NATIONAL BANK OF SLOVAKIA

DIRECT FOREIGN INVESTMENT IN SLOVAKIA DURING 1995 - 1998

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Bratislava 1999

Direct Foreign Investment in Slovakia during 1995 - 1998

Direct foreign investment represents an irreplaceable source of finance for the Slovak economy. According to estimates made by the Ministry of Economy, the volume of capital required for restructuring and revitalisation of industry during 1996 - 2000, is expected to reach Sk 216.9 billion, of which own-resources of the entrepreneurial sector account for Sk 150.7 billion (69.5%). The remainder will have to be financed from other sources, where direct foreign investment and bank loans are expected to play a significant role.

Importance of direct foreign investment

The current level of direct foreign investment (DFI) in Slovakia neither satisfies the needs of the corporate sector, nor the expectations of economic and political bodies.

However, the effects of direct foreign investment on the Slovak economy (particularly in the production sector) can be characterised, on the basis of previous results, as positive. Organisations with foreign capital participation, or those 100% owned by foreign investors, showed, in many cases, marked improvement in the effectiveness of production. This was due to the modernisation of technological equipment; improvements in product quality, accompanied by a price increase; growth in the economic efficiency of production; improved management and organisation; rise in the professional level of employees; wage increases; and increase in labour productivity and production volume, through the maintenance of the domestic market and its extension to foreign markets, mostly with the help of a foreign partner. All this is having a positive effect on the pro-export orientation of business organisations.

A significance role could also be played by the so-called 'multiplication effects' arising from extension of the range of domestic products. This applies mainly to small domestic production companies that are not able to enter into international cooperation by themselves, but with the participation of leading foreign investors, have the opportunity to take part in local and international cooperation (e.g. Volkswagen co-operates with 15 small Slovak enterprises, which manufacture spare parts for the company in large amounts). This will significantly influence the regional structure of foreign investment in the country.

With regard to employment, direct foreign investment in Slovakia makes a significant contribution to the stabilisation, or growth of domestic employment, improved workforce skills, and higher wage levels. A significant factor attracting foreign investment in Slovakia is the workforce factor: Slovakia has a well-qualified and highly competitive workforce (due to the low level of wages). Therefore, during the selection of a suitable location for DFI, a significant stimulus will arrive from the low level of labour costs, especially in areas with labour-intensive production. However, the advantage arising from low wages will gradually diminish with the rise in wages in the Slovak economy.

The criterion of profitability is reflected in structural and political goals, among which the level of expertise occupies a central place. This applies both to technological expertise, associated with personnel and production characteristics, and management expertise, as they are interdependent.

The application of a specific technology is determined by its close connection to the location of the organisation's registered office. The quality and level of technology are dependent on direct aspects and relationships with various sub-contractors, through pressure exerted on the level of production and indirect employee-related effects.

The variety of ratings published in banking journals indicates that, when a country is being evaluated by potential investors, the main criteria are the country's political and economic stability and, to a lesser but still significant extent, the size of the market. For the time being, the results of such evaluations are not positive enough in the case of Slovakia and represent an obvious reason for the low level of investment in the Slovak economy. For this reason, most investment in the Slovak Republic is short-term (trade, services, small production companies), since large-scale investments require long-term guarantees of safety and security.

From a regional point of view, transport conditions in the given country are also important, especially for large companies involved in internal cooperation. This applies mainly to the production of spare parts and components, which is dependent on local transport conditions in the country concerned. Large corporations seek to economise on the transport of spare parts as well, so the saving of time during transport is a prime factor in the selection of company site with regard to access to motorway, airport, railway, or waterway networks. This aspect is often taken into account in the case of two-way transport between company site and the place of further processing. Prior to 1998, direct foreign investment was concentrated mainly in Bratislava and its environs, and accounted for 60 - 65% of total investment, to the detriment of other towns and regions. This was due to the strategic location of Bratislava, the concentration of executive, legislative, and banking institutions, the presence of a skilled workforce, undeveloped infrastructure, etc. The other towns and regions accounted for less then 40% of the total, and that was unevenly distributed: 32% in the Trnava, Nitra, and Trencin regions; about 5% in the Banska Bystrica and Zilina regions; and less than 1% in the Presov and Kosice regions.

From this point of view, the year 1998 is interesting since the occurrence of two large-volume activities caused a change in absolute terms. During the first half of the year, the volume of DFI reached 56.9% in the Košice region; 37.4% in the Bratislava region; and less than 6% in other regions.

Up to now, direct foreign investment (DFI) has had a positive effect on the balance of trade and payments. The assumption that foreign exchange reserves would be considerably reduced during the initial years due to restructuring and modernisation, has failed to be borne out in the last eight years. On the contrary, it was already clear by 1995 that the inflow of foreign capital to Slovakia was slow, but in respect of its capitalisation through foreign trade, it represents a relatively high proportion of total imports (30 - 42%) and exports (29 - 37%). While imports are dominated by large business organisations, which also import raw materials and machinery for Slovak production companies, exports in the joint venture sector support domestic production companies, mainly in metal-working, pharmaceutical, chemical, timber industries, consumer electronics (white-goods), etc.

Results for the 1st half of 1998, however, showed a relatively sharp decline in comparison with the corresponding period of the previous year. During the 1st half of 1998, numerous organisations in machine and chemical industries recorded reduced volumes of exports; some machine engineering companies failed to export at all. With regard to imports, large business companies saw an increase of approximately 15%. On the other hand, the volume of car imports increased. Annual results are, however, more significant since many companies supply goods towards the end of the year.

The exclusion of business organisations from the material under review confirms that large business organisations increase the import of foreign capital and are responsible for the fact that the exported capital continues to be exceeded by imports. This confirms our belief that

DFI in production companies is having a positive effect on the balance of trade and payments, i.e. via an increased share in exports.

Export of Slovak capital to foreign markets

An increase has also been recorded in the volume of direct investments made by Slovak entities abroad.

The export of capital from Slovakia, which started only a short-time ago, is having a positive effect on the country's exports - through the establishment of business organisations abroad (assuming they sell domestic products), production activities, exports of semi-finished goods and spare parts for finished products abroad, and where our joint ventures promote the so-called additional sale of products (i.e. the parent company's products that are not included in the joint venture's production programme or the products of other domestic manufacturers). Unlike import, the export of investment capital is having a very positive effect on trading activity. It promotes the export of domestic goods and, where earnings are remitted to the home country, they positively influence the level of foreign exchange reserves. In the future, the volume of Slovak capital exported and invested in business organisations in the production sector, may significantly influence the balance of trade and payments.

Investment by Slovak companies abroad will need to be adequately secured against political and economic risks. For smaller companies, it will be necessary to create reliable sources of information on countries, where Slovak capital is to be invested. There is a need for detailed information on potential partners, legislative conditions, including the capacity of the market in the host country (small and medium-sized companies have insufficient resources for the provision of own-advisory services).

Direct foreign investment in the banking sector

At present, most direct foreign investment (DFI) is made in the banking sector, i.e. 22.6% of the total volume of DFI in Slovakia during the first half of 1998 (compared with 25.7% in 1997). Direct foreign investment has had a highly positive effect on the development of the banking sector. It has created a competitive environment in the banking market, which has stimulated domestic banks to develop to foreign banking institution standards in a relatively short period of time. Banking technology is being upgraded along with the culture of banking business. To complete the ongoing process of restructuring, it will be necessary to stabilise the positions of domestic banks (which will require another 2 or 3 years); to extend the range of banking products; improve the bad loan portfolios of banks (where it is necessary); increase the productivity of banking personnel; and to upgrade the equipment of banks.

In the near future, the banking sector will have to prepare for the establishment of branches and representative offices abroad. Banks have numerous reasons for doing so: to maintain the existing clientele, mediate important information on business opportunities abroad to Slovak entities, and to develop international strategies.

In this area, we should concentrate first and foremost on countries that have long-term trade relations with Slovakia, particularly in terms of exports. It is fair to assume that Slovak businesses will direct their exports to those countries, and will therefore need the services of their domestic banks.

The approach of Slovak banking to banking standards in advanced economies is very important with regard to Slovakia's intention to join the European Union.

Problems related to direct foreign investment in Slovakia

A significant criterion for the entry of foreign capital to a specific country is political and economic stability. The country's economy should be characterised by sound macroeconomic development, stable political situation, legal framework, and a sound banking system. Such conditions are essential for large investments, which need long-term guarantees. Frequent political changes are a major reason why major investors employ wait-and-see tactics in relation to certain countries. Frequent legislative changes also have a destabilising effect.

For foreign investors, a factor of uncertainty is the long lasting provisional situation in the area of ownership relations, where the protracted privatisation of Slovak companies has had marked negative consequences.

Another factor influencing potential foreign investors is the overall entrepreneurial climate in the economy, including tax incentives for investors. In this respect, Slovakia has much to offer compared with advanced market economies. It will be necessary to strike a balance between stimulation of investment in the Slovak economy (such a system has not yet been created) and measures designed to direct foreign investment to selected industries and regions (which could be viewed unattractive by foreign companies). In the interest of complex economic development and the achievement of maximum multiplication effects from foreign investments (via customer- supplier relations, the transfer of new technologies, know-how, etc.), the two approaches will have to be combined if foreign organisations are not to be discouraged from investing in the Slovak economy.

For that reason, it is important that the State should create favourable conditions for foreign investment in other sectors as well. Such conditions are essential for foreign investors in making decisions on the allocation of resources. The existence of a complex economic infrastructure (transport, communications, information, financial, educational systems, etc.) is very important. In some areas of the infrastructure, especially in information and transport, Slovakia is below the level of advanced industrial countries.

Businesses that pay increased attention to international cooperation and select their foreign partners after careful consideration, have begun to achieve positive results.

On the other hand, many Slovak companies apply only short-term criteria when selecting a foreign partner. They are often ready to establish a joint venture with the first potential partner they meet (often by chance), who can help them to overcome current problems. They often give preference to immediate results to long-term strategic prospects. Before the selection of a partner in a joint venture, it is necessary to obtain basic data on all potential partners, e.g. their position in the world, size and stability of capital, market share (in the home country and in international markets), prospects for growth during the next ten years, product quality, latest innovations, suitability of products to Slovak conditions, assistance in entry to foreign markets, etc.). It is also important that the company wishing to establish a joint venture with a foreign partner, should have its own business strategy.

Conclusion

The inflow of foreign capital to Slovakia, i.e. the volume of year-on-year increase as a share of GDP, accounted for 1.6% in 1997 and 2.2% during the first half of 1998 (at current prices), which are very low figures indeed.

As DFI, a significant source of capital for the financing of industry, services, privatisation, etc. is represented by portfolio investment, which was dealt with in the previous issue of BIATEC. The positive influence of DFI in Slovakia has already been confirmed, and it is to be expected that long-term portfolio investment will also have a positive effect on the economy.

For the time being, the share of portfolio investment in Slovakia is negligible, due primarily to the current level of political and economic stability in Slovakia, and to other factors that caused an outflow of foreign capital invested in Slovakia before 1998.

Theoretically, the disproportionately high inflow of foreign capital, especially in terms of net capital import, which exceeds the deficit in the current account of the balance of payments, could generate a growth in the country's money supply, at the risks of price inflation. With regard to the level of DFI and portfolio investment in Slovakia, this problem has yet not occurred.