168</b>	<b>5208</b>	<b>5772</b>	<b>6437</b>	<b>6636</b>	<b>7411</b>	<b>8073</b>	<b>8023</b>	<b>9483</b>	<b>100</b>

<b>Imports</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2000 (%)</b>
<b>Croatia</b>	659	509	421	446	471	412	385	417	487	4.4
<b>Macedonia</b>	60	76	68	67	57	50	42	35	52	0.5
<b>BiH</b>	15	9	4	6	12	27	42	53	63	0.6
<b>FRY</b>	207	0	0	2	42	37	61	34	45	0.4
<b>Total SEE</b>	<b>942</b>	<b>595</b>	<b>493</b>	<b>520</b>	<b>582</b>	<b>525</b>	<b>530</b>	<b>538</b>	<b>646</b>	<b>5.9</b>
<b>TOTAL</b>	<b>4751</b>	<b>5565</b>	<b>6175</b>	<b>7347</b>	<b>7523</b>	<b>8284</b>	<b>9018</b>	<b>9466</b>	<b>10986</b>	<b>100</b>

<b>Balance</b>	<b>1992</b>	<b>1993</b>	<b>1994</b>	<b>1995</b>	<b>1996</b>	<b>1997</b>	<b>1998</b>	<b>1999</b>	<b>2000</b>	<b>2000 (%)</b>
<b>Croatia</b>	77	123	203	244	212	329	342	213	261	31.3
<b>Macedonia</b>	43	93	117	80	78	83	102	131	119	14.3
<b>BiH</b>	2	8	54	86	199	228	243	288	343	41.1
<b>FRY</b>	102	7	14	5	35	62	31	46	111	13.3
<b>Total SEE</b>	<b>224</b>	<b>231</b>	<b>387</b>	<b>415</b>	<b>524</b>	<b>703</b>	<b>717</b>	<b>679</b>	<b>834</b>	<b>100</b>
<b>TOTAL</b>	<b>418</b>	<b>-358</b>	<b>-402</b>	<b>-910</b>	<b>-887</b>	<b>-873</b>	<b>-945</b>	<b>-1443</b>	<b>-1503</b>	

Source: SURS; author's calculations.

Share of exports to SEE markets in total Slovenian exports remains relatively stable at 16% from 1993 on. On the other hand, imports from SEE region stagnated in 1990s with a 9% increase of € figures only from 1993 to 2000 (a 14% decrease when measured in US\$), resulting in a monotonically decreasing share in total Slovenian imports. As a consequence, huge and increasing trade surplus of Slovenia amounting to some €800 mill. in 2000 can be

<sup>4</sup> In present case, € figures reflect current trends more correctly due to high volatility of US\$ currency in 1990s and due to de facto export pricing of shipments to SEE region in €based currencies.

observed. In absolute terms most of the surplus stems from trade with Croatia. In relative terms trade surplus is more severe for BiH, FRY and Macedonia reflecting their damaged production potential over the last decade. Trade coverage ratio of their bilateral trade with Slovenia ranges between 16% (BiH), 30% (FRY and Macedonia) and 65% (Croatia). To put it differently, Slovenia participates in overall trade imbalances of FRY, Croatia, BiH and Macedonia with 7%, 22%, 33% and 37%, respectively (Mrak 2001).

Another standard tools of analysis of bilateral trade patterns will be used here, namely analysis of intra-industry trade (IIT) and revealed comparative advantage (RCA). Table 2 reveals that bilateral trade between Slovenia and SEE countries consists mainly of one-way trade due to comparative advantage reasons. In almost all product lines Slovenia is a net exporter. There is some scope for intra-industry trade with Croatia, especially in textiles, wood, chemicals and metal products. However, share of two-way trade is mostly tied to some 20% of total trade. With BiH and FRY there is some scope for two-way trade in wood & furniture and textiles sectors, respectively. Note that share of two-way trade between Slovenia and EU ranges between 60 and 70%.

**Table 2: Pattern of bilateral trade between Slovenia and SEE countries in 2000 - one-way (RCA) vs. two-way trade (IIT)**

NACE-2 Sector	Intra-industry trade (IIT) <sup>1</sup>				Revealed comparative advantage (RCA) <sup>2</sup>			
	CRO	BiH	M	FRY	CRO	BiH	M	FRY
<b>A</b> Agriculture	4.4	2.2	0.1	14.4	0.1	0.0	4.8	0.0
<b>DA</b> Food, bev., tobacco	18.8	0.5	2.6	1.0	0.1	1.5	0.7	1.6
<b>DB</b> Textiles	23.2	9.1	4.6	46.3	0.0	0.3	0.1	-2.1
<b>DC</b> Wood and products	29.3	56.0	10.2	5.8	0.0	-3.2	0.0	0.1
<b>DD</b> Leather, footwear	10.5	3.4	0.0	0.7	0.3	0.3	2.0	3.0
<b>DE</b> Paper, publishing	10.6	4.6	0.5	2.2	0.4	0.2	0.5	1.8
<b>DG</b> Chemicals	21.1	1.1	6.7	3.7	0.9	0.6	-0.1	0.3
<b>DH</b> Rubber and tyres	16.5	3.7	0.3	5.4	0.3	0.2	0.4	0.7
<b>DI</b> Non-ferrous prod.	12.5	0.8	6.3	4.3	0.1	0.2	-0.1	0.2
<b>DJ</b> Metal prod.	20.9	8.2	1.2	4.8	0.1	0.0	0.2	0.1
<b>DK</b> Machinery	9.5	1.9	1.0	1.3	0.5	0.6	0.5	1.6
<b>DL</b> Elec. appliances	14.2	2.7	1.3	2.4	0.1	0.2	0.4	0.5
<b>DM</b> Vehicles, parts	15.3	11.8	1.9	4.0	1.2	-0.1	0.4	0.3
<b>DN</b> Furniture, misc.	14.8	21.8	4.3	6.8	0.4	-0.1	0.3	0.1

<sup>1</sup> GL index:  $IIT_i = \left(1 - \frac{|x_i - m_i|}{x_i + m_i}\right) * 100$ , <sup>2</sup> RCA index:  $RCA_i = \left(\frac{x_i}{\sum x_i} - \frac{m_i}{\sum m_i}\right) * 100$

Note: IIT and RCA indices are calculated at the CN 9-digit level and aggregated to NACE 2-digit level with export shares used as weights.

Source: SURS; author's calculations.

Sources of attractiveness of SEE markets for Slovenian firms can be easily identified in Figures 1 and 2. Figure 1 compares brand awareness of firms' major brands in SEE markets relative to EU markets and the importance SEE markets relative to EU markets (in terms of market shares)<sup>5</sup>. A positive value reflects higher importance of SEE relative to EU markets. It is straightforward to see that higher relative brand awareness in SEE markets corresponds

<sup>5</sup> Figures are based on firms' estimates of their brand awareness in different markets and importance of different markets in terms of market shares as conducted in our survey (N=115). Estimates of manufacturing firms only are aggregate to NACE 2-digit level.

to higher relative importance of these markets in terms of market shares relative to EU markets. Especially firms operating in food, leather and footwear, chemicals, paper and machinery sectors find their products more competitive in SEE markets resulting in higher export performance to these markets.

### **Insert Figure 1**

Almost the same picture can be depicted from Figure 2, which switches from firms' perceptions to real data. Figure 2 relates average export prices (unit values) of Slovenian products in SEE and EU markets to export shares of these markets. In order to calculate export unit values a highly detailed trade data at CN 9-digit level for 2000 has been used. After adapting for different trade structures, 1506 different products, which are simultaneously exported to all observed markets, were matched. These products account for 75% of total Slovenian exports to EU, Croatia and BiH, and to 85% of exports to FRY and Macedonia.<sup>6</sup> Individual average export prices were then aggregated to NACE 2-digit level with export shares used as weights. In Figure 2 sectors are ranked by increasing export shares of individual sectors to EU. In the Figure, one can observe a complete overlap between export attractiveness measured by average export prices and export performance in both EU as well as SEE markets. More importantly, Figure 2 points towards completely opposite exports attractiveness of EU and SEE markets for Slovenian products. Slovenian firms in agriculture, food, paper, chemicals and wood sectors can on average obtain twice as high export prices when exporting to SEE markets relative to EU markets. Consequently, a clear pattern of export specialisation by sectors appears, i.e. sectors that are less competitive in EU markets tend to specialise in exports for SEE markets. Hence, it is not surprising that more than 50% of exports of agricultural and food goods is sold to SEE markets.

### **Insert Figure 2**

These "undecently high" export prices in SEE markets, nevertheless how attractive they may appear for current operations of firms, might in the longer run lead to unfavourable macroeconomic developments. As exporting to SEE markets is less demanding in terms of quality of products an increased export orientation towards these markets might hinder further restructuring of firms and increase technology gap against firms exporting to EU markets. A kind of dual economy may be the long run outcome. Relocation of manufacturing activity of these sectors via FDI to SEE countries instead of export specialisation might be a better policy. In particular, when having in mind that production in all of above listed sectors is intensive in natural resources.

## **3.2. Pattern of outward FDI**

Stock of outward FDI into SEE countries is upward trended since 1994. In 2000 total stock of FDI into SEE countries amounted to some €60 mill., which represent about 65% of total Slovenian stock of outward FDI. Due to proximity a majority (45%) of total outward

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<sup>6</sup> After excluding FRY and Macedonia from our analysis, 3042 simultaneously exported products to EU, Croatia and BiH could be matched. Adding up, these products account for 90% of total exports to individual markets. However, sample expansion did not alter the magnitude of export unit values for EU, Croatia and BiH.

FDI has been directed to Croatia, while 8% has been located both into BiH and Macedonia. Until the end of 2000 there have been 804 investment projects conducted by Slovenian firms in the SEE region. Only one half of them, however, has been directed into establishment of new or acquisitions of existing firms. Other half of Slovenian outward FDI projects is being directed into real estate, bankrupt local firms, etc. In contrast to this, a majority of outward FDI into non-SEE countries consists of establishments of new or acquisitions of existing firms. This fact reflects specific cautiousness of Slovenian firms regarding the type of investments in SEE region. This fact will become even more characteristic in next section, in which survey data of largest Slovenian companies will be analysed.

**Table 3: Pattern of Slovenian FDI projects in SEE countries 1994-2000 (€mill.)**

	1994	1995	1996	1997	1998	1999	2000	2000 (%)
<b>Croatia</b>	163.2	176.9	188.8	206.0	286.2	301.3	388.5	45.1
<b>Macedonia</b>	13.4	16.4	18.3	24.3	22.1	36.4	71.8	8.3
<b>BiH</b>	12.5	12.5	13.9	14.7	16.3	24.3	67.2	7.8
<b>FRY</b>	23.6	41.8	27.5	25.4	30.4	24.2	28.9	3.4
<b>Total SEE</b>	<b>212.7</b>	<b>247.5</b>	<b>248.4</b>	<b>270.4</b>	<b>355.1</b>	<b>386.3</b>	<b>556.4</b>	<b>64.5</b>
<b>TOTAL</b>	<b>299.3</b>	<b>379.2</b>	<b>382.0</b>	<b>400.5</b>	<b>534.9</b>	<b>583.1</b>	<b>862.4</b>	<b>100.0</b>

Source: Bank of Slovenia, Foreign investments 1994-1999; Foreign investments 2000; author's calculations.

## 4. TRADE vs. INVESTMENT MODE OF PENETRATING SEE MARKETS

In this section we analyse data obtained through surveys of largest Slovenian companies. Special questionnaires on firms' operations in SEE markets were sent out to 410 privatised manufacturing as well as non-manufacturing firms. In return, 115 completed questionnaires were collected. Firms' responds give a picture of prevalent modes of entry into SEE markets, estimates of entry costs, main reasons for each of the two entry modes, characteristics of individual SEE markets as well as of firms' present and planned investment activities in SEE region in the future.

### 4.1. Entry costs and modes of entry into SEE markets

Following **Dunning (1993)**, motives for outward FDI by parent firms can be classified into market-seeking, efficiency-seeking and resources-seeking. Trade-barriers-jumping motives for FDI are a clear case of market-seeking FDI. However, due to lower labour costs and possible relative resource abundance in developing countries efficiency-seeking and resource-seeking motives may often prevail over market-seeking motives. In international trade theory and theory of multinational firm trade barriers (e.g. tariffs and transport costs) were given a crucial role in firms' considerations of internalisation of their operations through FDI. Evidence show that in early 1960s US multinational companies (MNCs) started to penetrate European markets via FDI more extensively in order to avoid transport costs as well as new trade barriers set up by recently established European Economic Community (see **WIR 1998**). In order to study substitutability-complementarity relation between international trade and capital mobility, **Brainard (1993)** provides a formal proximity-concentration model of international trade, which points out to trade-off between

proximity to consumers and loss of economies of scale due to division of production into many smaller locations. Using firm level trade data for US MNCs, Brainard shows that US outward FDI substitute for US exports.

In case of SEE markets the (perception of) different kinds of entry costs may play a crucial role in determination of firm's penetration strategy. In case of high entry costs relative to other factors (such as stability of local business environment, scale of operations, etc.) firms are more likely to penetrate these markets through FDI. In case of low relative entry costs firms will keep penetrating the markets through exports. In our survey, firms were asked to assess the level of entry costs into individual SEE countries as well as the degree of stability of local economic and political environment.

**Table 4: Estimates of entry costs and of stability of local business environment (1 - low, 5 - very high)**

<b>Entry costs</b>	<b>EU</b>	<b>CRO</b>	<b>BiH</b>	<b>FRY</b>	<b>MK</b>
<b>Transport costs</b>	3.0	2.3	2.8	3.5	3.8
<b>Tariffs</b>	1.8	2.7	2.7	3.4	2.9
<b>Entry into local store chains</b>	3.4	2.7	2.6	2.8	2.6
<b>Technical and health standards</b>	3.4	2.1	1.9	2.0	1.9
<b>Non-tariff trade barriers)</b>	1.9	2.0	1.8	2.3	2.0
<b>Informal administrative barriers</b>	1.4	1.9	1.8	2.5	2.0
<b>Stability of business environment</b>	<b>4.4</b>	<b>3.1</b>	<b>2.4</b>	<b>1.5</b>	<b>1.7</b>

Source: RCEF & ISEE Survey; author's calculations.

According to Table 4, major entry barriers Slovenian firms are faced with in Croatia and BiH are high tariffs and hindered entry into local store chains followed by transport costs. Due to larger distance for FRY and Macedonia firms claim transport costs to be the major trade barrier, followed by high tariffs and hindered entry into local store chains. However, what is important is the magnitude of estimated entry barriers. In Croatia and BiH entry barriers are modest (not exceeding score 2.8 with 5 the maximum value) while in FRY and Macedonia the barriers are higher by order one. For comparison, in EU markets technical & health standards and hindered entry into local store chains are estimated to be higher than in SEE markets. Tariff barriers in EU are estimated much lower than in SEE markets while transport costs are assessed to be higher than in Croatia and BiH but lower than in FRY and Macedonia. Based upon these estimates one can hardly make suggestions upon modes of entry into SEE markets. In order to do so one should refer to estimates of stability of local business environments. Business environment in Croatia has been estimated by firms to be modest, in BiH as unstable, while in FRY and Macedonia it has been estimated as extremely unstable. Adding it up, estimates of trade barriers relative to stability of local business environments would not suggest much of FDI as a way of penetrating SEE markets. In Croatia (and partly in Bosnia) with modest stability the trade barriers are also modest, which may or may not encourage much of FDI. Here, industry-by-industry and case-by-case considerations are important. In contrast, in FRY and Macedonia higher probability of FDI encouraged by higher trade barriers is then offset by extremely unstable economic and political climate. Very little FDI into these countries might be the outcome.

Above considerations find support in the data. Table 5 compares prevalent modes of entry of Slovenian firms into individual SEE markets by 2000. In general, Slovenian firms prefer conventional export to FDI mode of entry into all of SEE countries. As expected, there is some FDI promoted sales taking place in Croatia. On average about one third of total firms' sales to this market can be accounted to local affiliates of Slovenian firms. In BiH and

Macedonia, 85% of total firms' sales in these markets have been achieved through regular exports, while in FRY share of exports in total firms' sales to this country reaches 95%. A breakdown of firms' responds by sectors reveals almost unaltered picture. Only in Croatia, in some sectors (e.g. foods, chemicals, metal and non-ferrous products) firms' market penetration through local affiliates exceeds 50% of total sales.

**Table 5: Modes of entry - share of firms' sales to SEE markets through regular exports and through sales by local affiliates in 2000 (in %)**

Mode of entry	CRO	BiH	MK	FRY
Exports	66.1	83.2	84.6	95.5
Sales through local affiliates	33.9	16.8	15.4	4.5

Source: RCEF & ISEE Survey; author's calculations.

#### 4.2. Reasons for choosing trade entry mode into SEE markets

In this subsection reasons for preferred trade entry mode into SEE markets are further explored. Firms exporting to Croatia claim good business co-operation and lower investments required than in case of FDI to be major reasons for preferring exports mode. In BiH, FRY and Macedonia, firms stress low investment needed and low scale of current operations. In FRY poor local legislation is also very pronounced. Trade and transaction costs seem to play very little role.

**Table 6: Major reasons for export entry mode in 2000  
(1 - unimportant; 5 - very important)**

Reasons	EU	CRO	BiH	FRY	MK
Good business cooperation	3.9	4.1	3.4	3.2	3.0
Lower investments required than in case of FDI	3.8	3.8	3.7	3.6	3.6
Low scale of sales	3.3	3.3	3.4	3.4	3.4
Specific products	3.4	3.2	3.3	3.3	2.8
Good financial discipline	4.1	2.9	2.7	2.7	2.7
Low trade and transaction costs	2.9	2.9	2.6	2.6	2.4
Poor local legislation	1.8	2.7	3.1	3.4	2.9

Source: RCEF & ISEE Survey; author's calculations.

#### 4.3. Reasons for choosing investment entry mode into SEE markets

As argued above, despite trade barriers FDI into SEE countries might well be driven by lower labour costs and possible relative resource abundance. However, none of the above key theoretical reasons for FDI seem to be very important for Slovenian firms conducting businesses with SEE countries. Slovenian firms, on the contrary, stress the importance of investment mode of penetration into these markets in order to secure payments in the first place. Bad financial discipline of local customers is being estimated as major reasons for choosing investment mode. Large scale of sales and access to adjacent local markets also stimulate Slovenian investments into region. High entry costs and low costs of labour and materials in SEE countries are important investment motives relative to EU figures, however, much less important when compared to above motivation.



**Table 7: Major reasons for investment entry mode in 2000  
(1 - unimportant; 5 - very important)**

Reasons	EU	CRO	BiH	FRY	MK
Bad financial discipline	1.3	3.8	3.7	3.7	3.4
Large scale of sales	3.8	3.8	3.5	3.2	3.2
Access to adjacent local markets	3.7	3.6	3.5	3.7	3.3
Low costs of labour and materials	2.3	3.2	3.6	3.5	3.3
Specific products	2.9	2.8	2.7	2.6	2.6
High entry costs	1.8	2.7	3.1	3.1	2.7

Source: RCEF & ISEE Survey; author's calculations.

Breakdown by sectors reveals some slight differences to above general picture. Firms in textiles, chemicals and rubber&tyres sectors claim high entry cost as major reason for choosing investment mode of entry. On the other side, firms in textiles, wood, rubber&tyres and electric appliances sectors stress importance of low costs of local labour and materials. These reasons may become important after SEE countries will get stabilised in terms of stable political systems and basic macroeconomic stabilisation.

As terms of business with SEE countries in still very specific Slovenian firms try to make use of their past experience with the region in order to achieve some first-mover-advantages over western firms which are still very cautious in this respect. Doing business with most of the firms in the region is very risky as there are no firm guarantees that export shipments will in fact be paid. Firms in our survey claim that key mode of payments in this region is cash, followed by completely insecure payments to open account and barter deals. Documentary credit or letter of credit as one of the most secure modes of payments in international trade is almost unsuitable for this region as local banks are either untrustworthy or they have no relations to Slovenian and western banks. Hence, in the short run Slovenian firms make use of investments into SEE region predominantly to secure payments for their shipments. So far, Slovenian firms invested mainly into representative offices and own stores with their major task to promote trade, i.e. imports of goods produced in Slovenian parent firms. Only 20% of Slovenian firms that have invested into the region have established local production facilities.

## **5. TRADE-PROMOTING OR EFFICIENCY SEEKING- INVESTMENTS?**

Major conclusion that can be drawn upon analysis in previous section is that, so far, trade-promoting motivation of present Slovenian FDI in the SEE region clearly dominates the efficiency-seeking motivation. In this section this finding is further explored by analysing intra-firm trade flows and investment plans of Slovenian firms.

### **5.1. Intra-firm trade**

Theory of multinational firm suggest that FDI should result in increased intra-firm trade between parent firm and affiliates (Ethier 1986, Markusen 1995, Markusen and Venables 1995). This might be the outcome both in the case of horizontal as well as vertical organisation of MNC. In case of vertical organisation affiliates serve as suppliers of intermediate goods of parent company. In case of horizontal organisation affiliates and

parent firm specialise in production of horizontally differentiated intermediate goods, such as different parts of a final good (Damijan 1999). Intermediate goods are then exchanged among all affiliates and final goods are then simply assembled from intermediates. Globalised automotive industry may be thought of as a case where this particular mode of investment and trade takes place.

We discussed earlier our anticipations that Slovenian firms investing into SEE region might be aimed at creation of new or restoration of former supply-chain organisation resulting in a kind of trade reintegration. Due to a huge technology gap between Slovenian firms and local firms in SEE region one can expect only vertical organisation of production within a MNC to take place. Hence, according to the theory a majority of intra-firm trade flows should be directed from affiliates towards parent company and not vice versa. The evidence, however, does not support these anticipations, as sales of parent firms to affiliates are on average three times higher than sales in the opposite directions (see Table 8).

**Table 8: Volume of intra-firm trade among Slovenian parent firms and their affiliates in SEE countries in 2000 (in % of total sales of parent firms)**

	Sales of parent firms to affiliates	Sales of affiliates to parent firms
CRO	10.8	1.9
BiH	2.3	0.1
FRY	0.0	0.0
MK	5.2	4.6
<b>Total SEE</b>	<b>18.3</b>	<b>6.6</b>
EU	6.5	0.9

Source: RCEF & ISEE Survey; author's calculations.

Only in case of Macedonia, shipments in both directions are balanced indicating that Macedonian affiliates (especially in food and tobacco sector) serve as a resource base for Slovenian parent firms. On average, Slovenian parent firms perform some 18% of their total sales in SEE countries via shipments to their affiliates in SEE region. However, these shipments are mainly consisting of final goods intended for sales, where function of local affiliates (mainly trade representative offices and stores) in individual countries is limited to whole-sale or retail-sale activities only. The evidence, hence, is again rejecting the anticipation of efficiency seeking motivation of Slovenian firms in SEE markets.

## 5.2. Firm characteristics and investment behaviour of Slovenian firms in SEE markets

In this subsection, present and planned investment behaviour of Slovenian firms in SEE region is analysed. We make use of data on time varying investment activity of largest Slovenian companies drawn from survey and combine these data with firms' income statements and balance sheets. In doing so, we believe to obtain more insights into potential time varying changes in investment preferences of Slovenian firms. Simple probit model is used to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004.

In our questionnaires firms were asked to indicate their past and planned investment activities in SEE. Firms' responds suggest that largest Slovenian firms captured in our survey have performed very few FDI projects in SEE region before 2001. Before 1990, out of 115 surveyed firms there were only 27 FDI projects in SEE region, 80% of them being directed into manufacturing sector. Between 1990 and 2000 42 FDI projects in SEE among

our sample of firms is recorded, 70% of them in manufacturing sector. Short run (until the end of 2001) and long run (until 2004) investment plans reveal significant differences. In short run only 16% of surveyed firms plan an investment into SEE region, while in the long run 42% of firms indicate serious intention to perform FDI in SEE region. In long run, the highest investment propensity to SEE is recorded amongst manufacturing firms, i.e. 50% of manufacturing firms in our sample confirm to perform FDI in SEE. Manufacturing firms state to spend about 3% and 8% of their annual total income for their short run and long run investment activities in SEE region. There are significant differences among manufacturing and commercial firms in respect of attractiveness of investment location. Commercial firms, both in short and long run prefer investment to Croatia, while manufacturing firms in both periods prefer FRY. One can ascertain that commercial firms are looking for higher purchasing power of Croatian market, while for manufacturing firms efficiency-seeking motives for FDI in FRY may prevail.

**Table 9: Location preferences of Slovenian manufacturing and commercial firms for their investment plans in SEE countries until 2004 (in % of firms)**

	Short run (2001)		Long run (2002-2004)	
	Manufacturing	Commercial	Manufacturing	Commercial
<b>CRO</b>	50	80	39	100
<b>BiH</b>	50	20	45	43
<b>FRY</b>	60	60	77	57
<b>MK</b>	0	40	0	29
<b>N</b>	10	5	31	7

Source: RCEF & ISEE Survey; author's calculations.

In order to get an insight into evolution of investment motives of Slovenian firms in SEE region over the period 1990-2004 we employ simple probit model. The dependent variable in our model ( $FDI_t$ ) is existence of FDI by a firm. Dependent variable has the value 1 ( $FDI_t=1$ ) if in observed period a firm has had or plan to have a FDI in one of the SEE countries, otherwise ( $FDI_t=0$ ). Dependent variable is regressed on a set of firms' characteristics, such as size, factor intensity, labour and capital productivity, export propensity, R&R intensity and sector dummies. The model is estimated for three different time periods: (1) period before 2000, (2) period 2001 and (3) period 2002-2004. For period before 2000 set of firm characteristics for year 1996<sup>7</sup> has been used, while periods 2001 and 2002-2004 are estimated with firm level data for year 2000.

Before switching to results an important methodological issue should be addressed. As our sample of firms is intentionally biased toward largest Slovenian firms the results do not necessarily reflect actual pattern of behaviour of all Slovenian firms. More pronounced investment preferences to investment activity in SEE region by largest Slovenian firms may not be shared by a majority of smaller firms. In other words, a biased sample of firms may give biased estimations of coefficients. In order to control for this sample-selection bias we have used two-stage Heckman procedure (Heckman 1979), which enables us to control for these unobserved effects<sup>8</sup>.

<sup>7</sup> Note that using firm level data sets for different years (data is available for 1994-2000) does not alter the results significantly.

<sup>8</sup> See more about the use of Heckman procedure in case of TFP growth and export performance of domestic and foreign firms in transition countries in Damijan et al (2001a, 2001b).

Results of probit estimations in Table 10 confirm our findings from previous sections. Common characteristics of firms investing to SEE markets before 2000 are large size, high export propensity or that they operated in food sector. Similar characteristics were found also for short run investment plans of firms in 2001. The only exception being that food producing firms have tempered their eagerness to invest into SEE region. These findings confirm that past investments and short run investment plans of Slovenian firms into exhibit mainly trade-promoting motives, i.e. large firms attempted to increase utilisation of their capacities by exporting to SEE markets. This is especially true for firms in food sector, which have found themselves competitive in SEE markets only.

**Table 10: Probability of firms' investments into SEE region in 1990-2004 (Results of probit model)**

	Before 2000	Year 2001	2002-2004	2002-2004
	1	2	3	4
<b>FDI<sub>2000</sub></b>				<b>***1.125</b> <b>(3.07)</b>
<b>Size</b> (Sales)	<b>**0.012</b> <b>(2.45)</b>	<b>*0.011</b> <b>(1.91)</b>	0.000 (0.08)	-0.003 (-0.74)
<b>Capital intensity</b> (Assets/employee)	0.000 (1.39)	0.000 (0.98)	0.000 (0.51)	0.000 (0.13)
<b>Skill intensity</b> (Labour costs/employee)	0.000 (-0.37)	0.000 (-0.60)	0.000 (-1.00)	0.000 (-0.85)
<b>Labour intensity</b> (Labour costs/	0.010 (0.61)	0.004 (0.18)	<b>*0.038</b> <b>(1.88)</b>	<b>**0.045</b> <b>(2.11)</b>
<b>Labour productivity</b> (Sales/employee)	0.000 (0.98)	0.000 (0.78)	<b>*0.000</b> <b>(1.70)</b>	<b>**0.000</b> <b>(2.09)</b>
<b>Capital productivity1</b> (Profits/employee)	-0.0003 (-1.24)	0.0001 (0.33)	0.0000 (0.08)	0.0000 (0.05)
<b>Capital productivity2</b> (Profits/assets)	0.022 (1.21)	-0.003 (-0.42)	-0.006 (-1.18)	-0.007 (-1.32)
<b>Export propensity</b> (Exports/sales)	<b>0.013</b> <b>** (2.00)</b>	<b>*0.020</b> <b>(1.88)</b>	0.000 (0.07)	-0.003 (-0.54)
<b>R&amp;R intensity</b> (Intangible assets/sales)	-0.991 (-0.10)	-5.328 (-0.39)	<b>16.870</b> <b>(1.82)</b>	<b>*15.735</b> <b>(1.68)</b>
<b>dummy Food sector<sup>1</sup></b>	<b>**1.328</b> <b>(2.26)</b>	0.300 (0.29)	0.251 (0.45)	-0.338 (-0.58)
<b>dummy Commercial<sup>1</sup></b>	0.248 (0.39)	1.361 (1.60)	-0.458 (-0.87)	-0.553 (-1.06)
<b>dummy Other services<sup>1</sup></b>	-0.117 (-0.21)	-0.249 (-0.33)	<b>** -1.178</b> <b>(-2.18)</b>	<b>** -1.150</b> <b>(-2.12)</b>
<b>Constant</b>	<b>*** -2.943</b> <b>(-2.87)</b>	<b>** -3.237</b> <b>(-2.43)</b>	<b>** -1.698</b> <b>(-1.98)</b>	<b>** -2.019</b> <b>(-2.41)</b>
<b>N</b>	111	111	111	111
<b>Pseudo R2</b>	0.203	0.296	0.165	0.210

Notes: t-statistics in parentheses; \*, \*\* and \*\*\* denote significance at 10, 5 and 1 per cent.

<sup>1</sup> Reference group is non-food producing manufacturing firms.

Probit results for long run investment plans of Slovenian firms, however, reveal some change in investment preferences by firms. It seems that trade-promoting motive for FDI in SEE has been substituted by more distinctive efficiency-seeking motive. In the future, firms with higher labour intensity, higher labour productivity and higher R&R intensity seem to tend to relocate part of their production to SEE region in order to combine their firm-specific intangible assets with lower local labour costs.

The last model (column 4) includes a variable on existence of firms' past FDI in the region in order to capture the effects of past experience with investing into the region. Past experience with investments in SEE region may significantly affect future investment plans. Results point towards positive past experience since firms which have already had a FDI in one of the SEE countries tend to extend their investments in the future also to other countries in the region.

## 6. CONCLUSIONS

The aim of the paper is to analyse current trade and investment activity of Slovenian firms in the SEE region in order to reveal the motivation of Slovenian firms investing in SEE. We try to find out whether the pattern of trade and investment of Slovenian firms in the region tends to promote Slovenian exports to the region or whether it tends to create or restore former "multinational type" of vertical supply chain organisation. In other words, the paper attempts to uncover trade-promoting versus efficiency-seeking motives for Slovenian present increased investment activity in the region.

Anticipation of efficiency-seeking motivation of Slovenian FDI in SEE markets in the past decade, however, has been clearly rejected by the data. Trade-promoting motivation of present Slovenian FDI in the SEE region has been found to be clearly dominating over the efficiency-seeking motivation. Slovenian firms might be predominantly aimed at increasing sales to the region from their Slovenian headquarters rather than at setting up local production facilities due to comparative advantage reasons (lower costs of local labour). In the past Slovenian firms made use of investments into SEE region predominantly to secure payments for their shipments from Slovenian headquarters. So far, Slovenian firms invested mainly into representative offices and own stores with their major task to promote trade, i.e. to increase imports of goods produced in Slovenian parent firms. Only 20% of Slovenian firms that have invested into the region in the past have established local production facilities. Major reasons for this lie in a still very unstable political and economic environment of the SEE region, in low financial discipline of local customers as well as in still under-utilised resources of Slovenian parent firms.

In addition, the paper studies the evolution of investment motivation of Slovenian firms in SEE region over the period 1990-2004. Past and planned investment behaviour of Slovenian firms vis-à-vis SEE region combined with firms' operational characteristics is studied using a simple probit model. Indeed, evidence shows a change in firms' long run investment motivation to the region relative to their past motivation. Efficiency-seeking motive has become more pronounced. In the future, firms with higher labour intensity, higher labour productivity and higher R&R intensity seem to tend to relocate part of their production to SEE region in order to combine their firm-specific intangible assets with lower local labour costs. Results also point out positive past experience with investments into SEE region since firms which have already had a FDI in one of the SEE countries tend to extend their investments in the future also to other countries in the region.

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Figure 1: Importance of markets and brand awareness of products in SEE markets relative to EU markets

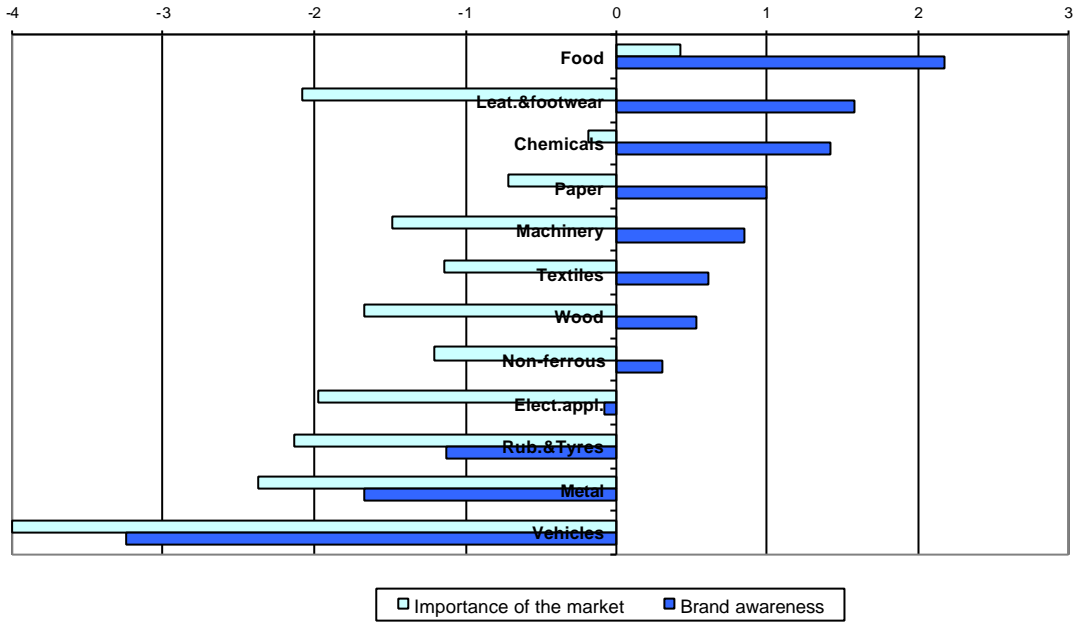


Figure 2: Export prices and shares in exports to SEE and EU markets in 2000

