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Foreign Direct Investments in Transition Economies – the Case of Serbian Financial Industry

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Abstract

In this paper we analyze the influence of foreign investments on the host economy. Since 1990 most developing and transition countries have recognized foreign direct investments (FDI) as a major source of financial capital inflow, with the importance of state and capital market inflows significantly decreasing. We use econometric analysis of data from countries which have already gone through transition process, follow the trends of foreign investments, and divide them into mergers and acquisitions on the one side and greenfield investments on the other side. Finally, we analyze investments into the Serbian financial system where, from the beginning of the reform, foreign banking groups have brought significant positive trends, especially through improving the sector's financial performances and providing stable funding sources from abroad. Financial institutions in Serbia have gone through several transformations since the beginning of nineties. We end the paper concluding that the Serbian financial sector is today completely consolidated and represents the core for the development of the whole economy and the potential source of capital inflows.

Key words: *capital inflow, FDI, financial institutions, assets, profitability, Serbia*

JEL Classification: *F21, F43, G15*

Introduction

Capital flows include transfer of real and financial funds between different countries' entities, with a counter transfer being postponed for a certain period of time, with the goal of achieving economic and political goals of participants in the transfer[1]. According to Kovač[2], there are three major types of international funds flows:

- international flow of loan capital - state inflows;
- portfolio investments - capital market inflows;
- foreign direct investments.

Host country economy is obtaining capital inflow from different public and private sources. Since 1990 the most developing and transition countries have recognized foreign direct

[1] U n k o v i ć , M., *Međunarodno kretanje kapitala i položaj Jugoslavije*, Belgrade, Naučna knjiga, 1980, pp. 1
[2] K o v a č , O, *Platni bilans i međunarodne finansije*, Beograd, Cesmecon, 1994, pp. 274

investments as a major source of financial capital inflow. After 1993 foreign direct investments became major source of inflows with state and capital market inflows importance decreasing.

In Serbia, the similar trends are present. Foreign direct investments were the most important type of capital inflows during 2001-2008. We will show that FDI in Serbian financial sector has made it healthy and gave it a central role in the transition process.

Foreign Investments to Developing and Transition Countries

As noted, FDI is the major source of capital inflow to developing and transition countries. According to Miyamoto (2003, pp. 12), such a trend has been persistent in the 21st century as well. In Figure 1, we show the levels of three types of inflows to developing countries within the period of 10 years. What is notable is that despite the fluctuation of total levels of inflows, FDIs have strengthened their position as compared to two other types of inflows.

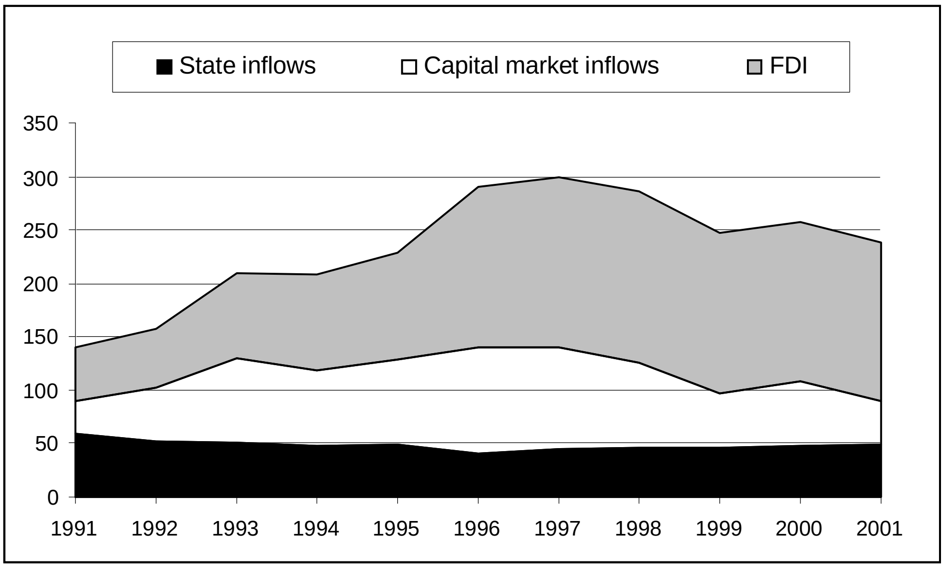

Fig. 1. Net capital inflow in developing countries (US$ bill.)

Source: Miyamoto (2003, pp. 12)

The beginning of nineties brought the expansion of investment activities in developing countries. The factors which made these countries attractive for investments were, as follows: the rapid economic growth especially in South East Asia and Latin America; privatization programs open for foreign investors; and liberalization of FDI regimes (UNCTAD, 1994). FDI inflow, capital markets investment growth and renewed private loans changed the structure of global financial inflows to developing countries during nineties (UNCTAD, 1995).

Table 1. FDI by groups of countries and in Serbia (billion US$)

	1990	2000	2001	2002	2003	2004	2005	2006	2007
World	207	1,398	824	625	561	718	959	1211	1,833
Developed countries	172	1,135	600	443	361	404	611	941	1,248
EU	97	698.10	384	309	259	214	498	562	804
Developing countries	35	257	214	171	180	284	316	413	500
SEE transition countries*	4.10	3.70	4.50	4.20	8.40	13.40	15.20	28.90	30.10
Serbia	0.10	0.10	0.20	0.50	1.40	1.00	2.10	5.10	4.00

*Note: * including Bulgaria and Romania*
Source: FDI Stat

Table 1 gives data about FDI inflow by groups of countries, where we can observe significant growth in developing countries until the beginning of the century, and raise of FDI in SEE transition countries and in Serbia. After global investment crisis in 2001-2003, despite nominal growth, share of investments in developing countries started decreasing from the highest of 40.00% in 2004 to 27.00% in 2007. Without detailed analysis what caused this decrease, one may say that investors shifted towards other regions like Canada, Russia, Australia, China, Ireland and rising SEE transition countries.

It is also important to note that not all FDI are of the same type. We can divide foreign direct investments to greenfield investments on the one side and mergers and acquisitions (M&As) on the other side. Establishment of new affiliations in foreign country is defined as greenfield investments, whereas takeover of existing capacities in foreign country is named M&A. Importance of M&As as a FDI tool grew after 1980, so that its share in total FDI today varies between 55.00% and 75.00%, and it is the highest in developed countries.

Table 2 gives data about share of FDI, greenfield investments and M&As in groups of countries' GDP. Except for selected years, when privatization of large scale state owned companies took place, in transition countries, greenfield investments play a much more important role. This is to say that the share of M&A shows the stage of development of the host country, which means that foreign investors see existing companies as a good and profitable investment location.

Table 2. Total FDI, mergers and acquisitions and greenfield investments (share of GDP)

		1990	**2000**	**2001**	**2002**	**2003**	**2004**	**2005**	**2006**
World	total	0.94	4.39	2.61	1.90	1.52	1.73	2.14	2.91
	greenfield	0.26	0.80	0.73	0.78	0.71	0.81	0.54	1.09
	M&A	0.68	3.59	1.88	1.12	0.80	0.91	1.60	1.82
Developed Countries	total	0.99	4.60	2.45	1.73	1.26	1.26	1.83	2.68
	greenfield	0.21	0.24	0.39	0.47	0.40	0.27	0.02	0.61
	M&A	0.78	4.35	2.06	1.26	0.85	0.99	1.81	2.07
EU	total	1.34	8.25	4.48	3.31	2.28	1.63	3.64	3.87
	greenfield	0.48	1.14	1.89	1.08	1.17	0.27	0.51	0.90
	M&A	0.86	7.10	2.59	2.23	1.11	1.36	3.13	2.97
Developing countries	total	0.91	3.78	3.20	2.49	2.37	3.22	3.06	3.44
	greenfield	0.53	2.80	1.93	1.85	1.86	2.62	2.15	2.38
	M&A	0.38	0.99	1.27	0.64	0.51	0.60	0.91	1.06
SEE transition countries	total	0.08	3.99	5.41	3.81	5.79	4.09	5.49	9.61
	greenfield	0.06	2.53	4.07	2.51	4.17	2.47	3.24	4.84
	M&A	0.02	1.46	1.33	1.30	1.62	1.62	2.25	4.76
Serbia	total	0.08	0.46	1.19	2.87	5.97	3.77	8.32	14.53
	greenfield	0.08	0.46	1.19	1.46	2.31	3.34	4.07	3.88
	M&A	0.00	0.00	0.00	1.41	3.66	0.43	4.25	10.65

Source: FDI Stat

In countries like Serbia, which have completed the first phase of transition in which the state owned companies' privatization is completed, it is necessary to search for other ways to attract foreign investors. Foreigners are not attracted for further M&As, and high dependency of local GDP on foreign investments, taking almost 15.00% of GDP has to be replaced with other sources of financial inflow. Greenfield investments create good source of funding for public and private sector of host countries, in particular for complementary investments in infrastructure and development of human resources (Miyamoto, 2003, pp. 13). It is important to have viable development policy which will guarantee that funds raised from FDI will be used to increase the host country's attractiveness for renewed M&A. For that reason we have analyzed Serbian financial industry, since according to IMF (2008) liberalization of the banking sector has brought large scale capital inflow.

According to Zubović and Domazet (2009) over the past years, service sectors have proven to be the most attractive to international investors in Serbia. The financial sector recorded the biggest FDI inflow of $ 5.20 billion (Table 3) which is equal to almost 30.00% of all foreign investments in Serbia since the beginning of transition. For that reason we have in this paper analyzed the transformation and current situation in so called financial industry, which includes commercial banks, insurance companies and financial leasing companies.

Table 3. Inward FDI by industries (US$ mil., 2004-march 2009)

Industry	Total investments
Financial intermediation	5,193.40
Transport and telecommunications	3,107.20
Manufacturing	2,773.60
Real estate, renting	1,954.50
Wholesale, retail, repairs	1,909.60
Mining and quarrying	576.10
Construction	345.40
Agriculture	119.20
Hotels and restaurants	93.20
Electricity, gas, and water	89.00

Source: National Bank of Serbia (NBS 2008)

Transition of Serbian Financial Industry

Transition countries are in different stages of financial sector change, from the former model of state controlled into market oriented model. Major changes were required in banking and insurance sub-sectors.

Socialist banking system was characterized by high concentration and emphasized planning role (which practically eliminated commercial component of banking). In such environment, the core of the financial system was a central bank with few specialized state banks, such as: development bank, investment bank, foreign trade bank, industrial-trading bank or agricultural bank.

In transformation of the banking systems of transition countries important role are playing foreign banks, which dominate privatization process of state owned banks and introduction of new banking products on the market (Milojević 1996, pp. 23).

Real reform of such banking system, as a long-term process of consolidation and restructuring in Serbia has begun in 2001. Today we have completely different banking system which is market oriented. In 2005 a new Law of Banking has been passed, and National Bank of Serbia is since entitled for providing licenses to commercial banks, performing supervision on banks' operations, enforcing the law, regulating prudential standards, and protecting stability and integrity of the banking system (NBS, 2008).

The project of empowering and reorganization of the insurance sector started in 2003. The intent of that project was to strengthen insurance industry in Serbia and to provide help to National Bank setup of sector for supervision of insurance (SNO) activities and to adopt standards of International Association of Insurance Supervisors (IAIS). Activities on the project have taken pace after the Law of Insurance in 2004 was passed.

Other changes include the adoption of the Law on Financial Leasing by which National Bank of Serbia was given a supervision role over operations of financial leasing companies in Serbia. It also gave authority to National Bank for issuing licenses for operations in this area and for performing correcting measures in case of irregularities.

In the next section we will analyze the activities of the Serbian financial industry and the effects of foreign investments.

Business Analysis of the Financial Sector in Serbia

Business structure of commercial financial institutions in Serbia is by 99.80% created by three groups of institutions: 34 commercial banks, 24 insurance companies and 17 leasing companies. Table 4 shows the assets of these three groups of financial institutions.

Table 4. Assets of commercial financial institutions in Serbia (000 dinars)

Institution	31.12.2006 1€=79.0 din	31.12.2007 1€=79.5 din	31.12.2008 1€=88.6 din
Commercial Banks	1,103,013,317	1,516,313,400	1,776,919,418
Insurance companies	50,407,294	61,129,001	84,807,422
Financial leasing companies	67,062,220	95,817,510	121,465,290
TOTAL	**1,220,482,831**	**1,673,259,911**	**1,983,192,130**

Source: National bank of Serbia, Serbian company registers agency-financial reports

Data from Table 4 shows that there was a significant nominal growth in assets values. That growth was only partially due to entry of new institutions on the market (by 1.00%), while the rest is to be assigned to contribution of improved quality of financial sector due to change of ownership structure.

Analysis of assets values is given in nominal values and in dinars in Table 4. For that reason and in order to give more representative insight we have to look at both nominal and real growth rates. Real vales are computed by revalorization of nominal values with price consumption rates growth indices, which are for the year 2007=1,101 and for the year 2008=1,068 (RZS, 2009). Cumulative coefficient for the period 31.12.2006-31.12.2008 is 1,176 (Table 5).

Table 5. Nominal and real change of assets values in Serbian financial sector

Groups of institutions	Nominal 2007/2006	Real 2007/2006	Nominal 2008/2007	Real 2008/2007	Real 2008/2006
Banks	37.00%	25.00%	17.00%	10.00%	37.00%
Insurance Companies	21.00%	10.00%	39.00%	30.00%	43.00%
Leasing Companies	43.00%	30.00%	27.00%	19.00%	54.00%
Total	37.00%	25.00%	19.00%	11.00%	38.00%

Source: Own calculations from Table 4

From Table 5 we can trace the changes in assets values for the period of three years. Total growth of the sector in real values is 38.00%. The lowest growth was in the banking sector with 37.00%, as long as in the insurance sector growth reached 43.00%, and in the leasing sector 54.00%. Banks have had the slowest growth rate, which is not a sign of weaker operations, but rather the sign that bank centricity is diminishing, and other financial sectors are gaining their share.

Foreign Capital in Serbian Financial Sector

Since year 2000, and the beginning of privatization of Serbian financial institutions, there has been significant change in ownership structure. Table 6 shows the share of foreign ownership in all commercial financial institutions in Serbia in 2009. It is important to note that foreign owners are also considered to be domestic companies owned by foreign entities.

Table 6. Foreign ownerships share in commercial financial institutions in Serbia

Institution	%	Institution	%	Institution	%
BANKS		**INSURANCE CO.**		**LEASING CO.**	
AIK Bank	60	AIG Lfe Insurance	100	EFG Leasing	100
Alpha Bank	100	AMS Insurance	36	Hypo-Alpe-Adria Leasing	100
Intesa Bank	100	AS life Insurance	100	INTESA Leasing	100
Post savings Bank	1	Basler Insurance	100	Lipaks Leasing	0
Credy Bank	3	Basler life Insurance	100	Meridian Leasing	100
Čačanska Bank	40	Credit Agricole life Insurance	100	NBG Leasing	100
Erste Bank	100	DDOR Insurance	85	NLB Leasing	100
Euro Bank EFG – savings Bank	100	Delta Generali Insurance	50	OTP Leasing	100
Findomestic Bank	100	Delta Generali re-Insurance	50	Piraeus Leasing	100
Hypo Alpe Adria Bank	100	Dunav Insurance	25	PORSCHE Leasing	100
Jubmes Bank	50	Dunav re-Insurance	25	Pro-credit Leasing	100
Jugo-Bank	0	Energoprojekt guarantor	3	Raiffeisen Leasing	100
KBC Bank	100	Globos Insurance	6	S-Leasing	100
Commercial Bank	30	Grawe Insurance	100	Soge-lease Leasing	100
Kosovsko metohijska Bank	0	Merkur Insurance	100	Uni-credit Leasing	100
Marfin Bank	100	Millennium Insurance	100	VB Leasing	100
Meridian Bank-Credit Agricole Group	100	Sava life Insurance	98	Zastava Istrabenz Leasing	95
Metals Bank	70	Sava life Insurance	98		
Moscow Bank	100	Takovo Insurance	24		
NLB Continental Bank	100	Triglav kopaonik Insurance	100		
Opportunity Bank	100	Uniqa life Insurance	100		
OTP Bank	100	Uniqa Insurance	100		
Piraeus Bank	100	Wiener re-Insurance	100		
Agro Bank	30	Wiener Stadtische Insurance	100		
Economy Bank Pančevo	1				
Economy Bank Beograd	65				
Pro credit Bank	100				
Raiffeisen Bank	100				
Société Générale Bank	100				
Serbian Bank	0				
Uni credit Bank	100				
Universal Bank	36				
Vojvođanska Bank	100				
Volks Bank	100				

Source: National Bank of Serbia, Central securities depository and clearing house-ownership structure

In Table 7 we have compiled data from previous tables, and showed companies assets by ownership structure. This facilitates analysis of the impact of foreign capital on companies' operations. We have used current ownership structure for all three years backward to facilitate comparison.

Assets owned by foreign entities in Serbia are growing in nominal values. But if we look at share of foreign owned assets in total financial institutions, we may observe that there has been a decrease of 0.20% from 84.30% to 84.10%, despite the entry of 13 new fully foreign owned institutions during the analyzed period.

Table 7. Assets by ownership in Serbian financial institutions

	2006	2007	2008
Total assets (mil. dinars)			
Banks	1,103,013	1,516,313	1,776,919
Insurance co.	50,407	61,129	84,807
Leasing co.	67,062	95,818	121,465
Total	1,220,483	1,673,260	1,983,192
Assets owned by foreign entities 2008. (mil. dinars)			
Banks	938,924	1,272,739	1,497,521
Insurance co.	26,172	32,743	52,603
Leasing co.	64,070	92,216	117,812
Total	1,029,165	1,397,697	1,667,935
% of total assets owned by foreign entities			
Banks	85.1%	83.9%	84.3%
Insurance co.	51.9%	53.6%	62.0%
Leasing co.	95.5%	96.2%	97.0%
Total	84.3%	83.5%	84.1%

Source: own calculation from Tables 4 and 6

This confirms that financial institutions owned by domestic entities are operating even better than the foreign owned ones. Since we know that before the restructuring of the financial sector in Serbia most banks and insurance companies have operated with significant loss, we may conclude that the remaining domestic owned institutions have significantly changed their business culture.

Profitability analysis of financial institutions in the period 2007-2008 is another proof of improved quality of domestic owned companies (Table 8). Return on assets of all companies is in 2008 1.98% as long as foreign owned made ROA is 1.89%. In the insurance sector profitability was significantly lower for foreign owned companies.

Table 8. Profitability of Serbian financial institutions (dinars)

	Total profit		Profit made by foreign entities		FE share in total profits		ROA total		ROA owned by foreign entities	
	2007	**2008**	**2007**	**2008**	**2007**	**2008**	**2007**	**2008**	**2007**	**2008**
Banks	23,218	34,957	20,935	29,339	90.20%	83.90%	1.53%	1.97%	1.64%	1.96%
Insurance	1,501	2,417	234	380	15.60%	15.70%	2.46%	2.85%	0.71%	0.72%
Leasing	1,565	1,984	1,442	1,828	92.10%	92.10%	1.63%	1.63%	1.56%	1.55%
Total	26,284	39,358	22,611	31,547	86.00%	80.20%	1.57%	1.98%	1.62%	1.89%

Source: own calculations on previous tables' data

According to Zubović and Hanić (2009) as a direct consequence of improved quality of financial institutions activities, there have been completely new financial instruments introduced on the Serbian market, which include financial leasing and private pension funds. Positive investments environment attracted new foreign investments both on greenfield investments and mergers & acquisitions side of the remaining state owned companies.

Finally, we may say that the quality of operations of Serbian financial institutions is growing, that assets values are rapidly increasing, and that all companies, regardless weather they are domestic or foreign, are equally profitable. It is certain that this sector is ready to become the core of the Serbian economy, and a boost for increased FDI in the second stage of transition.

Conclusions

During the last two decades, foreign direct investments have been the most important channel of capital inflow to developing and transition countries. Such inflow has brought several positive effects to host countries, among which the consolidation of the economy, healthier operations and growth of profitability.

In Serbia, FDI in the previous decade reached US$ 17 billion, which was sufficient to boost the economic activity. Highest investments were made in the financial sector, accounting to over US$ 5 billion. This sector which was characterized by low capitalization and weak profitability in the past due to foreign capital has become the sector with very high growth rate. The influence of foreign capital on the Serbian financial sector was twofold. Apart from the already named high growth rate, there has been the overflow of technology, since it is proven that in today's financial institutions in Serbia, foreign and locally owned entities are operating equally well. Profitability of local companies is even higher than that of foreign owned ones, so we may conclude that the effects of foreign capital on this sector are very prosperous for the whole economy, and that the results should be applied to all the other business sectors.

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Investițiile străine directe în economiile în tranziție – cazul industriei financiare din Serbia

Rezumat

În acest articol analizăm influența investițiilor străine asupra economiei țării-gazdă. Din 1990, țările cele mai dezvoltate şi cele aflate în tranziție au recunoscut investițiile străine directe (FDI) ca fiind o sursă majoră de aflux de capital financiar, ce a condus la descreşterea importanței afluxului de stat şi al pieței financiare. Vom folosi analiza econometrică a datelor din țări care deja au trecut prin procesul de tranziție, urmărind tendințele din cadrul investițiilor străine şi le separăm pe de-o parte în fuziuni şi achiziții, iar pe de altă parte în investiții „greenfield". În final, analizăm investițiile din sistemul financiar din Serbia, unde grupările bancare străine au produs încă de la începutul reformei schimbări pozitive semnificative, în special prin îmbunătățirea performanțelor financiare ale sectorului şi deschiderea unor surse de finanțare stabile din străinătate. Instituțiile financiare din Serbia au suferit câteva transformări de la începutul anilor '90. Încheiem lucrarea cu concluzia că sectorul financiar din Serbia este astăzi complet consolidat şi reprezintă miezul dezvoltării întregii economii şi o sursă potențială de aflux de capital.