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Current and Potential Chinese Foreign Direct Investment in the Slovak Republic[1]

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Abstract: *This article presents an overview of current and potential investment from China into the Slovak Republic within the broader CEEC region cooperation based on the 16+1 platform. Based on a business study on the automotive industry in the CEEC region, and particularly Slovakia as one of the industrial sectors for possible Chinese investment with immense potential, the article aims to identify the main advantages and disadvantages of the region as a foreign direct investment destination. The article also analyses the impact of FDI inflows on the Slovak economy. We come to the conclusion that the recent FDI inflow from China to Slovakia has*

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been statistically insignificant, which may, however, change in case the envisaged Chinese investment into the steel industry in Slovakia will be realised. With respect thereto, the article also points at the need to set out a new revised framework for the international legal protection of Chinese investment in the EU. It has been established that further research is required to assess the impact of Chinese FDI on the Slovak economy.

Keywords: *16+1 cooperation, automotive industry, CEEC region, China, FDI, investment, investment protection*

1. Introduction

Cooperation between China and Central and Eastern European countries (CEEC) within the 16+1 platform started in 2012 as Chinese initiative aimed at activating and fostering cooperation between China, 11 EU Member States and 5 Balkan states. Areas of cooperation include trade, investment, transport, science, technology, finance, agriculture, forestry, education, culture, tourism, health, and people-to-people contacts. China has defined three potential priority areas of economic cooperation, including infrastructure, high technologies, and green technologies. The initiative was announced at the first 16+1 Summit held in Warsaw, Poland in 2012 entitled China's Twelve Measures for Promoting Friendly Cooperation with Central and Eastern European Countries (MFA of PRC, 2012). Of those 12 measures, one third (measures 2–5) focus on investment and trade cooperation between China and the CEEC region.

Over the last decade, mutual relations between China and the EU have significantly expanded with Chinese investments in the EU reaching 23 billion US dollars in 2015 (an eightfold increase from 3 billion US dollars in 2009) (Zeneli, 2016). Even though most of the investment flowed to Western European countries, the CEEC region also attracted Chinese attention starting the cooperation of 16+1. Even though economic performance in the CEEC region based on the GDP p.c. in PPP is lower than the EU average (Table 1), there is potential for economic growth in the region that may exceed the growth in Western European countries. Also, the region represents a total population of 120 million. Hence, both the market potential of the region and serving as the entrance to the EU market are significant.

This article focuses on the cooperation between China and Slovakia, providing an overview of the industrial sector of Slovakia, where potential areas of cooperation and possible Chinese investment inflow could be identified. The present article also provides a basic analysis of Chinese FDI in the Slovak economy.

Table 1. Economic performance of 16+1, 2015, GDP p.c., PPP, constant 2011 international (US dollars)

EU average	35,622	Croatia	20,664
Czech Republic	30,381	Romania	20,484
Slovenia	29,097	Bulgaria	17,000
Slovak Republic	28,254	Montenegro	15,254
Estonia	27,345	China	13,572
Lithuania	26,807	Serbia	13,278
Poland	25,323	Macedonia, FYR	12,732
Hungary	24,831	Albania	11,015
Latvia	23,080	Bosnia and Herzegovina	10,119

Source: World Bank, 2017

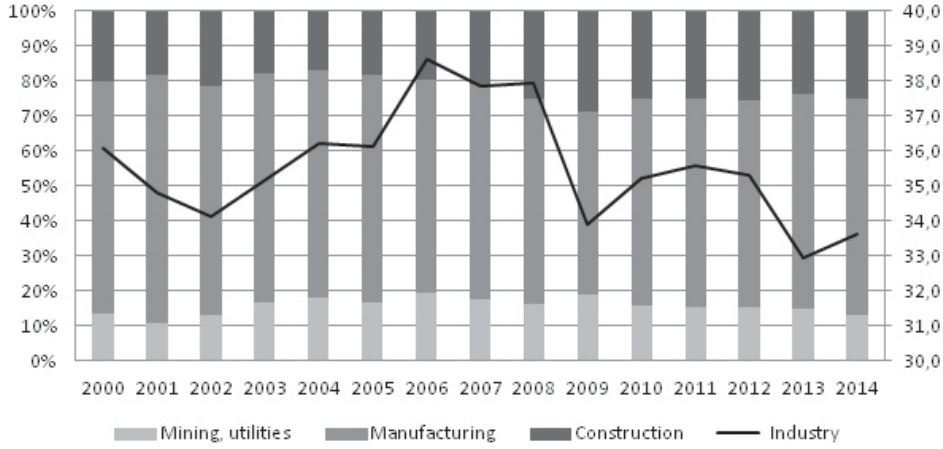
Note: In descending order based on GDP p.c.

2. Industrial sector in Slovakia

Industrial sector of the Slovak economy and its share of the GDP during the first decade of the 21st century was approximately at 33–39%. (UNCTAD, 2017). The most developed industrial sectors are electrotechnical, automotive, and engineering industries with the greatest share of their outputs being exported abroad. The development in these industrial sectors was the main force behind the rapid economic growth of the Slovak economy among the European Union countries. However, Figure 1 shows negative development in the value added of industry on GDP share after 2006 (right axis). A sharp decline was witnessed in 2008 with the global crisis widespread over the world. The share of GDP prior to the crisis and accession to the EU was approximately at 36% (with a slight decline in 2001 and 2002 to 34.8 and 34.1%, respectively). After joining the EU, the share of industrial sector has risen to 36% with a maximum share in 2006

at 38.6%. Because of the global crisis, the share has declined and in the second decade of the 21st century it averages at 34% with a possible positive outlook in the second half of the decade (UNCTAD, 2017).

Figure 1. Industrial sectors and their share of total industry value added



Source: UNCTAD Statistics 2017

Note: ISIC Rev. 3; mining and utilities divisions 10–14, 40–41; manufacturing divisions 15–37; construction division 45.

Looking at the breakdown of industrial sectors (Fig. 1, left axis) based on ISIC, Rev. 3, we note that the largest share in industrial sector belongs to manufacturing (divisions 15–37) with a total share of approximately 60%. Even though the share of manufacturing in the total industrial production has been almost the same since the beginning of the 21st century, its value-added as a share of total industry value added declined from a maximum of 24.8% in 2001 to 21.9% in 2014. The lowest share was witnessed in 2009 at 17.7%, which is clearly associated with the outbreak of the global crisis (UNCTAD, 2017).

The second important sector within the industry is construction (division 45), constituting approximately 25% of industry value added in 2014. The share of this subsector in the Slovak economy has slowly risen since 2000. This sector was the only sector (together with mining and utilities) where the value added during the crisis years increased (from 7.9% in 2007 to 9.5% in 2008 and 9.7% in 2009). Even though there was a slight decline in value added to 8.9% in 2010, the share of this subsector is around 25% on total industry value added since 2010. (UNCTAD, 2017).

The last subsector is mining and utilities (divisions 10–14 and 40–41). This subsector has the smallest share in value added of all industrial sectors (4.3% in 2014). Its share from a long-term point of view has risen and fallen since 2000 with the maximum share of 7.5% in 2006 and the lowest share of 3.7% in 2001. Overall, its share in total industrial value added is approximately 12%. The small share of this subsector of the Slovak economy is based on a fact that almost all energy needs in the Slovak economy are covered by energy sources produced abroad and imported to Slovakia. (UNCTAD, 2017)

3. Manufacturing developments

The position of manufacturing as a subsector of industry over the last 15 years has become quite dominant, even though its value added share in total industry declined during 2000–2014 from 23.9% to 21.9%. Another aspect is the share in total employment, where we notice a slight increase in the employment in the last six years. The real growth of value added between 2004 and 2012 increased by 7.5% p.a., while the growth of labor productivity was even higher at 8% p.a. As the authors mention, in real terms the manufacturing subsector (in terms of value added) gained a higher value in the Slovak economy. They also point out the significant difference between nominal and real prices for some subsectors of manufacturing, especially the production of computers, electronic and optical devices (per annum real growth of value added of 44.2%, nominal growth 14.3%) and production of electric devices (real growth 18.4%, nominal growth 6.8%). (Gabrielová & Habrman, 2014; National Bank of Slovakia, 2017)

The most important subsector which has influenced the structure of the entire manufacturing sector in the past years is automotive industry. Nominal growth of value added as a share in the manufacturing industry was 41% with a significant impact on the overall employment in the manufacturing industry. The employment in automobile industry increased by 25,400 which in turn had an impact on the decline in employment in textile industry (-35 000) and food processing (-10 000). (National Bank of Slovakia, 2017)

According to Gabrielová and Habrman (2014), looking at the changes in the manufacturing structure in the V4 countries, one can see a slight resemblance. The share of employment declines faster than the share of value added. There is also a decline in the share of light manufacturing subsectors and an increase in the subsectors that are more technologically demanding, such as automobile production, electronic devices, etc.

4. Advantages and disadvantages of the industrial sector in Slovakia—a case study for the automotive industry

Based on various studies on this topic (Gabrielová & Habrman, 2014; Šikulová, 2014; Deloitte, 2016; *Národná banka Slovenska*, 2017), we have identified below the following advantages and disadvantages of the industrial sector in Slovakia.

Advantages:

- The rising share of private enterprises
- The rising share of private enterprises with foreign ownership
- Low labor costs and skilled labor force
- Favorable tax regime

Among the disadvantages, there are:

- Low level of specialisation in pharmaceuticals, machinery and electrotechnical industries
- Lagging behind in economic performance in comparison with western EU countries
- High dependence on a small number of companies
- Orientation to commodities with low value added
- Infrastructure deficiencies
- Poor reliability of legal system
- Changes in external environment

These findings on advantages/disadvantages of the industrial sector in Slovakia have also been supported by a Deloitte study conducted in 2016 regarding the automotive industry by asking questions concerning location-related factors and their change with 80 executives of the CEEC region (8 automotive manufacturers and 72 supplier companies).

> *The importance of automotive factory locations in the European Union member states of Central Europe (CE) has steadily increased in recent years. Automotive facilities in Western Europe have been subject to closure and total employment has been reduced since 2009. However, employment opportunities have been partly re-established in CE countries, based on the fact that the previously closed factories have been relocated in the new EU member states. As a result of these changes, approximately one in three vehicles are produced within*

> *the following EU member states: the Czech Republic, Hungary, Poland, Romania, Slovakia and Slovenia. Based on manufactured vehicles per capita, Slovakia is the leading producer of vehicles with 180 units per thousand inhabitants, according to the industry association European Automobile Manufacturers' Association. The Czech Republic ranks second with 108 vehicles and Germany third with 70 vehicles.* (Deloitte, 2016, p. 4)

The surveyed companies were supposed to identify three key competitive advantages and three disadvantages, and the results were the following:

> *The most beneficial factors were low labor cost; skilled labor and its availability; and the favorable tax regime. The most disadvantageous factors were the reliability of the legal system; the problematic educational system; and the inadequate traffic infrastructure and logistics.* (Deloitte, 2016, p. 6)

Other factors, both advantageous and disadvantageous, were identified. From a positive point of view, apart from the abovementioned factors, also grants and incentives were mentioned, from a negative side, the energy prices.

Based on the results, tax regime and incentives may play a crucial role in where a foreign company chooses to locate its factory. In general, taxes are lower in the CEEC region than in the rest of the EU. On the other hand, almost 50% of all respondents consider the legal system and its reliability a disadvantage and recommend measures to be taken by governments in the CEEC region to improve the situation.

It was concluded from the survey that the companies are willing to stay in the CEEC region and to make additional investments to catch up with the changes in the industrial sector, especially with Industry 4.0 which will have an impact on their businesses in the future. Surveyed companies are preparing to meet these new trends in their short and medium-term plans (Deloitte, 2016, p. 5).

A positive signal to the CEEC region is the fact that 97% of all respondents did not consider relocation of their production to another country in the next five years. None of the respondents in Slovakia was considering relocation. Only a small percentage of respondents in the Czech Republic and Hungary were considering relocation.

Another positive signal for the CEEC region are the answers concerning the production capacity increase in the next five years, where 74% of all respondents agreed on a positive outlook. According to the study, "This is clearly a very

optimistic message for the CE region: the automotive sector has not yet reached its limits in terms of growth potential." (Deloitte, 2016, p. 15)

5. The impact of Chinese FDI on the Slovak economy

We used the data on Chinese FDI inflow as the main source of independent variable X. Table 2 provides data for GDP (Y) and FDI inflows to Slovakia from China (FDI_{China}). Since no Chinese FDI inflows to Slovak economy were present prior to 2007, only the period 2007–2015 was analysed.

Table 2. Input data for regression models (Y in euros, FDI in million euros)

Year	Y	FDI_{China}
2007	64,396,897	6,133
2008	68,022,300	1,447
2009	64,333,762	-15,212
2010	67,577,288	12,308
2011	69,482,359	24,781
2012	70,633,785	-7,315
2013	71,686,685	-10,609
2014	73,529,644	4,597
2015	76,346,627	-15,912

Source: National Bank of Slovakia.

To find the impact of Chinese investment on the Slovak economy, we used simple linear regression model in the following form:

$$Y_i = \alpha + \beta X_i + \varepsilon_i$$

where Y_i = GDP (dependent variable);
α = the y-intercept;
β = slope of the regression line;
X_i = FDI inflow to Slovakia (independent variable);
ε_i = error term.

The model is represented by following equation:

$$GDP = \alpha + \beta FDI_{China}$$

with resulting equations:

$$GDP = 69\,558\,252 - 68.293 \times FDI_{China}$$

Table 3. ANOVA results

Measure	
R^2	0.054
F-test	0.399
F-significance	0.548

Source: Authors' own calculations in MS Excel

If FDI inflows to Slovakia rise by one unit, the model predicts a decrease of the GDP by 68.293 euros. However, as presented in Table 3, ANOVA results, especially F-significance, are statistically insignificant. Based on R^2, the equation explains only 5.4% of variation in GDP, leading to the conclusion that either the number of observations is too small to fully assess the impact of Chinese FDI inflows to Slovakia or there are other more relevant factors impacting the economy of Slovakia or both. Based on R^2, we can say that currently the inflow of Chinese FDI to Slovak economy has no real impact on its overall economic performance measured by the GDP. We also note that at present, Chinese FDI do not compose a significant part of total FDI inflows to Slovakia ranging from 0.045% in 2008 to 2.33% in 2013 (based on data of National Bank of Slovakia, 2017).

However, based on the news published in the daily press, the Chinese He Steel Group, the second largest steel producer in the world, has announced plans to acquire one of the largest steel mills in the CEEC region—the Slovak U.S. Steel Košice for 1.4 billion euros. In case of this acquisition, which will be one of the largest foreign direct investments in the CEEC region, we anticipate a significant positive impact of future Chinese FDI inflows on the Slovak economy.

6. The legal protection of current and future Chinese investment in the Slovak Republic

With the prospective growth in the flow of foreign investment from the People's Republic of China into the Slovak Republic, the issue of legal protection of Chinese investment comes to the fore. The current legal framework for the protection of Chinese investment in the Slovak Republic has been—from an international law perspective—considered to be insufficient. The applicable bilateral investment treaty concluded in 1991 belongs to the 'first generation' of investment treaties concluded between China and its counterparts. It only provides for a limited scope of the now widely accepted standards of international investment protection and does not provide for an open access to international investment arbitration in case of violation of investors' rights under this investment treaty. Therefore, the international investment protection standards included in this bilateral investment treaty are currently practically unenforceable.

However, as of January 2014, the European Union has started the process of negotiating a new comprehensive Investment Treaty with the People's Republic of China which, once concluded, would also be applicable to Chinese investment to Slovakia. As of September 2016, during the 12th Round of the EU–China investment negotiations in Brussels, there has been a significant progress in negotiating particular terms of the future investment agreement, such as the core definitions of 'investment', 'covered investment', 'investor', performance requirements, standards of investment protection such as fair and equitable treatment, minimum standard of protection, expropriation as well as dispute settlement, procedural fairness in competition related procedures and standard setting. (EC DGT, 2016)

With respect to future potential dispute settlement, the negotiators have taken on the task of defining a modern comprehensive system that would avoid the infamous challenges of the current international investment arbitration system, such as lack of transparency, the risk of contradictory decisions in international investment arbitration and the resulting lack of legitimacy of the current system perceived by the public. According to the EC DG for Trade Note, the discussion on the future investment court system focused on the need to "reform the old-style system through means such as establishment of binding interpretations, an appeal mechanism or the selection procedures for the composition of panels." (EC DGT, 2016)

7. Conclusion

This article focuses on the cooperation between China and Slovakia, providing an overview of the industrial sector of Slovakia, in which potential areas of cooperation and possible Chinese investment inflow could be identified. Since the automotive industry constitutes an important part of the Slovak economy, part of the article focuses on the analysis of this industry through the case study provided by Deloitte. The subsequent part of the article analyses the impact of Chinese FDI inflows on the Slovak economy, mainly on the key economic indicator—GDP. We used the data provided by the National Bank of Slovakia for both the GDP and FDI inflows. We note that the current Chinese FDI do not compose a significant part of total FDI inflows to Slovakia. Since the first Chinese FDI inflow in 2007, it constituted a rather small share of the total FDI inflows with the highest share achieved in 2011 at a level of 0.99% (EUR 24.8 million euros compared to 2.51 billion euros) (National Bank of Slovakia 2017).

We came to the conclusion that FDI inflow from China is currently statistically insignificant. However, the sample for data analysis was not big enough since Chinese FDI inflows to Slovakia started only in 2007 (based on the data provided by the National Bank of Slovakia) with latest available data for 2015, which means only nine observations.

Even though the Chinese FDI inflow proved statistically insignificant, we believe that with possible acquisition of the U.S. Steel's steel mill in Košice by He Steel Group would turn the negative development of Chinese FDI inflow to Slovakia to a more positive trend. This may be followed by other potential investments, with especially favorable conditions in the automotive sector, which, according to the Deloitte study from 2016, still has a great growth potential not only in Slovakia but also in other CEE region countries. Steel industry also serves as a subcontractor for the automotive industry, which may have significant synergic effects and positive effects not only on the GDP growth in Slovakia and other CEE region countries, but also on the net profits of possible Chinese FDI inflows to these sectors of the economy.

In the last section of this article, we outlined the shortcomings of the currently applicable international legal protection of Chinese investment in the Slovak Republic. However, with the prospective EU-wide Investment Treaty with the People's Republic of China which has been under negotiations since 2014, many of the current challenges of the system are addressed and may be resolved once concluded.

We conclude that further research will be required to fully assess the complex nature and impact of Chinese FDI on the Slovak economy.

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