

HORIZONTAL FOREIGN DIRECT INVESTMENTS AND THEIR EFFECTS

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Abstract. *The basic goal of this paper is to indicate the importance and the influence of horizontal foreign direct investments on the countries that receive and invest FDI. Horizontal foreign direct investments are mostly implemented on the relation between developed countries, because the mentioned countries have similar production factors available, which represent the main precondition for their application. Horizontal foreign direct investments are based on the idea that through their usage we can eliminate specific trade barriers and decrease the cost of business between countries. Furthermore, while working it has been determined those horizontal foreign direct investments have positive effects on the countries that receive them and the investors of foreign direct investments.*

Key Words: *investments, transfer, mobility, factors, knowledge, costs.*

INTRODUCTION

Literature that deals with foreign direct investments makes a difference between horizontal and vertical foreign direct investments. Horizontal foreign direct investments are dominant among industrialized countries that are not significantly different in the aspect of production possibilities and availability of production factors [1].

Liberalization of the world trade in the last couple of decades has affected development of foreign direct investments, i.e. investment form. Horizontal forms of foreign direct investments are most frequently used form of investing in relation to other forms of investing. Primarily, it is about investing in production of the same products or services in several world counters. In this way, horizontal forms of foreign direct investments offer certain advantages in the aspect of production costs, reduction of delivery etc.

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Horizontal forms of foreign direct investments particularly take care of the costs of establishing new production plants abroad in comparison to the savings of variable costs of avoiding tariff barriers and transport costs. In these forms, the significance of economies of scale is particularly pointed out, i.e. where total costs of establishing two production plants abroad are less in relation to one production plant.

Horizontal forms of foreign direct investments have evolved through various forms: export duopoly, multinational monopoly and multinational duopoly. In case of export duopoly, it is about national companies with an enterprise or plant where costs of doing business abroad are higher in relation to export transport costs. Multinational monopoly implies two plants in one market where monopoly generates negative loss. Finally, multinational duopoly consists of two multinational companies that each have two plants abroad. In order for this form to be sustainable, it is necessary to reduce specific costs of the plant so that multinational duopoly would be profitable and dominantly exporting.

Horizontal forms of foreign direct investments represent an alternative to export, i.e. it is about a situation when trade costs are higher than total fixed costs of establishing a new plant abroad. In the same way, these forms affect the reduction of trade flows, which can seem rather negative at first sight. Here, it is about serving or servicing a local market through local production. In addition to the above-mentioned, horizontal forms offer advantages in the aspect of import costs reduction that are higher in relation to the costs of establishing new plants. This is particularly expressed in big markets that enable coverage of fixed business costs of newly-founded production plants.

Horizontal models of foreign direct investments give a special contribution to host countries in the aspect of transferring new knowledge, technological transfer, labour mobility etc. The mentioned advantages are mostly transferred through multinational companies that transfer the effects mentioned on domestic enterprises or economy by their investments.

1. LITERATURE REVIEW

Observed from theoretical aspect, theory of multinational enterprise can be divided into two aspects. The first aspect refers to OLI concept developed by Dunning in 1977, who believes that foreign direct investments determine ownership, location and international advantages [2].

The second concept divides foreign direct investments in three different forms: horizontal, vertical and capital knowledge form. Until 1990's there was no formal theory that treated relationships between the activities of multinational companies and characteristics of the country of origin and host country [3]. Afterwards, economists have set basic theory on foreign direct investments and multinational company calculating multinational company in base theory of trade in balance.

Development of the theory of multinational company developed in three levels. The first form of multinational company appears in traditional literature that refers to international trade and competitiveness or the form of constant growth rate. Early analyses have observed the activity of multinational companies as a part of capital flow theory. This theory has reached clear cognitions that activities of headquarters of parent company should be located in countries that are rich in capital, while affiliations should be located in countries that are poor in capital. According to this theory, there was no motivation for foreign direct investments between identical or similar countries. This was opposed to empirical studies and it

led to the following level or trade theory that includes the idea of increasing the rate of return on economies of scale and imperfect competition in relation to traditional form.

Early theoretical works of Helpman and Markusen from 1984 mostly referred to segments of unique theory of multi-nationality stressing the horizontal foreign direct investments. After that, theory of multinational enterprise was divided into two parts. In the first part, vertical foreign direct investments appear when a company geographically disperses the phases of production [4]. In this way, the theory of capital flows originates, where foreign direct investments were primarily in the form of foreign production affiliations. On the other hand, we have a form of horizontal foreign direct investments where enterprises manufacture the same products and services on different locations.

In case when there is no difference in the price of production factors between countries, logistics services of headquarters and production activity are performed in the country of origin. However, when there is a difference between production factors, the enterprises become multinational and they perform the separation of headquarters' activity from dislocated plant abroad themselves. Enterprises locate the headquarters in countries that are relatively rich in labour, that own the skills necessary, while production plants are located in countries in which there exists almost no labour with skills required.

Horizontal forms of foreign direct investments gain in importance because they enable the avoidance of trade barriers that make cross-border business through export more expensive. When trade barriers in host country are low, company can supply host country through export. However, when trade costs are high, company becomes multinational by assuming the same production, both at home and abroad and foreign market is supplied based on initiated production in host country instead of directly importing. This type of foreign direct investments is called horizontal because companies organize the same production activities in several countries. According to this, horizontal foreign direct investments are motivated on the basis of a desire to achieve the approach to cross-border markets with lower trade costs.

2. METHODOLOGY

This paper represents theoretical analysis of the influences of foreign direct investments on host countries and investors of FDI. In order to explain the effect of horizontal foreign direct investments we used the following scientific research methods: analysis, synthesis, deduction, induction, comparative method, statistic method etc. Furthermore, our analysis is based on data from a database of global market information (Global Market Information Database, Euro monitor International), and also on research studies and relevant scientific and expert articles.

3. THEORETICAL GENESIS OF DEVELOPMENT OF HORIZONTAL FOREIGN DIRECT INVESTMENTS

Foreign direct investments, as it is known, have a positive effect on host countries in the aspect of technology and knowledge transfer to domestic companies, they affect productivity growth, improve competitiveness, approach to foreign markets and represent a significant source of financial means [5].

Foreign direct investments substitute the trade when they are horizontally invested, which means that multinational companies produce the same products and services in different countries. This is the most frequent form of foreign direct investments and it

refers to bilateral investments between developed countries. In case of horizontal foreign direct investments, companies sell their products to host country in high volume-coefficient of domestic sale of subsidiaries is rather high [6].

In this paper we went through main hypotheses or zero hypotheses which says:

HO: *Horizontal foreign direct investments have more positive influence on the countries which are on the similar level of economic development*

Besides zero hypotheses we set up additional hypothesis:

HI: Horizontal foreign direct investments influence the host countries in the sense of transfer technology and know-now etc.

H2: Horizontal foreign direct investments influence the mobility of work force between a country that invests and a country that receives foreign direct investments;

H3: Horizontal foreign direct investments influence the improvement of complementarity and competitiveness of linked economies.

Horizontal foreign direct investments are understood as location of production closer to consumers in order to avoid trade cost. Horizontal foreign direct investments refer to the same products or services of enterprise, which are produced in several plants in different countries, where each company or plant services local market. Development of horizontal foreign direct investments is influenced by two factors: trade costs and economies of scale. Therefore, the main driving factor of horizontal foreign direct investments is avoiding high transport costs or accomplishment of the possibility of entrance to foreign markets that can only be locally serviced. Companies will choose horizontal foreign direct investments if transport costs of production and physical presence in host country are lower than loss of plants abroad from economies of scale and fixed costs. In addition, company does not have to give a license to another company if it wants to keep special knowledge to itself etc. [7].

Background of horizontal foreign direct investments can be best explained through costs equation on one hand, and benefits on the other. Establishing production abroad instead of servicing of the market based on export implies additional business costs in new country. In addition, production costs depend on the price of production factors and technology. Economies of scale of the enterprise lead to the increase of costs of newly-established plants abroad. On the other side of equation, we have savings of costs that are related to the export of local production. It particularly refers to transport costs. Additional benefits refer to market proximity, reduction of delivery etc. [8].

Certain forms of horizontal foreign direct investments include multinational companies and assume the similarity between countries according to size, availability of resources, technology and economies of scale at the level of enterprise or plant. Theoretical forms of horizontal foreign direct investments are based on comparison between additional fixed costs of founding new enterprises and savings of variable costs based on avoiding tariffs and transport costs.

One of the earliest forms of horizontal foreign direct investments was developed by Markusen in 1984. According to him, economy of scale at enterprise level represents a driving force. Company with two plants has fixed costs that are twice lower than in case when a company has one plant. This was a key moment for initiation of production in several plants. Extension and improvement of this form was performed by Horstman in 1987 and Markusen in 1992.

Models of Horstman and Markusen from 1992 and Brainard from 1993 point out that balance depends on the evaluation between market proximity and concentration of pro-

duction capacities. In other words, these models enable alternative solutions that depend on relative size of enterprise's economies of scale, transaction costs, including transport and also trade barriers, investments and economies of scale of the plant.

Primarily, based on given technological characteristics (with specific fixed costs of enterprise and specific fixed costs of the plant), Horstman and Markusen identify three types of equilibriums. The first, export duopoly consists of national companies with one enterprise or plant. It appears when specific business costs of the plant are higher in comparison to export and transport costs. The second, multinational monopoly (multinational companies with two plants in one market) appears when specific costs of enterprise and transport costs grow to the point where monopoly generates negative loss. In the end, multinational duopoly consists of two multinational companies that have two plants abroad each. In order for this form to be sustainable, it is necessary to reduce specific costs of the plant so that multinational duopoly would be profitable and dominantly exporting.

Brainard's model from 1993 stresses the role of economies of scale at the level of enterprise and plant in relation to transport costs. Foreign direct investments appear as alternative to the export, i.e. if trade costs are higher than fixed costs of establishing a new plant abroad. Here, it is about the approach known as "proximity-concentration". Driving force is the advantage from market proximity to the avoidance of transport costs (proximity) and effect of the economies of scale, in case of production in one plant (concentration). Effect of the economies of scale appears due to fixed costs that appear with construction of a new plant. Form predicts two situations when horizontal foreign direct investments dominate over export. First, when transport costs are higher in comparison with fixed costs of founding the plant abroad. Second, when the impact of economies of scale is higher at the level of enterprise than at the level of plant. This means that initiative for horizontal multifunctionality is increased when transport costs are higher in comparison to fixed costs of establishing the plants abroad and when the increase of the rate of return at the level of enterprise is greater in relation to plant level.

In 1993, Brainard has developed the model of two sectors, two countries, where enterprises in different manufacturing sector choose between export and foreign direct investments as alternative method of foreign penetration to the market. This sector is characterized by the increase of the rate of return on economies of scale at enterprise level due to specialization of certain inputs (such as R&D), economies of scale at the level of plant and transport costs that grow with the growth of the distance of the location for export. In a simple model of production with two levels, Brainard's model also represents three possible equilibriums. The first one, weak trade equilibrium, consists of national enterprises with one plant located in the same market where the headquarters of enterprise are located. In this case, there are two ways of balancing the trade (intra-industrial trade) with different final products (scope of interindustrial trade is a decreasing function of transport costs). The second, weak multinational equilibrium, refers only to multinational companies that perform production activities and sell abroad. In the end, we have a combination of equilibriums where, in addition to multinational company, we also have national companies [9].

Horizontal forms were further developed by Markusen in 1998 and Venables in 2000. Markusen and Venables have extended above-mentioned forms into a form of several countries that enables a mixture of multinational and local enterprises in every country. In previous forms, multinationality dominates in countries that are similar according to the size, production factors and technological level.

In the last form, authors show that diversity in comparison of possessing the factors reduces horizontal activities of multinational companies. Based on results of forms of horizontal foreign direct investments, various characteristics of flows of foreign direct investments can be explained. Firstly, horizontal foreign direct investments reduce trade flows, since the market is serviced through local production instead the import. Secondly, horizontal foreign direct investments gain in importance if the import costs are higher in relation to investment costs. Thirdly, horizontal foreign direct investments will probably appear in big foreign markets that enable coverage of fixed costs of new plants on the basis of economies of scale. In the end, value of local production can exceed net costs of exchange, especially in case when local production plant with strategic value is built. Based on oligopolistic market, sale of each company depends on marginal costs of other competitors. By undertaking horizontal foreign direct investments, enterprises reduce marginal costs, which can affect the other enterprises to reduce their sale. Establishment of new plants is also a determination of supply to local market and this determination can be changed with behaviour of competition.

4. HORIZONTAL EFFECTS OF FOREIGN DIRECT INVESTMENTS

Horizontal effects can be provided through the presence of multinational companies that ensure technological externalism on local enterprises through certain mechanisms. Firstly, local enterprises can be able to learn simply on the basis of demonstrations and copying innovative products or innovative forms of organization and adapting them to local conditions. Costs of obtaining the information on new technologies or processes in the absence of multinational companies are rather high for local enterprises. In addition, domestic companies do not have much information regarding costs and benefits from innovations of new technologies, and therefore they are considered as highly risky [10]. However, when they are in direct contact with affiliations of multinational companies, information is available, uncertainty is reduced and there is a possibility of adaptation. Namely, we need to stress that it is most important for domestic companies to invest in learning process because thus modern technology will be transferred towards the affiliations by multinational companies (having in mind that multinational companies try to maintain their competitive advantage over local companies) [11].

Secondly, the most striking mechanism of technological impact within the same industry is movement or mobility of labour. Mobility of labour can be beneficial for domestic companies in the following situations: workers employed in affiliations of multinational companies can reach the knowledge necessary (e.g. training in foreign affiliations) which can be used out of the company; when workers leave the company they can be employed in domestic company and thus influence the increase of productivity. At the same time, we can have negative impact here when multinational companies try to reach the best workers from local companies, by offering them the best earnings [12].

Thirdly, technological impact can occur based on competition that is generated by the presence of multinational companies. If multinational companies have the advantage over domestic enterprises in technology, then big pressure of competition will make domestic companies introduce new products or new technologies, to defend their market share and for the new management to adapt to new methods that will increase productivity. How-

ever, multinational companies can have a negative effect on domestic enterprises since they can be more attractive in the aspect of demand in relation to domestic companies, which causes for domestic companies to reduce their productivity of volume of production.

Certain studies have used different types of databases on property and impact of horizontal investments of domestic enterprises. Impacts can be positive and negative. Early studies were used in industrial data. For example, Caves, in 1974 for Australian manufacturing industry, and Globerman, in 1979 for Canadian production, have discovered that foreign presence has a positive impact on productivity of domestic enterprises.

The following studies of Blomstroma and Persson in 1983 have also found a positive effect in case of Mexican manufacturing industry. Afterwards, Blomstrom and Sjöholm discovered a positive impact for manufacturing sector of Indonesia in 1999, and Liu discovered the same for manufacturing industry of China in 2002. Positive correlation between foreign presence and productivity of domestic enterprises can be partial owing to the fact that foreign companies invest in more productive industries.

Table 1. Rough data on components that are used for the creation of potentials index impact

| Country | Year | Share of produced outputs of foreign companies | Share of domestic inputs in total input that is used from manufacturing industry | Personnel with higher education level | Business expenditures on R&D in production | Real GDP per capita in constant prices | Openness (export, along with import in GDP) |
|----------------|------|--|--|---------------------------------------|--|--|---|
| Czech Republic | 2007 | 0,63 | 0,491 | 0,838 | 0,95 | 22 399 | 1,63 |
| | 2006 | 0,62 | 0,487 | 0,836 | 1,01 | 21 038 | 1,51 |
| | 2005 | 0,54 | 0,483 | 0,832 | 0,89 | 19 695 | 1,41 |
| | 2004 | 0,53 | 0,480 | 0,824 | 0,78 | 18 546 | 1,38 |
| | 2003 | 0,48 | 0,476 | 0,820 | 0,76 | 17 804 | 1,20 |
| Hungary | 2007 | 0,68 | 0,436 | 0,738 | 0,49 | 17 487 | 1,71 |
| | 2006 | 0,63 | 0,433 | 0,728 | 0,48 | 17 294 | 1,50 |
| | 2005 | 0,60 | 0,430 | 0,715 | 0,41 | 16 644 | 1,33 |
| | 2004 | 0,58 | 0,424 | 0,699 | 0,34 | 15 275 | 1,27 |
| | 2003 | 0,58 | 0,445 | 0,796 | 0,17 | 15 249 | 1,15 |
| Poland | 2007 | 0,46 | 0,445 | 0,796 | 0,17 | 15 249 | 0,86 |
| | 2006 | 0,45 | 0,439 | 0,790 | 0,18 | 14 315 | 0,82 |
| | 2005 | 0,44 | 0,432 | 0,782 | 0,18 | 13 481 | 0,75 |
| | 2004 | 0,42 | 0,426 | 0,770 | 0,16 | 13 029 | 0,72 |
| | 2003 | 0,41 | 0,419 | 0,759 | 0,15 | 12 354 | 0,67 |
| Slovakia | 2007 | 0,79 | 0,423 | 0,816 | 0,18 | 18 681 | 1,72 |
| | 2006 | 0,71 | 0,421 | 0,811 | 0,21 | 16 940 | 1,70 |
| | 2005 | 0,71 | 0,420 | 0,800 | 0,25 | 15 644 | 1,54 |
| | 2004 | 0,69 | 0,418 | 0,793 | 0,25 | 14 735 | 1,48 |
| | 2003 | 0,64 | 0,417 | 0,794 | 0,32 | 14 099 | 1,43 |

Source: Calculated on the basis of 1) Eurostat Structural Business Statistics; 2) Eurostat Symmetric Input-Output tables; 3) Eurostat Education and Training; 4) Eurostat Science, Technology and Innovation; 5) Heston-Summers-Aten (2011) Eurostat date available at; <http://epp.eurostat.ec.europa.eu>. Available online between 10 April and 15 May 2011.

In addition to positive effects, certain studies have also found negative effects of horizontal impacts on host countries. In 1993, Haddad and Harrison discovered that there were no data on effects for Morocco and it seemed as if the competition was pushing local enterprises towards the industries with lower technological level. For Venezuela, Aitken and Harrison, in 1999, discovered that the increase of foreign ownership in industry has had a negative impact on productivity of domestic enterprises. They describe this negative effect as "market effect of theft of foreign enterprises". This effect makes domestic companies reduce the production. Similar results were found for Indonesia, but we need to stress that the effect was lower. On the other hand, certain studies have found a positive horizontal impact on majority of developed countries, such as Great Britain and USA [13].

As for transition countries, there is also negative impact observed. In 2001, Konings observed that foreign direct investments are important for transfer of technology to affiliations, but still they had negative impact on local companies in Bulgaria and Romania from 1993 to 1997. In 2003, Damijan et al. found rare positive impacts in ten transition countries of East Europe, but there are no data on negative effects. In 2003, Damijan et al. found significant horizontal impacts, especially in Romania after the verification of absorptive capacity. On the other hand, they have pointed to horizontal impacts on domestic enterprises that are significant and positive, although relatively small, in Czech Republic, Poland, Romania and Slovakia.

In 2000, Konings found a positive impact on Bulgaria and Romania and significantly negative on Poland. In 2004, Vahter observed horizontal impact on Slovenia, but not on Estonia. In recent detailed study of countries, Ayyagari and Kosova have found great foreign presence in Czech Republic stimulating the entrance of domestic enterprises within the same industry (positive horizontal impact of foreign direct investments) [14].

Table 2. Total volume of horizontal investments

| Time period | November | December | January | February | March | April | May |
|---|----------|----------|---------|----------|-------|-------|-----|
| Horizontal investments in service sector: | | | | | | | |
| Hungary, Slovakia and C. Republic | 3 | 6 | 4 | 0 | 3 | 3 | 1 |

Source: [14].

In 2006, Tytell and Yudaeva were focused on four most popular countries of East Europe: Russia, Ukraine, Poland and Romania. They list positive effects that have occurred in case of export-oriented foreign direct investments and that they were initiated by more productive foreign companies. They list border effects: benefits are materialized when great amounts of capital are accumulated. In addition, absorptive capacity of domestic enterprises plays an important role in accomplishment of benefits from foreign direct investments. In the end, the effect of knowledge and advancement of technology mostly appears in better educated and less corrupted regions. In Table 3, we can see the impact of FDI on growth of gross domestic product of transition countries.

Table 3. Impact of horizontal FDI on countries of Central and East Europe in 2010

| Country | Horizontal FDI amount in millions of dollars |
|----------------|---|
| Albania | 4,335 |
| B&H | 7,151 |
| Bulgaria | 47,988 |
| Croatia | 34,374 |
| Czech Republic | 129,893 |
| Estonia | 16,438 |
| Hungary | 91,933 |
| Latvia | 10,838 |
| Lithuania | 13,444 |
| Macedonia | 4,493 |
| Montenegro | 5,456 |
| Poland | 193,141 |
| Romania | 70,012 |
| Serbia | 20,584 |
| Slovakia | 50,578 |
| Slovenia | 15,022 |

Source: [15] <http://www.euromonitor.com/passport-gmid>

In the study of Damijan et al. in 2008, ten transition countries were included (sample consisted of more than 90.000 enterprises): Bulgaria, C. Republic, Croatia, Estonia, Latvia, Lithuania, Poland, Romania, Slovenia and Ukraine. They have discovered that horizontal impacts have gained in increased presence during the last decade and can become more important than vertical effects. Heterogeneity of enterprises refers to absorptive capacity, size, productivity and technological level. Enterprises with higher absorptive capacity are able to compete with foreign affiliations in the same sector and to achieve benefit from the increase in demand for semi-products generated by foreign affiliations. In the end, presence of foreign direct investments has a higher impact on small than big enterprises [16].

CONCLUSION

Special contribution of this paper is reflected in the theoretical illumination of problems, i.e. understanding the development of horizontal forms of foreign direct investments. Horizontal forms of foreign direct investments are defined as form of initiating the production by parent company in several countries of the world from which local markets are supplied, which circumvents classic trade flows. It is obvious that mentioned forms of foreign direct investments are mostly oriented among developed countries of the world, because these forms are primarily based on similarity of market in the aspect of economic level of development and factor availability. Therefore, it is obvious that these forms of foreign direct investments are considered reserved for developed countries or countries of similar level of economic development.

However, lately we also have certain change in the direction in which horizontal forms of foreign direct investments move, towards less developed countries or transition economies. This change can be attributed to the process of economic progress of transition economies. Transition economies that record significant economic results see in horizontal forms a possibility for the accomplishment of positive effects. Those effects are particularly reflected in technological transfer, mobility of workers, process of learning and transfer of business philosophy etc. The mentioned effects are achieved in almost all those industries where horizontal forms of foreign direct investments existed.

Accordingly, it was expected that horizontal forms of foreign direct investments will increasingly gain in importance having in mind permanent growth of business costs, i.e. transport costs, trade and tariff barriers which make trade flows more expensive and complicated. This is particularly expressed today when we live in a world of increased protectionism that occurs as a result of economic recession of the majority of developed world countries. However, we must notice that horizontal forms of foreign direct investments do not offer only positive effects, but also negative effects in the sense of elimination of domestic companies from certain industries as a result of foreign companies' power. It is necessary to pay attention to this and other negative effects and find a way to reduce their presence.

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HORIZONTALNE STRANE DIREKTNE INVESTICIJE I NJIHOVI EFEKTI

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Osnovni cilj ovog rada je da ukaže na značaj i uticaj horizontalnih stranih direktnih investicija na zemlje primaocice i investitore. Horizontalne strane direktne investicije se uglavnom primenjuju na relaciji između razvijenih zemalja jer navedene zemlje raspolažu sličnim faktorima proizvodnje, što predstavlja osnovni preduslov za njihovu primenu. Horizontalne strane direktne investicije počivaju na ideji da se kroz njihovu primenu nastoje eliminisati određene trgovinske barijere i smanjiti troškovi poslovanja među zemljama. Pored toga, u radu je utvrđeno da horizontalne strane direktne investicije imaju pozitivan uticaj na zemlje primaocice i investitore stranih direktnih investicija.

Ključne reči: *investicije, transfer, mobilnost, faktori, znanje, troškovi.*