Foreign direct investment into transition economies: Are the Balkans different?

Saul Estrin & Milica Uvalic

July 2013
All views expressed in this paper are those of the author and do not necessarily represent the views of the editors or the LSE.
© Saul Estrin & Milica Uvalic
Foreign direct investment into transition economies: Are the Balkans different?
Saul Estrin* & Milica Uvalic**

Abstract
The paper explores the determination of foreign direct investment (FDI) into the Balkan transition economies – Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. Detailed FDI inflows to Southeast Europe (SEE) are analysed to determine the main differences in the volume, timing and sectoral structure of FDI within the region and in comparison to the Central East European countries. A gravity model to all transition economies during 1990-2011 is then estimated to assess whether the factors driving FDI to the Western Balkans are different. They are found to be so; even when size of their economy, distance, institutional quality and prospects of EU membership are taken into account, Western Balkans countries receive less FDI. These issues are of high policy relevance for the Balkan economies and ought to contribute to the current debate on the ‘new growth model’.

JEL Classification: P3, O4, F2
Keywords: foreign direct investment, Balkans, transition

* Department of Management, London School of Economics
Houghton St, London WC2A 2AE, UK
Email: s.estrin@lse.ac.uk

** Department of Economics, Finance and Statistics, Faculty of Political Sciences, University of Perugia
Piazza Università, 1, 06100 Perugia, Italy
Email: uvalic@unipg.it
Foreign direct investment into transition economies

Table of Contents

Abstract

1. Introduction ......................................................................................... 5

2. Historical background and brief overview of the literature......7

3. Patterns of FDI inflows in Southeast Europe.........................11

   Main features of FDI in the 1990s...............................................................11
   Upsurge of FDI in the 2000s: Political and economic background..................13
   Increasing FDI flows in the 2000s...............................................................14
   Annual variations of FDI inflows.................................................................17
   FDI per inhabitant.....................................................................................19
   FDI by sector of economic activity...............................................................20
   Origins of FDI...........................................................................................23

4. Determinants of FDI in the Balkans...........................................25

5. Impact of FDI.....................................................................................32

   Share of FDI in gross fixed capital formation........................................32
   Share of FDI in GDP................................................................................33
   FDI contribution to structural changes...................................................34
   FDI contribution to exports.....................................................................35
   Employment generation..........................................................................36

6. Conclusions and policy implications .......................................37

References.............................................................................................40

Acknowledgements
For fruitful discussion and useful comments the authors would like to thank Laza Kekic, as well as Will Bartlett and other participants of two conferences where an earlier version of the paper was presented - 12th EACES conference (University of the West of Scotland, Paisley, September 2012) and the International Conference on occasion of the 75th Anniversary of the Faculty of Economics, University of Belgrade (Belgrade, 20-22 September 2012). We also thank Adeline Pelletier for excellent research assistance. Any remaining errors are our own.
Foreign direct investment into transition economies: Are the Balkans different?

1. Introduction

The paper characterises and explores the determinants of foreign direct investment (FDI) into eight transition economies in Southeast Europe (SEE): the six Western Balkan (WB) countries - Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia,¹ as well as Bulgaria and Romania, in comparison with the other transition economies. Although Bulgaria and Romania became EU members in 2007 and are today more frequently considered within the group of 10 new EU member states,² the SEE countries have many common features as a result of a shared history and similar transition experiences. Most SEE countries experienced high political and economic instability in the 1990s, while economic recovery and transition related economic reforms have been generally slower than in Central Eastern Europe (CEE).

The paper considers whether there is a negative ‘Balkans’ effect on FDI, as suggested by some contributions to the literature. Despite many positive developments during the 2000s, the Balkans may still face an image problem: namely, for many potential foreign investors, the mention of the word Balkan ‘conjures up troubled images of war and conflict, rather than investment

¹ Montenegro and Serbia used to be part of Federal Republic of Yugoslavia, constituted in 1992 after the disintegration of the Socialist Federal Republic of Yugoslavia, that was transformed into the State Union of Serbia and Montenegro in 2003; in June 2006 Serbia and Montenegro became two independent states. Serbia’s southern province, Kosovo, officially remained part of Serbia after the 1999 conflict (according to UN SC Resolution 1244), but in February 2008 Kosovo proclaimed political independence.
² Together with the five countries from Central Eastern Europe (CEE) - Czech Republic, Hungary, Poland, Slovakia and Slovenia, and the three Baltic states.
opportunities and economic potential’ (Cviic and Sanfey, 2010, p. 124). The paper explores whether FDI into the WB region has indeed been even lower than can be explained by economic characteristics of the region, such as smaller size of domestic markets and greater distance from the investing economies – in comparison with other transition economies. Our analysis confirms this view; FDI to the Balkans are driven by geographical and institutional factors, similarly to other transition economies, but there is evidence of a significant negative regional effect. The paper also tries to answer the question of how FDI levels might be affected by prospects of EU membership.

The structure of the paper is as follows. After providing a historical background and brief overview of the literature on FDI in SEE, the key characteristics of FDI inflows to the region are analysed in the third section to determine the cross-country differences in the timing, volume and sectoral structure of FDI, within the SEE region and in comparison to the CEE countries. We go on in the fourth section to test hypotheses about FDI to the Western Balkans empirically on the basis of a gravity model (see Bevan and Estrin, 2004). An attempt is also made to identify the main differences in the impact of FDI on the individual SEE countries. The conclusions in the sixth section point to the main results of policy relevance for the SEE countries that could contribute to the current debate on the ‘new growth model’, which is particularly important for the less developed Balkan economies. Given the present unfavorable global climate for FDI, exhausted privatization opportunities in most Balkan countries and still unsettled political issues, the return of large amounts of FDI is unlikely in the short run.
2. Historical background and brief overview of the literature

Over the past fifteen years there has been a flourishing literature on FDI in Eastern Europe. This is not surprising, since foreign capital has played an important role in most countries during the twenty-year transition to market economy. A number of studies have looked into the key features of FDI in Eastern Europe – its volume, forms, origins, destination by economic activity, and case studies (see, for example, Lankes and Venables, 1996; Meyer, 1998; Estrin, Richet and Brada, 2000; Bartlett, 2008; Kolotai, 2010; Hunya, 2011, 2012), as well as the determinants of FDI based on econometric research (for example, Bevan and Estrin, 2004; Bevan, Estrin and Meyer, 2002; Janicki and Wunnava, 2004; Dikova and van Witteloostuijn, 2007). Despite the growing literature on FDI in transition economies, there has been relatively little research on FDI in the SEE countries.

During the first decade of transition to market economy, FDI in most of the Balkan region was low, most probably deterred by the unstable political environment. Since 1991, a number of political processes and events have had negative economic implications for the whole SEE region (Uvalic, 2003).³ Political instability in the 1990s has left deep traces on the Balkan region and unresolved political problems remain on the agenda.⁴

³ Including the disintegration of former Yugoslavia, five military conflicts during 1991-2001 in practically all the countries of former Yugoslavia (in chronological order Slovenia, Croatia, Bosnia and Herzegovina, FR Yugoslavia/Kosovo, and Macedonia), international sanctions against FR Yugoslavia, the Greek embargo related to the problems of recognition and name of the Former Yugoslav Republic of Macedonia, and the NATO bombing of FR Yugoslavia in 1999 (see Uvalic, 2010).
⁴ The most difficult is the issue of Kosovo. Although five years have passed since it declared political independence in February 2008, by late 2012 it has still not been officially recognized by 95 countries or 49.2 percent of UN members, including five EU member states (Cyprus, Greece, Romania, Slovakia and Spain).
Foreign direct investment into transition economies

The economic implications of these events have been particularly serious for the countries of former Yugoslavia, all except Slovenia. The disintegration of the Yugoslav federation led to the break-up of traditional economic and trade links, a very deep recession, delays in economic reforms and in integration of most countries with the EU (Uvalic, 2012a). Bulgaria and Romania also had unsatisfactory macroeconomic performance during much of the 1990s and delayed many fundamental economic reforms. After a marked drop in GDP in the first half of the 1990s, the majority of SEE countries continued to have negative growth rates in the second half of the decade. Economic recovery has generally been slow, so that by 2011 three countries had still not reached their 1989 GDP level (Serbia, Montenegro and Bosnia and Herzegovina). Integration with the rest of Europe has also proceeded very unevenly: Bulgaria and Romania concluded an Association Agreement with the EU in 1993 and became EU member states in 2007, but the other countries were able to deepen their political and economic relations with the EU only after 2000.

These features may account for the fact that, in the mushrooming literature on FDI in transition economies, there has been little research focusing on the SEE region. Demekas et al. (2005) note that SEE is a region not comprehensively covered in econometric studies on FDI in transition economies, in part due to the lack of comparable data. Of the more than 40 empirical studies reviewed in the paper, only four included any SEE countries and even that coverage is patchy and inconsistent (Demekas et al, 2005, p. 4).

Christie (2003) applies a gravity model to FDI stocks in five SEE countries (Serbia, Montenegro and Albania were omitted because data was lacking) from nine selected West European source countries, using five CEE countries as a control group. The findings suggest that FDI to CEE is mainly of the horizontal, market-seeking type. The evidence for SEE is less clear since neither the vertical, efficiency-seeking type nor the horizontal type dominates.
The SEE countries are found to have lower stocks of FDI in relation to the CEE countries. Evidence is found on complementarity, rather than substitutability, between trade and FDI for the CEE group, while no conclusive results were found for SEE.

Kekic (2005) analyses trends in FDI in the Balkans during the early 2000s, concluding that the upsurge in FDI has been based on only a few minimal conditions – the restoration of peace and basic security, the beginnings of economic recovery and modest improvements in the business environment. Kekic also relates, in a cross-section gravity model, FDI inflows into the 27 East European countries during 1998-2002 to a number of variables that influence FDI including GDP, wages, the business environment, natural resource endowments, privatization and geographic distance. The estimated equation for 1998-2002 explained almost the whole inter-country variation in FDI inflows. The impact of market size, natural resources and labour costs on FDI flows were all statistically significant, but FDI inflows were also found to be sensitive to the policy framework, particularly the business environment and privatization strategy. The further a country is from the EU core, the less FDI it was found to attract.

Brada, Kutan and Yigit (2006) examine the effects of transition and of political instability on FDI flows to the transition economies of Central Europe, the Baltics and the Balkans. In their specifications, they relate FDI inflows to a country’s economic characteristics. The results show that FDI flows to transition economies unaffected by conflict and political instability exceed those that would be expected for comparable West European countries. In the case of Balkan countries, conflict and instability reduced FDI inflows below what one would expect for comparable West European countries and reform and stabilization failures further reduced FDI to the region. In the case of Albania, the actual inflows of FDI are much greater than predicted by the
Foreign direct investment into transition economies

model specifications. The conclusion is that the economic costs of instability in the Balkans in terms of foregone FDI have been quite high.

Finally, Demekas et al. (2005) analyse the size and distribution of FDI in SEE. According to their findings, there is evidence that SEE countries lag behind the CEE countries in attracting FDI. Their results show that gravity factors explain a large part of FDI inflows in SEE, but that host-country policies also matter notably relative unit labour costs, the corporate tax burden, infrastructure and the trade regime. The paper develops the concept of potential FDI for each country and uses its deviation from actual level to estimate what policies can realistically be expected to achieve in terms of additional FDI. Particularly for Macedonia, Croatia, Albania, Moldova and Bosnia and Herzegovina, the gap between the estimated potential and actual FDI stocks in 2003 was found to be large.

These papers are inconclusive as to whether there is a negative ‘Balkans’ effect on FDI. Christie (2003) finds FDI in the SEE region to be lower than normal in relation to the CEE countries, but his analysis is incomplete, insofar as it excludes three Balkan countries (as indicated earlier). Brada, Kutan and Yigit (2006) find that conflict, instability and delayed transition have reduced FDI inflows in the Balkans. Demekas et al. (2005) also find actual FDI in most Balkan countries lower than potential. Only Kekic (2005) finds that the determinants of FDI to the Balkans do not differ from those in other transition regions. Moreover, these results are now dated, being based on data which refer to the 1990s and/or the early 2000s. This is why it is important to re-examine these issues taking into account more recent data. There has been a strong upsurge in FDI in most Balkan countries in the 2000s, particularly after 2003, which may have more than compensated for the earlier lack of FDI.
3. Patterns of FDI inflows in Southeast Europe

Foreign investors arrived later to most SEE than to the CEE countries and the inflow of FDI to this region in the 1990s was low in comparison. Since 2000, most SEE countries have been receiving more FDI, at least until the outbreak of the global economic crisis. Due to the distinct features of these two periods, the patterns of FDI in SEE during the two decades of transition will be considered separately.

Main features of FDI in the 1990s

The SEE region attracted little FDI during the 1990s, probably because of the political risk and economic instability described earlier, as well as competition from more promising transition economies. During the first half of the nineties, a period characterized by major political and economic instability, FDI inflows to SEE were particularly low. By 1996, inward FDI stock in Albania, Bulgaria, Croatia, Macedonia, Romania and FR Yugoslavia (without Bosnia and Herzegovina that in 1992-95 was at war) amounted to only US$ 3.4 billion or 5.7 percent of total inward FDI stock in all 27 transition economies. This is rather less than their share (7.7 percent) in total population of the transition region. The situation improved after the signing of the Dayton Peace Accords in 1995, although many SEE countries continued to lag behind the CEE as FDI recipients. Over the whole 1989-2000 period, the inward FDI stock in the seven SEE countries amounted to around US$ 15.3 billion or 9.4 percent of total inward FDI stock in all 27 transition countries (see Figure 1).
Foreign direct investment into transition economies

**Figure 1.** Inward FDI stock, by transition regions (2000)

![Pie chart showing inward FDI stock by transition regions in 2000](chart)

*Source: Authors’ elaboration based on UNCTAD data (World Investment Report).*

Moreover, the volume of FDI by country (see Figure 2) was very uneven; by 2000 Romania had attracted by far the most FDI in the Balkans, almost as much as all the other SEE countries put together. The size of Romania’s economy, with a population of 21.4 million probably helps to explain the amount of FDI it has attracted, but other factors, primarily higher political risk in most other countries, are also responsible.

**Figure 2.** Inward FDI stock in SEE countries, 2000 (millions of US dollars)

<table>
<thead>
<tr>
<th>Country</th>
<th>FDI Stock (millions of US dollars)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Romania</td>
<td>6000</td>
</tr>
<tr>
<td>Croatia</td>
<td>4000</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>3000</td>
</tr>
<tr>
<td>Bosnia &amp; H.</td>
<td>2000</td>
</tr>
<tr>
<td>Serbia</td>
<td>1000</td>
</tr>
<tr>
<td>Macedonia</td>
<td>500</td>
</tr>
<tr>
<td>Albania</td>
<td>200</td>
</tr>
</tbody>
</table>

*Source: Authors’ elaboration based on UNCTAD data (World Investment Report).*

In 2000, Bulgaria, Croatia and Romania accounted for more than 80 percent of the total inward FDI stock in the SEE region (see Figure 3; no data are available for Montenegro). Bosnia and Herzegovina received some FDI after the end of the war from 1997 onwards, but its inward FDI stock in 2000 was just over US$ 1 billion. A similar amount went into Serbia, mainly thanks to a
major foreign investment deal in 1997, when 51 percent of Telekom Srbija was sold to Greek and Italian partners (Uvalic, 2010). The other two countries attracted even less.

**Figure 3.** Inward FDI stock in SEE, by country, in 2000

[Pie chart showing FDI stock by country: Albania, Macedonia, Serbia, Bosnia & Herzegovina, Bulgaria, Croatia, Romania. Source: Authors’ elaboration based on UNCTAD data (World Investment Report).]

**Upsurge of FDI in the 2000s: Political and economic background**

There has been a considerable increase in FDI inflows to the SEE region since 2000, probably because of the improved general political and economic environment. In addition to positive political responses towards more democratic regimes in two key countries, Croatia and Serbia, from the early 2000s the SEE countries have greatly improved their economic performance. Macroeconomic stabilization, relatively strong GDP growth, increasing foreign trade and gradual catching up with the more developed countries in the transition region characterized the SEE countries between 2001 and 2008. Acceleration in economic reforms also took place, even in countries that until 2000 had been lagging behind (Uvalic, 2010, 2012a). Since 2001 the SEE countries have implemented trade liberalization with the EU and within the Balkans region, gradually improved the business environment, and privatized many enterprises and almost the entire banking sector.
Foreign direct investment into transition economies

The international community also changed its policies towards the region after the end of the Kosovo conflict in mid-1999. The EU launched the Stabilization and Association Process specifically for the WB countries offering trade liberalization measures, a new financial assistance programme, contractual relations through the signing of Stabilization and Association Agreements, and even prospects of EU membership. In the meantime, Bulgaria and Romania have joined the EU in 2007 and Croatia is set to become the 28th EU member in July 2013. Macedonia, Montenegro and Serbia are EU candidates, Montenegro has in mid-2012 started its accession negotiations, Albania and Bosnia and Herzegovina remain potential candidates, while Kosovo has special treatment (in part due to its non-recognition by some EU member states).

Increasing FDI flows in the 2000s

Perhaps as a consequence of the improving political and economic conditions, there was a significant increase in FDI to the whole SEE region after 2000. Still, by 2010, the eight SEE countries had received only around a third of the volume of FDI that has gone towards the eight countries in CEE and the Baltics (although the latter group has attracted relatively less FDI in the 2000s, due to the strong increase in the share of the CIS countries). Despite the fact that most SEE countries started attracting FDI rather late, some only after 2003, the share of the eight SEE countries in total inward FDI stock in the transition region increased from 9.4 percent in 2000 to 14.7 percent in 2010 (of which 5.8 percent in the Western Balkans and another 8.9 percent in Bulgaria and Romania, see Figure 4), thus by 2010 representing almost double their relative share in population (7.7 percent) of the transition region.
Figure 4. Inward FDI stock, by transition regions (2010)

Source: Authors’ elaboration based on UNCTAD data (World Investment Report).

During the 2000s there have also been some changes in the share of FDI by country (see Figure 5). All SEE countries have attracted significantly more FDI with respect to the 1990s, but the increase has been uneven. The major recipient of FDI - Romania - had a tenfold increase in its inward FDI stock between 2000 and 2010 - from US$ 7 billion in 2000 to US$ 70 billion in 2010, but most other SEE countries have registered even greater increases. By 2010 the FDI inward stock, in comparison to ten years earlier, increased in Croatia by 12 times, in Albania and Bulgaria by 17 times, while in Serbia by as much as 20 times (from only US$ 1 billion to US$ 20 billion). The only two countries that had a less impressive increase in inward FDI stock during the 2000s were Bosnia and Herzegovina (a sixfold increase) and Macedonia (an eightfold increase).
Foreign direct investment into transition economies

Figure 5. Inward FDI stock in SEE countries, 2010 (millions of dollars)

![Chart showing inward FDI stock in SEE countries, 2010](chart.png)

Source: Authors’ elaboration based on UNCTAD data (World Investment Report).

As a consequence, intra-regional shares in FDI have not changed substantially since the 1990s (see Figure 6). Romania, Bulgaria and Croatia continue to be responsible for the largest part (78 percent) of total inward FDI stock in 2010. Romania continued to rank first, Bulgaria has now overtaken Croatia, while Serbia has also recently attracted increasing FDI. The uneven increase of FDI into SEE during the past decade can also be observed by comparing inward FDI stock in 2000 and in 2010 by country (see Figure 7).

Figure 6. Inward FDI stock in SEE, by country, 2010

![Chart showing inward FDI stock in SEE, by country, 2010](chart.png)

Source: Authors’ elaboration based on UNCTAD data (World Investment Report).
**Figure 7.** Inward FDI stock, 2000 and 2010 (millions of dollars)

Source: Authors’ elaboration based on UNCTAD data (World Investment Report).

**Annual variations of FDI inflows**

FDI inflows in the SEE countries from 2001 until 2011 confirm that Romania and Bulgaria have attracted by far the largest amount of FDI in absolute terms during the past decade (see Figure 8).

**Figure 8.** Inward FDI stock in the SEE countries, 2001-2011 (in US dollars)

Source: Authors’ elaboration based on UNCTAD data (World Investment Report).
Foreign direct investment into transition economies

Since the regional distribution of FDI within the SEE region has somewhat changed in recent years, it is of interest to look at the annual FDI inflows from 2004 onwards (Figure 9). The differences in FDI inflows among the SEE countries as well as annual variations have been striking. Under the impact of the global economic crisis, most SEE countries have registered a fall in FDI after 2007-8. In Bulgaria, after a peak of over US$ 12 billion reached in 2007, annual FDI inflows dropped to under US$ 2 billion in 2010-11. Similarly in Romania, after a record of almost US$ 14 billion FDI in 2008, annual inflows declined to about half in 2009 and continued declining thereafter. In Croatia, FDI also started declining after 2008, to US$ 1.5 billion in 2011. Serbia has also registered a fall in FDI inflows during the 2006-10 period, but a strong increase in 2011 when FDI inflows almost doubled (to US$ 2.71 billion).

**Figure 9.** Annual FDI inflows to the SEE countries (millions of dollars)

![Annual FDI inflows to the SEE countries](image)

*Source: Authors’ elaboration based on UNCTAD data (World Investment Report).*

The other four countries - Albania, Bosnia and Herzegovina, Macedonia and Montenegro - have had annual FDI inflows of well under US$ 2 billion (Macedonia under US$ 1 billion) throughout the 2004-2011 period. Most of these countries have also registered a sharp drop after 2007-8, Albania being the only exception. The very different impact of the global economic crisis on the individual SEE countries, as well as particular large privatization deals.
probably explain most of these variations in FDI inflows during the past eight years.

**FDI per inhabitant**

In order to account for the very different size of the individual SEE countries - Montenegro has a population of just 0.6 million while Romania has 21.5 million - data on inward FDI stock per capita (in 2010 and 2011) are reported in Figure 10. Montenegro as the smallest SEE country is ahead of all the others in FDI per capita terms, followed closely by Croatia and Bulgaria. In comparison with the five CEE countries, Montenegro in terms of FDI stock per capita comes close to Hungary and Slovakia but remains behind the Czech Republic, while FDI per capita in Bulgaria and Croatia is comparable to that of Slovenia.

**Figure 10. FDI stock per capita in SEE and CEE (million EUR), 2010 and 2011**

![FDI stock per capita in SEE and CEE](image)

*Source: Authors’ elaboration based on WIIW (2011) and (2012) data, pp. 8 and 7 respectively.*

Although in the ranking of 13 countries from SEE and CEE in FDI per capita terms, Montenegro ranks third while five SEE countries occupy the bottom places, this indicator may be misleading because larger countries generally attract more FDI. There are no perfect indicators of FDI, so it is sensible to
consider a variety of indicators jointly. Hence our analysis will later be supplemented by additional indicators which consider the contribution of FDI to gross fixed capital formation and as a share of GDP (see section 5).

**FDI by sector of economic activity**

The sectoral distribution of FDI has been different across the transition regions. Although this indicator cannot be taken into account in our econometric work, the sectoral distribution of FDI is likely to be important in assessing the longer-term impact of FDI on individual SEE economies, such as its contribution to the promotion of exports or to the generation of new employment (see section 5). FDI by sector of economic activity is reported in Figure 11 for seven SEE countries (comparable data for Montenegro are not presently available).\(^5\) Drawing on the WIIW database that reports FDI stock for individual economic sectors, the data have been aggregated to present inward FDI stock grouped into the primary, manufacturing and services sector of the SEE countries in 2010.

\(^5\)Note that for Serbia, only data on the annual FDI inflows from 2005 onwards were available; these have been summed to obtain inward FDI stock for the 2005-10 period. The graph on inward FDI stock in Serbia by sector of activity is therefore not fully comparable to that of the other countries.
By 2010, the services sector accounted for most inward FDI stock in all SEE countries, on average 69.8 percent of total, but with substantial variations among countries. The services sector represented just over 60 percent of total

---

Footnote:

Were data on FDI by sector of economic activity available for Montenegro, the average FDI stock in services in the SEE region would undoubtedly be even higher, since many foreign investors in Montenegro have invested in tourism.
Foreign direct investment into transition economies

inward FDI stock in Bosnia and Herzegovina, Macedonia and Romania, but more than 75 percent in Croatia and Serbia and as much as 81 percent in Bulgaria. Banking, telecommunications, real estate and retail trade have been among the most favoured sectors of foreign investors in the region. Regarding manufacturing, there are even greater differences across countries. The only three countries that have attracted a considerable amount of FDI in manufacturing are Bosnia and Herzegovina (35 percent of total), Macedonia (31 percent) and Romania (32 percent), which is in contrast to the lower shares in the other countries - 16 percent in Albania, 17 percent in Bulgaria, 19 percent in Serbia and 21 percent in Croatia.

How does this compare to the situation in the CEE transition economies (see Figure 12)? The share of FDI invested in various services is slightly lower in CEE than in SEE – on average, 67.7 percent (as compared to the SEE share of 69.8 percent). Although the averages for the two regions are similar, the variations within CEE have been much lower than within SEE. A share of FDI in services of over 70 percent was registered in only one CEE country (Slovenia), but in as many as four SEE countries. The differences between the two regions are even more pronounced regarding manufacturing. In the CEE countries manufacturing accounts, on average, for 30 percent of inward FDI stock, compared to 24.6 percent in the SEE countries, again with substantial country variations. Particularly the Czech Republic, Poland and Slovakia have attracted substantial amounts of FDI in manufacturing, well over 30 percent. This probably helps to explain why FDI has been less an agent of structural changes in SEE than in CEE.
Figure 12. FDI inward stock in CEE countries by economic activity, 2010 (or last available)

Source: Authors’ calculation and elaboration based on data provided by the WIIW FDI database.

Origins of FDI

Data on inward FDI stock by source country are presented in Table 1, which shows the top five countries by value of investment in each of the SEE countries. The five major source economies together typically account for more than 50 percent of inward FDI stock.
Foreign direct investment into transition economies

**Table 1. Inward FDI stock by country (latest available year)**

<table>
<thead>
<tr>
<th>Country</th>
<th>Year</th>
<th>Top 5 investors and their respective shares (in percent of total) in brackets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Albania</td>
<td>2010</td>
<td>Greece (27.4), Italy (15.2), Austria (13.7), Canada (10.6), Turkey (10.6)</td>
</tr>
<tr>
<td>B&amp;H.</td>
<td>2010</td>
<td>Austria (19.7), Serbia (18), Croatia (14.1), Slovenia (11.2), Russia (9.6)</td>
</tr>
<tr>
<td>Bulgaria</td>
<td>2011</td>
<td>Netherlands (21.9), Austria (16.5), Greece (7.7), UK (6.6), Cyprus (5.7)</td>
</tr>
<tr>
<td>Croatia</td>
<td>2011</td>
<td>Austria (21.2), Hungary (13.9), Germany (13.7), Netherlands (8.6), Luxembourg (5.4)</td>
</tr>
<tr>
<td>Macedonia</td>
<td>2010</td>
<td>Netherlands (16.5), Greece (12.9), Slovenia (12.4), Austria (11.1), Hungary (10.3)</td>
</tr>
<tr>
<td>Montenegro</td>
<td>2011</td>
<td>Russia (15.4), Italy (11.8), Switzerland (9), Hungary (8.4), Cyprus (8.2)</td>
</tr>
<tr>
<td>Romania</td>
<td>2010</td>
<td>Netherlands (20.7), Austria (17.8), Germany (12.2), France (8.3), Greece (5.7)</td>
</tr>
<tr>
<td>Serbia</td>
<td>2011</td>
<td>Austria (17.1), Netherlands (10.1), Greece (9.6), Germany (9.1), Norway (8.4)</td>
</tr>
</tbody>
</table>

*Source: Compiled on the basis of data provided by the WIIW FDI database.*

Among the major investors in the eight SEE countries we find Austria (a top investor in all countries except Montenegro), Greece (in 5 countries) and the Netherlands (in 5 countries). Germany has been among the top five investors in only 3 countries (in Croatia, Romania and Serbia), the same as Hungary (in Croatia, Macedonia and Montenegro). Among countries that represent the major investors in only two SEE countries are Italy (in Albania and Montenegro), Cyprus (in Bulgaria and Montenegro), Russia (in Bosnia and Herzegovina and Montenegro), and Slovenia (in Bosnia and Herzegovina and Macedonia). This suggests that distance between host and home country may have been a significant determinant of FDI.
4. Determinants of FDI in the Balkans

The theory of the multinational enterprise (MNE) suggests that firms engage in outward FDI when they have some resources that they can transfer and exploit, known in the literature varyingly as firm specific advantages (FSAs) (Rugman, 1982) or ownership (O) advantages (Dunning, 1993). Only certain types of firms and products are suitable for exploiting these advantages through internalisation (I), namely creating subsidiaries for research, production and distribution in other countries, rather than by exporting or the use of licenses and long term contracts. Finally, the choice of location (L) is driven by firms finding the optimal place where to combine their FSAs with locational advantages to both exploit and explore their FSAs. This framework is known as the OLI paradigm (Dunning, 1993, Dunning & Lundan, 2009). It argues that firms expand internationally where they can redeploy their internationally-transferable proprietary resources and capabilities to both exploit and explore their resource base. The combination of the FSAs of the firm with the specific conditions found in potential host locations is essential. In other words, different types of firms are attracted to different locational advantages.

The study of locational determinants of FDI represents a long-established literature that originated with Mundell’s (1957) factor endowment theorem (see Brainard, 1997). The predominant empirical approach to the study of FDI flows is based on gravity models borrowed from international trade research, which posit that the main drivers of trade or foreign investment flows are a) the size of the host economy, b) the size of the source economy, and c) the distance between the two economies (Bloningen, 2005, Carr et al., 2001). While these variables have persistently shown to be an important – if not the most important – determinants of the attraction of FDI (Chakrabarti, 2001,
Foreign direct investment into transition economies

Anderson and van Wincoop, 2003), recent literature has considerably broadened the notion of locational advantages to encompass the attractiveness of a potential host economy as both a site for production and as a market. Contemporary literature therefore additionally considers:

1. the costs of production, especially unit labour costs (or wage differentials) and locally available intermediate goods (Bevan and Estrin, 2004);

2. specifically for investment in the primary sector, the presence of natural resources (Hejazi & Pauli, 2003);

3. the institutional framework facilitating or inhibiting the operations of foreign investors, either in an aggregate form, by focusing on specific aspects such as corruption (Habib and Zurawicki, 2002), or by analysing multiple aspects simultaneously (Bevan et al., 2004, Globerman and Shapiro, 2003, Grosse and Trevino, 2005);

4. membership of international trade and economic associations; for example Bevan and Estrin (2004) studying transition economies explored the effects of announcements of likely European Union (EU) membership.

One can also come to a similar estimating framework by considering the four classic motivations for FDI (Dunning, 1993); these are market seeking; efficiency seeking; resource seeking; and asset seeking. Market seeking FDI is driven by size and growth of the host economy market; for example the large inflows of FDI to China in recent years have often been argued to be explained in terms of firms seeking new or quickly growing markets for their products. Market seeking investments probably also played an important role in the investment into the transition economies, especially in the early years (Lankes and Venables, 1996; Estrin et al., 2004). The size of the economy is represented in the gravity model by the GDP of the host economy, and this variable is sometime supplemented by the rate of growth of the host economy. The ability to exploit market seeking opportunities is enhanced by
scale economies, and these will be greater if the host source economy provides a larger domestic market for investing multinational enterprises which provides a basis for the inclusion of the host economy GDP in the estimating equation. In such a framework, distance reflects the transactions costs of foreign investment and these costs are also positively related to the quality of institutions in the host economy.

Efficiency seeking FDI usually takes the form of investment by firms seeking lower manufacturing costs, for example by relocating production facilities to countries of lower labour cost or outsourcing elements in a firm’s value chain to lower cost of suppliers abroad. Bevan and Estrin (2004) controlled for this by enhancing the basic gravity model with the inclusion of labour costs in the host economy, and the variable was found to be significant for their panel of transition economies. More generally, efficiency seeking has often been cited as a motivation for investment to Thailand and the Philippines, and for much FDI into transition economies, for example the major investments by German car firms into Slovakia and the Czech Republic in the 1990s (Estrin, Richet, Brada, 2000). On the other hand, resource seeking is a quite distinct motivation, which leads multinationals in the resource sector to invest in host economies. This is not an important aspect of the Balkans story, but may be relevant across transition economies as a whole; hence we include an indicator of the resources available in the host economy as a control variable in our estimating equation.

Finally, asset seeking FDI is usually considered in terms of tangible or intangible assets, for example patents or brands. This motivation is likely to predominate in FDI between advanced economies, or perhaps in South-North investments, but is not obviously relevant for transition economies, especially the Balkans. However, the privatization process has created a specific asset seeking explanation for FDI in transition (see Estrin, Hanousek, Kocenda,
Foreign direct investment into transition economies

Svejnar, 2009). Thus, for most transition economies, the process of privatisation has formed a distinct motivation for FDI. Western multinationals are attracted to enter reforming economies during privatization programmes by making acquisitions because prices are relatively low and because of highly favorable tax policies or even subsidies associated with the privatisation. We have therefore included a variable for progress in large scale privatisation in our estimating formula. Our hypothesis about the independent effects of being located in the Balkans is tested by the sign and significance of a dummy variable for the WB (non EU member) countries (thus without Bulgaria and Romania). We have decided to focus only on the WB countries, since our previous analysis clearly indicated that Bulgaria and Romania have attracted far more FDI than the other countries. We therefore estimate an equation of the form:

$$ FDI_{ij} = f(GDP_i, GDP_j, \Delta GDP_j, distance_{ij}, wages_j, resources_j, institutions_j, EUmembership_j, Western Balkans_j) $$  (1)

where i denotes the source economy and j denotes the host economy. We estimate equation (1) across 17 transition economies from more than 70 source economies over the 1990-2011 period.

FDI is measured as the flows from country i to j in a given year, and is derived from the WIIW database. For source and host economy GDP we use IMF WEO data, and the impact of market seeking factors, which the latter measures, is in some regressions augmented by the inclusion of GDP growth ($\Delta GDP$) in the host economy. Turning to distance, we use the geographic measure (km) between capitals, sourced from CEPII. Host economy wages are defined as average gross monthly wages and sourced from the WIIW, while to control for resources, we include fuel, ores and metal exports of the host
economy as a percentage of merchandise exports (World Bank development indicators).

There is not an agreed single measure of institutional quality, and the literature notes the problems that arise from collinearity between alternative measures (Bevan et al. 2004). After some experimentation, we decided to use two measures of institutions, namely investment freedom ($\text{invtfreedom}$) and a quality of property rights protection index ($\text{propertyrights}$), derived from the Heritage Foundation’s Index of Economic Freedom. In addition, we take into account FDI opportunities from privatization using the EBRD’s large scale privatization index ($\text{ti_is_privatisation}$). We also control for EU membership and follow Bevan and Estrin (2004) in focusing on the announcement effect ($\text{eu_announcement}$). Hence we include a dummy equal to zero before 2001 and unity after that date for the relevant Western Balkan countries. Finally, we include a Western Balkans dummy variable, taking the value of 1 if a country is located in the Western Balkans and 0 otherwise. The economic variables are all included in logs to address non-linearities and non-normality of the data, and we lag all relevant variables (namely, all excluding distance, the WB dummy, resources and the EU announcement dummy) to address potential questions of endogeneity.

The correlation coefficients between the independent variables are reported in Table 2. There are some issues of collinearity among the institutional variables. Thus the institutional quality variables are collinear - countries tend to have good or bad institutions but there is no variation according to the type of institution. The Balkans dummy is correlated with institutional quality, and EU membership with institutional quality and privatization. Thus there is some evidence that institutional quality drives EU membership rather than the converse.
Foreign direct investment into transition economies

Table 2. Correlations between independent variables

<table>
<thead>
<tr>
<th></th>
<th>loggdpi</th>
<th>loggpdpj</th>
<th>logdistij</th>
<th>logwagesi</th>
<th>wbalkans</th>
<th>resources</th>
<th>invfr</th>
<th>proprights</th>
<th>eu</th>
<th>privatis</th>
<th>gdpgrowth</th>
</tr>
</thead>
<tbody>
<tr>
<td>loggdpi</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>loggpdpj</td>
<td>.0321</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>logdistij</td>
<td>.0273</td>
<td>.2451</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>logwagesi</td>
<td>.0736</td>
<td>.0459</td>
<td>-.0596</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>wbalkans</td>
<td>-.4070</td>
<td>.0040</td>
<td>-.0430</td>
<td>.4267</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>resources</td>
<td>.4100</td>
<td>.0273</td>
<td>.1174</td>
<td>-.5025</td>
<td>-.2148</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>invfr</td>
<td>-.1833</td>
<td>-.0132</td>
<td>-.0497</td>
<td>.1561</td>
<td>-.4275</td>
<td>.5476</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>proprights</td>
<td>.1840</td>
<td>-.0266</td>
<td>-.0225</td>
<td>.2737</td>
<td>-.5397</td>
<td>-.4075</td>
<td>.7518</td>
<td>1</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>eu</td>
<td>-.4591</td>
<td>-.0015</td>
<td>-.1042</td>
<td>.4131</td>
<td>.1339</td>
<td>.8403</td>
<td>.5601</td>
<td>.3485</td>
<td>1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>privatis</td>
<td>-.1605</td>
<td>.0146</td>
<td>.0062</td>
<td>-.1811</td>
<td>-.1343</td>
<td>.0721</td>
<td>.1724</td>
<td>-.0253</td>
<td>.0513</td>
<td>1</td>
<td></td>
</tr>
<tr>
<td>gdpgrowth</td>
<td>.2759</td>
<td>.0693</td>
<td>.0609</td>
<td>-.1103</td>
<td>-.2175</td>
<td>.4448</td>
<td>-.1718</td>
<td>-.1571</td>
<td>-.3341</td>
<td>.1061</td>
<td>1</td>
</tr>
</tbody>
</table>

To address these problems, we estimated over the entire sample period (1990-2011) a horse race to explore the effects of collinearity on our results, by adding one or several variables at a time. Selected regressions are reported in Table 3 (results on the key variables of interest are not affected by changes in specifications). Column 1 provides the basic gravity model, which as can be seen describes very well the FDI inflow process. Thus as expected, in logs, FDI is positively and significantly related to the GDP of the host and source economy, and negatively related to their distance apart. Column 2 reports an expanded specification, with wages, resources, and GDP growth, as well as the Balkans and EU dummies. These are all significant with the expected sign (except for GDP growth), and leave unchanged the results concerning the gravity model. In columns 3 and 4 we report the results of adding two institutional variables singly (privatization and property rights), and in column 5 we include a third institutional variable (investment freedom) together with the other two, but exclude the EU dummy. The investment freedom variable is not significant.
<table>
<thead>
<tr>
<th>VARIABLES</th>
<th>(1)</th>
<th>(2)</th>
<th>(3)</th>
<th>(4)</th>
<th>(5)</th>
</tr>
</thead>
<tbody>
<tr>
<td>m1 logfdi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m2 logfdi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m3 logfdi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m4 logfdi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>m5 logfdi</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>loggdpi_lag1</td>
<td>.80***</td>
<td>.65***</td>
<td>.72***</td>
<td>.87***</td>
<td>.30**</td>
</tr>
<tr>
<td>(0.04)</td>
<td>(0.11)</td>
<td>(0.12)</td>
<td>(0.12)</td>
<td>(0.12)</td>
<td></td>
</tr>
<tr>
<td>loggdpij_lag1</td>
<td>1.29***</td>
<td>2.02***</td>
<td>2.02***</td>
<td>2.03***</td>
<td>2.04***</td>
</tr>
<tr>
<td>(0.03)</td>
<td>(0.04)</td>
<td>(0.04)</td>
<td>(0.05)</td>
<td>(0.04)</td>
<td></td>
</tr>
<tr>
<td>Logdistanceij</td>
<td>-2.82***</td>
<td>-4.41***</td>
<td>-4.41***</td>
<td>-4.41***</td>
<td>-4.44***</td>
</tr>
<tr>
<td>(0.06)</td>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(0.08)</td>
<td>(0.08)</td>
<td></td>
</tr>
<tr>
<td>logwagesi_lag1</td>
<td>.85***</td>
<td>.87***</td>
<td>.30</td>
<td>1.44***</td>
<td></td>
</tr>
<tr>
<td>(0.26)</td>
<td>(0.26)</td>
<td>(0.32)</td>
<td>(0.31)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Westernbalkans</td>
<td>-3.93***</td>
<td>-3.75***</td>
<td>-2.59***</td>
<td>-4.29***</td>
<td></td>
</tr>
<tr>
<td>(0.27)</td>
<td>(0.28)</td>
<td>(0.46)</td>
<td>(0.48)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Resources</td>
<td>.11***</td>
<td>.11***</td>
<td>.13***</td>
<td>.02**</td>
<td></td>
</tr>
<tr>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td>(0.01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>eu_announcement</td>
<td>7.57***</td>
<td>7.22***</td>
<td>8.62***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(0.77)</td>
<td>(0.77)</td>
<td>(0.82)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>gdp_growth_lag1</td>
<td>-.01</td>
<td>-.36</td>
<td>1.22</td>
<td>.21</td>
<td></td>
</tr>
<tr>
<td>(0.93)</td>
<td>(0.94)</td>
<td>(1.00)</td>
<td>(1.01)</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ti_ls_privatisation_lag1</td>
<td>.39***</td>
<td>.40***</td>
<td>.47***</td>
<td></td>
<td></td>
</tr>
<tr>
<td>(0.11)</td>
<td>(0.11)</td>
<td>(0.11)</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>propertyrights_lag1</td>
<td>.03***</td>
<td>-.01</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(0.01)</td>
<td>(0.01)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>invtfreedom_lag1</td>
<td>.01</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(0.01)</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Constant</td>
<td>2.01***</td>
<td>1.11</td>
<td>-0.9</td>
<td>-1.16</td>
<td>5.82***</td>
</tr>
<tr>
<td>(0.48)</td>
<td>(1.68)</td>
<td>(1.69)</td>
<td>(1.70)</td>
<td>(1.63)</td>
<td></td>
</tr>
<tr>
<td>Observations</td>
<td>15,978</td>
<td>6,358</td>
<td>6,358</td>
<td>6,229</td>
<td>6,229</td>
</tr>
<tr>
<td>R-square</td>
<td>.22</td>
<td>.42</td>
<td>.42</td>
<td>.42</td>
<td>.41</td>
</tr>
</tbody>
</table>

*Note: Robust standard errors in parentheses; *** p<0.01, ** p<0.05, * p<0.1*

We can explore our main hypotheses using this table. As in Bevan and Estrin (2004) there is a strong and highly significant EU announcement effect. Successful policies to carry out large scale privatization are associated with increased FDI in the transition economy region. Moreover, despite the collinearity we are able to identify positive effects from better institutions on FDI: in column 3 through privatization and in column 4 via property rights. Columns 3 and 4 therefore represent well specified models of the FDI process, including all of the main variables noted in the literature. This is a demanding specification in which to test whether there is an independent Balkans effect on FDI. We observe in columns 2 to 5 inclusive that the Western Balkan
Foreign direct investment into transition economies

dummy variable is always negative and statistically significant. This indicates that even when the growth of their domestic economies, the relative weakness of institutions, the slow pace of privatization and non-membership of the EU is taken into account, the Western Balkans countries receive less FDI than would be expected on the basis of the size and location of their economies.

5. Impact of FDI

What has been the impact of FDI for longer-term economic development of the individual SEE countries? To what extent have foreign investors contributed to gross fixed capital formation, GDP growth, structural changes, exports and employment generation in the host countries? We will discuss available evidence on the impact of FDI in SEE based on descriptive statistics, although these are the most fundamental issues - possibly more important than the determinants of FDI - that deserve further empirical research.

**Share of FDI in gross fixed capital formation**

Throughout the transition region, foreign capital has been an important supplement to domestic savings, and thus has greatly contributed to financial accumulation during the past twenty years. In the transition region the ratio of FDI to gross fixed capital formation has tended to be higher than the world average and has increased over time (Kalotay, 2010: 61-2). Using three-year averages due to large fluctuations in data, Kalotay shows that the ratio for the whole transition region increased over the 1990s and reached a peak of 16 percent in 2000, but fell under 10 percent in 2002-04, exceeding 10 percent again in 2005 and 2006. However, in his analysis Bosnia and Herzegovina,
Montenegro and Serbia are not included due to missing data for a large part of the period analysed.

Recent data suggest that FDI has contributed quite substantially to gross fixed capital formation in all the SEE countries from 2003 onwards. During the 2003-11 period, the ratio of FDI to gross fixed capital formation has been, on average, 32 percent for the whole SEE region, but it has been particularly high in Serbia (over 30 percent), Bulgaria (over 50 percent) and especially Montenegro (over 70 percent) (see Figure 13). Because of lower national savings and investment in SEE, FDI has played a much more important role in the Balkan region than in the CEE and Baltic states, where annual FDI inflows over the same period represented on average 17 percent of gross fixed capital formation (only in Estonia was the ratio over 30 percent).

**Figure 13.** FDI inflows as percent of gross fixed capital formation: annual averages (2003-11)

![Graph showing FDI inflows as percent of gross fixed capital formation](image)

*Source: Authors’ elaboration based on WIIW data (2012), p. 43.*

**Share of FDI in GDP**

The stock of inward FDI as a percentage of GDP is considered an indicator of foreign capital penetration in an economy. Similarly to the previous indicator,
Foreign direct investment into transition economies

in 2011 foreign capital as a share of GDP played a more important relative role, on average, in the SEE than the CEE countries (see Figure 14). The inward FDI stock represented, on average, 62 percent of GDP of the eight SEE countries, in comparison to the average of 52 percent of GDP of the eight CEE and Baltic states.

**Figure 14.** Inward FDI stock as percentage of GDP, 2011

![Bar chart showing Inward FDI stock as percentage of GDP for different countries in 2011.](image)

*Source: Authors’ elaboration based on WIIW data (2012), p. 43.*

**FDI contribution to structural changes**

FDI has played an important role in enterprise restructuring in the whole transition region during privatizations, in this way greatly strengthening the private sector and contributing to structural changes. Industrial restructuring usually tended to accelerate when privatization involving FDI was implemented, frequently creating a dichotomy between the modern, foreign-owned enterprises and the traditional industries. The dominant view has been that FDI has had positive spill-over effects for the whole economy, though there have also been findings that run counter to such optimistic conclusions (see, for example, Mencinger, 2003).
Kalotay (2010) convincingly argues that the contribution of FDI to structural change in various groups of economies in transition has been very uneven, having created strong structural changes only in the new EU member states but much less in the Balkan countries (p. 73). In the Western Balkans there were substantial delays in privatisation in most countries; privatisation methods during the 1990s were based mainly on sales to privileged insiders; and the composition of FDI in SEE has often not favoured industrial restructuring, since the dominant part, as reported earlier, has gone into services rather than into key manufacturing sectors. Due to such a structure of FDI, the Balkan countries have not been successful in integrating into global supply chains (Handjiski et al. 2010, p. 16). Although various services can clearly be involved in supply chains and can be quite important for a country’s exports (the most well-known example is India), their share in overall exports of most Balkan countries, for the moment, is fairly low.

**FDI contribution to exports**

The composition of FDI also adds to our understanding why SEE countries foreign trade performance has not been more satisfactory, particularly of the Western Balkans. Although WB countries’ exports have been increasing steadily, both intra- and extra-regional exports remain below potential (Handjiski et al. 2010, p. xv). During the past two decades the structure of exports of most WB countries has changed only marginally. Given that most SEE countries have attracted a large part of FDI primarily in non-tradable services, FDI has not contributed much to promoting exports or to industrial diversification and upgrading. The manufacturing industry, as the key sector for developing export potential, has actually continued to decline in most SEE countries also during the past decade, after the very strong process of
Foreign direct investment into transition economies

deindustrialization in the 1990s which has been more extreme than in CEE. One of the consequences is that the SEE countries are less integrated into the global economy than the CEE or Baltic states, as measured by the standard indicator of a country’s integration or openness - the exports of goods and services/GDP ratio (see Figure 15). The average export/GDP ratio in the SEE countries in 2008 was still fairly low (37 percent) as compared to the average ratio for the CEE and the Baltics (66 percent) (see Uvalic, 2012b).

**Figure 15.** Exports of goods and services/GDP ratios in SEE, CEE and the Baltics (2008)

![Exports of goods and services/GDP ratios in SEE, CEE and the Baltics (2008)](chart.png)

*Source: Authors’ elaboration based on World Bank World Development Indicators.*

**Employment generation**

FDI also does not seem to have generated much new employment in SEE. Despite increasing FDI particularly from 2003 onwards, employment rates in the WB countries, in particular, have been generally much lower than the EU average and since 2002 have been stagnating or declining (in all countries except Croatia). Unemployment rates are presently (2012) among the highest in Europe, particularly in Bosnia and Herzegovina (28 percent), Kosovo (45 percent), Macedonia (31 percent) and Serbia (23 percent) (see Bartlett and
Uvalic eds, 2013). The sectoral structure of FDI probably again explains why foreign investors have not contributed more to employment creation, since traditional labor-intensive sectors have not been among the most preferred. It has been argued for Serbia that the tax system has also been a deterrent to major FDI in labour-intensive industries (Arandarenko, 2009; Uvalic, 2010). The regressive labour tax system introduced in 2001 has favored investment in sectors with above-average wages and disfavored those involving below-average wages, which has further reduced the chances for successful restructuring within labour-intensive sectors such as the textile and food-processing industries (Arandarenko, 2009). The Kragujevac area in Serbia seems to have seen a decline in unemployment with the arrival of the large FIAT investment, but on the aggregate level the unemployment rate in 2011 has further increased.

6. Conclusions and policy implications

How much government policies can help in attracting FDI is raised by Demekas et al. (2005). The main policy question is whether FDI in the SEE region has been influenced primarily by exogenous, predetermined, factors such as size, level of development and geographical position, or by endogenous, policy-induced measures? What governments can or cannot do to attract more FDI? This is a key issue for the current debate on the ‘new growth model’ for Eastern Europe, since the expectations after 2009 across the SEE region have generally been overly optimistic regarding the quick return of FDI. Given the present unfavorable global climate for FDI, exhausted privatization opportunities in most Balkan countries and still unsettled political issues, the return of large amounts of FDI is unlikely in the short run.
Foreign direct investment into transition economies

Our findings confirm that for the Western Balkans, both groups of factors are important. Their location is relatively more distant from the major foreign investors than the transition economies of Central Europe, but our empirical analysis shows that the institutional environment has also had a critical role to play. The Balkan countries have failed to improve their institutions, for example regarding the protection of property rights or the investment climate, to levels attained by other more advanced economies, and our estimates suggest that this has cost the countries dear in terms of FDI foregone. FDI to the Balkan countries could therefore be further increased by government policies, but this would imply grasping the nettle of deep rooted institutional reform.

We find that the levels of FDI to the Balkan economies can be explained by three categories of factors. The first is the size of the domestic economy; apart from Romania, these economies are relatively small and GDP of the host economy has a significant positive effect on FDI. Secondly, their distance from the investing economies of Western Europe, and their remoteness from the EU and other major trading blocs, summarized in our framework by the distance variable, which is always negative and significant in our equations. The third category of factors relates to institutional quality, though this is harder to interpret because of collinearity between the various measures. Taken together, the results suggest that a variety of institutional factors are the third significant determinant of FDI into transition economies; in general there is more FDI into countries where institutions are more market supporting. Institutional quality is closely related to EU membership – it is the countries which score more highly in terms of these indicators of institutional quality which are members of the EU, though it is not clear in which direction the causality runs. Thus, the process of joining the EU leads countries to improve their institutional quality. On the other hand, the EU tends to admit
as members countries which are further advanced in terms of developing their institutions. Thus we find that announcement of EU membership also leads to higher levels of FDI, but it is not clear whether this effect is independent from the institutional quality effect.

Even taking all these factors into account, our regressions (columns 2 to 5) confirm the view that there is a negative ‘Western Balkans’ effect on FDI. We observe in Table 3 that the dummy variable for the Western Balkans is always statistically significant, independently of whether the EU dummy is included or not. Thus being in the Western Balkans exercises an independent negative effect on FDI in a fully specified extended gravity equation. This seems to indicate that the unfortunate recent political history of the region, with conflicts, fragmentation and low growth, have exercised a long lasting and independent effect on their prospects for receipt of FDI. The political risk, deriving from various unsettled political issues in the region, still seems to exercise a negative effect on FDI.

Our empirical work establishes a positive correlation between announcement of EU membership and FDI. It is not clear whether this is because EU membership raises FDI per se, via reduced transactions costs and risk, because EU membership leads countries to improve their institutions, or because the EU only admits countries which already have superior institutions to membership. To the extent that the former phenomena are effective, it is clearly in the interest of Western Balkans countries seeking to increase their FDI in order to accelerate restructuring and reduce unemployment to strive towards EU membership. To the extent that EU membership is associated with superior institutions, the two policy recommendations of this paper are therefore mutually supportive.
Foreign direct investment into transition economies

References


Foreign direct investment into transition economies


Uvalić, Milica (2012b). 'Why has export-led growth not been achieved in Southeast Europe?', Paper prepared for the OECD - CEFTA Secretariat Conference on Regional Trade Liberalization, Tirana, June.


Recent LEQS papers

**Everson, Michelle & Joerges, Christian.** 'Who is the Guardian for Constitutionalism in Europe after the Financial Crisis?' LEQS Paper No. 63, June 2013

**Meijers, Maurits.** 'The Euro-crisis as a catalyst of the Europeanization of public spheres? A cross-temporal study of the Netherlands and Germany' LEQS Paper No. 62, June 2013

**Bugarcic, Bojan.** 'Europe Against the Left? On Legal Limits to Progressive Politics' LEQS Paper No. 61, May 2013

**Somek, Alexander.** 'Europe: From emancipation to empowerment' LEQS Paper No. 60, April 2013

**Kleine, Mareike.** ‘Trading Control: National Chiefdoms within International Organizations’ LEQS Paper No. 59, March 2013

**Aranki, Ted & Macchiarelli, Corrado.** 'Employment Duration and Shifts into Retirement in the EU' LEQS Paper No. 58, February 2013

**De Grauwe, Paul.** ‘Design Failures in the Eurozone: Can they be fixed?’ LEQS Paper No. 57, February 2013

**Teixeira, Pedro.** 'The Tortuous Ways of the Market: Looking at the European Integration of Higher Education from an Economic Perspective' LEQS Paper No. 56, January 2013

**Costa-i-Font, Joan.** ‘Fiscal Federalism and European Health System Decentralization: A Perspective’ LEQS Paper No. 55, December 2012

**Schelkle, Waltraud.** ‘Collapsing Worlds and Varieties of welfare capitalism: In search of a new political economy of welfare’ LEQS Paper No. 54, November 2012

**Crescenzi, Riccardo, Pietrobelli, Carlo & Rabelotti, Roberta.** ‘Innovation Drivers, Value Chains and the Geography of Multinational Firms in European Regions’ LEQS Paper No. 53, October 2012

**Featherstone, Kevin.** ‘Le choc de la nouvelle? Maastricht, déjà vu and EMU reform’ LEQS Paper No. 52, September 2012


**Everson, Michelle.** ‘A Technology of Expertise: EU Financial Services Agencies’ LEQS Paper No. 49, June 2012

**Cherrier, Nickolas.** ‘EU Diplomacy at 27: United in Diversity?’ LEQS Paper No. 48, May 2012


**Meyer, Niclas.** 'Political Contestation in the Shadow of Hierarchy' LEQS Paper No. 46, January 2012