DETERMINANTS OF FOREIGN DIRECT INVESTMENT IN THE ECONOMIES OF SOUTH-EAST EUROPE: ANALYSIS OF ECONOMIC AND INSTITUTIONAL FACTORS

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Introduction

- The goal of this paper is to measure the influence of certain economic and institutional variables over the attractiveness of FDI in the region of South East Europe. The countries that are included in the analysis are the countries that are memebers of CEFTA-2006 (Albania, Bosnia and Herzegovina, Kosovo, Macedonia, Montenegro, and Serbia), and the three countries that become EU members: Bulgaria, Romania, and Croatia.
- The study uses panel data for a period of twenty years (1995-2015) on a basis of a holistic approach using multiple regression.
- One of the objectives of the SEE 2020 Strategy is to increase the annual FDI inflow to the region by at least 103 % (160 % including Croatia).

Overall FDI inflows (EUR million)	**3,396 (2010)**	**8,800 (2020)**

Economic theories on FDI

- During the 1970's the economic thought focused on explaining FDI motivation from the position of the model of imperfect competition on the world market. FDI has exceptional positive influence upon the economic growth of both home and host economy (spill-overs of knowledge and material skills).
- The contemporary concepts on FDI were mostly influenced by Dunning's *OLI Paradigm* (Dunning 1987) and Porter's *Diamond of Competitive Advantages* (Porter, 2000).
- Dunning&Rojec (1993) were among the first who applied this model upon the <u>transition economies</u> and related the **inflow of FDI with the opportunity of increasing productivity** in manufacturing industries that already existed in those countries; the opportunity of bringing **innovations** and improvements of the existing productions, processes and **organizational structures**; the promotion of **new allocation of recourses** among different sectors; the opportunity to get **access to new markets**; and the acceleration of structural changes within the economy and decrement of costs needed for technological changes. **FDI is a key to growth and increased competitiveness especially when domestic investments and savings are low.**

Economic and institutional factors

- *Influence of economic factors* (such as market growth and trade openness of the economy) upon the inflow of FDI (Deichman et al, 2003; Asiedu, 2006; Mohamed and Sidiropulus, 2010). In 2017 Kikerkova I. et al., applied VECM on FDI and their impact in the Republic of Macedonia and found out economic factors, such as: the rate of GDP growth, trade openness and labor productivity were the leading factors for increasing FDI inflow in Macedonia.
- *Institutional approach* refers to the level of institutional reforms that influence the quality of institutions. Institutional reforms should provide tools for fighting corruption and political instability, as they both degrade quality of institutions and prevent their development (Cleeve, 2008). Bevan and Estrin (2004) found out that **announcements on EU accession proposals had an impact on FDI for future member countries**. Jovanovic B. and Jovanovic B. (2017) found out by analyzing 27 ex-socialist countries that **investors were discouraged by bureaucracy and bureaucratic impediments** rather than financial costs.

Fiscal and Financial incentives

- Cass F.,(2007) investigated the role of **fiscal and financial incentives**, on one hand, and the policy applied by **Investment Promotion Agencies (IPAs)** in attracting FDI into European transition economies. Results of different researches were basically conflicting or with **predominantly negative connotation** - strong negative impact upon the corruptive practices within the institutions of the system and might lead to withdrawal of the decision of a foreign investor to effectuate the investment. (Zemplinarova, 1996; Osman, 2000; Cleeve, 2008).

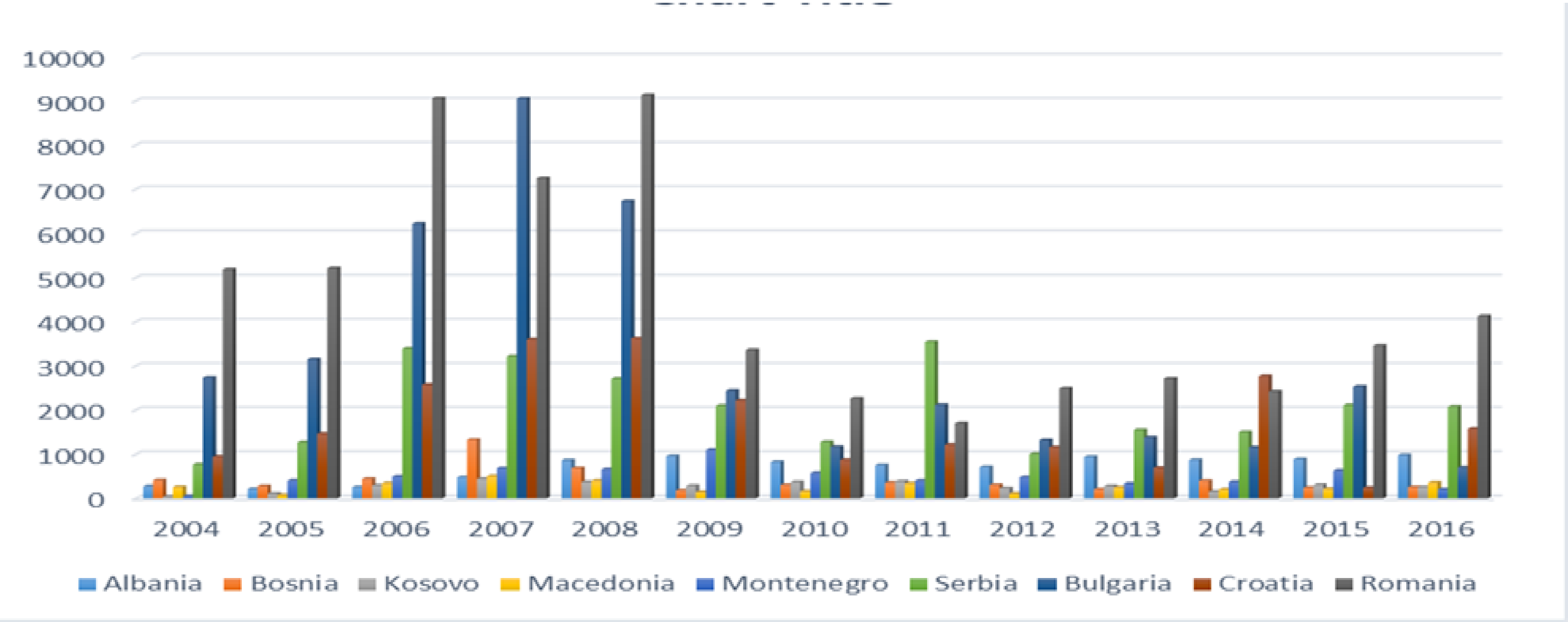
- <u>Abundant tax relieves</u> usually have a negative impact on the total effect from the attracted FDI, as they increase the costs for the host country to an extent that might overcome the total positive effect of the effectuated foreign investment.

- Kalotay K. (2008) analyzed the FDI inflows in Bulgaria and Romania at the beginning of their EU accession process and found that despite the major labor cost and corporate tax advantages these countries attracted relatively few efficiency seeking projects, mostly in garments and footwear.

Characteristics of FDI inflow in the countries of South-East Europe

- Due to political instability and the many war conflicts, the countries of South-East Europe lost a whole decade in the 90’s on macroeconomic stabilization, privatization and transformation of their systems towards a market economy.
- In the period from 2001-2008 economic reforms and privatization process in the region started to accelerate and the region gradually liberalized trade, especially with the EU.
- ***Most of the economic reforms that were implemented in different countries relied on legal reforms in favor of FDI regime liberalization and pursued active policies on attracting foreign investors’ attention***. These efforts led to an increment of the total FDI inflow, which reached its peak in the period before the world financial crises in 2007-2009.
- The crisis in 2008 had a strong negative impact upon FDI inflow in the countries of South-East Europe and cut more than a half of the total inflows of FDI at regional level (*The decline in WB countries as a group was 25% in 2009 in FDI inflow – BIH decline for 74%; Macedonia 64% and Serbia-30%*). The recovery period lasted until 2014, when FDI inflow started to increase again, but it was far from catching up the 2008 levels.

Figure 1: FDI inflow in South-East Europe in the period from 2004 to 2016 (in million EUR)



Characteristics of FDI inflow in the countries of South-East Europe

- FDI inflow within the region created about 8% of the total GDP on average.
- Serbia has the biggest capacity for attracting FDI within the region. Montenegro with 6,290 EUR per capita is the country with highest FDI stocks per capita in 2013, while Macedonia happens to be the least attractive country in the region (Pinto et al., 2016).
- FDI inflow was considerably higher in the countries that became EU member - states than in CEFTA-2006 members. This is completely in line with the finding of Bevan and Estrin (2004) that the announcements on EU accession have a positive impact on FDI for the future member-states.
- Barlett and Prica (2012) suggested that the **extent of openness to FDI flows was a major cause** of the transmission of the crisis to the region.
- The slow-down of FDI inflow in the region was not caused only by the crisis, but generally it was a **result of the completion of the privatization process** and the **lack of interest of foreign investors to invest in already existing enterprises.**

Specification of the model

Panel regression OLS model is used. The model is described in the following equation:

$$y_{it} = \alpha + \beta_{x_{it}} + u_{it}$$

where $y_{it}$is the dependent variable, α is the intercept term, β is a $kx1$ vector of parameters to be estimated on the explanatory variables, and x_{it} is a $1xk$ vector of observations on the explanatory variables, $i = 1, \dots, N$ and it stands for cross-sectional unit (number of countries), while $t = 1, \dots, T$ and it stands for time period (Brooks, 2014).

The analysis includes nine South East European countries (Albania, Bosnia and Herzegovina, Bulgaria, Macedonia, Montenegro, Romania, Serbia, Kosovo and Croatia) for the period from 1995-2015.

Economic factors		Source	Institutional factors	Source	
GDP annual percentage growth	(gdp_{it})	World Development Indicators	Political Stability and Absence of Violence Index	$(political_{it})$	Worldwide Governance Indicators
Trade as percentage of GDP	$(trade_{it})$	World Development Indicators	Rule of Law: Property Right	$(right_{it})$	2017 Index of Economic Freedom
GDP per employee measured in PPP in constant terms for 2011 as an indicator of labor productivity	$(productivity_{it})$	World Development Indicators	Regulatory Efficiency: Business Freedom	$(business_{it})$	2017 Index of Economic Freedom
unemployment as a percentage of total labor force	$(unemployment_{it})$	World Development Indicators	Regulatory Efficiency: Monetary Freedom.	$(monetary_{it})$	2017 Index of Economic Freedom
general government final consumption expenditure as percentage of GDP	$(government_{it})$	World Development Indicators	Open Markets: *Financial Freedom*	$(financial_{it})$	2017 Index of Economic Freedom
population growth as annual percentage growth	$(population_{it})$	World Population Prospects of the United Nations Population Division			

Presentation of results

	(1)	(2)	(3)	(4)	(5)	(6)
Log (GDP)	0.161**	0.177**	0.211***	0.215***	0.238***	0.251***
Log (Trade)	0.155***	1.870***	1.740***	1.720***	0.314***	0.850***
log (Productivity)	-0.554***	-0.652***	-0.665***	-0.655***	-0.626***	-1.428***
Unemployment		-0.017***	-0.020***	-0.022***	-0.027***	-0.018***
Government			0.044**	0.045***	0.057***	0.107***
Population				0.032	0.006	0.118
log(Rights)					0.05	0.125
Monetary					0.017***	0.012***
log(Political)						1.239***
log(Business)						1.325***
log(Financial)						1.250***
R-square	0.252	0.269	0.323	0.323	0.420	0.614
Adjusted R-square	0.240	0.248	0.296	0.298	0.373	0.563
Observations	133	108	108	108	96	87

Presentation of the results

- Both economic and institutional variables are important for the increment of FDI inflows in the region. Among the economic variables the General Government Final Consumption Expenditure as a percentage of GDP appears to be with the greatest influence in attracting FDI inflows. GDP annual growth and trade as a percentage of GDP are also significant and with positive influence but with a lower value of the coefficient.
- From institutional variables taken into account we can confirm that the influence of four factors: Political Stability and Absence of Violence Index, Monetary Freedom as a measure of price stability, Business Freedom as an indicator of the efficiency of government regulation of business, and Financial Freedom as a measure of efficiency of the banking and the whole financial sector, are statistically significant and have positive influence upon attracting FDI in the region of South East Europe.

Conclusion

- FDI inflow is lagging behind and in is not back to the pre-crisis levels measured as a % of GDP.
- Manufacturing is a major source of innovation and productivity growth in the countries of South East Europe. Foreign investors took advantage of previous existing manufacturing base through privatization of steel companies, food industry, textiles; or went to some smaller sectors; or have shaped new specialization patterns in slowly emerging medium-high-tech industries.
- The region's competitiveness is severely hampered by poor infrastructure development in all areas, which limit trade and investment opportunities within the region.
- All of the Southeastern European countries and especially CEFTA member-states are weakly or moderately integrated into international trade and production value chains.
- The results should be taken into consideration on creating better policies in future. Combined with the goals defined in the Berlin Process the regional dimension should be strengthened. The final goal is to enable positive influence upon future FDI inflow in the region and thus support and enhance its economic growth.