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FDI Flows in Balkans: What is Contributing to this Important Pillar for Growth?

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Abstract: Many countries in the Balkan region have long been awaiting their accession in the European Union. Countless efforts, governmental reforms and policies are undertaken to ensure compliance with the international standards, adoption of best practices and to steer economic growth. Foreign direct investments serve various functions in the host economies, thus potentially triggering also economic growth. Given other advantages that these countries have such as the favorable climate and geographical location, FDI can become an important complementary pillar for growth if supported by adequate reforms targeting justice system, fair competition, and stability. On the face of rapid globalization, it becomes important to know how the region is benefiting from international capital flows and how various factors from different spheres shape them. In this paper, secondary data collected over the course of the last decade is used to study the financial, political, legal, and economic factors that shape FDI. The panel-data regression analysis allows identifying how policymakers can channel their policies into supporting FDI and creating solid foundations to reap the full benefits arising from them. This study provides an up-to-date, comprehensive analysis, which does not only contribute to the existing regional literature, but also to academia, practitioners, and pertinent stakeholders.

1. Introduction

As the 21st century kicked in, the Western Balkan countries were given the green light of aspiring to become eventually part of the European Union (Dhimolea, 2023). Certainly, this goal would call for continuous efforts, persistence, massive reforms, and it would also start a long and dynamic path of developments affecting consolidation of democracy, the fight against corruption and organized crime, harmonization of the legal framework with EU Directives and most importantly socio-economic progress in all these countries. The region is known for its favourable climate, strategic geography, and natural resources, yet the historical context has played a major role in impeding the path to development, growth, competitive positioning in international trade arena and to EU integration. To secure the long-desired economic growth and sustainable development, it is needed to back up the domestic capital stock with external inflows of capital (Benmamoun & Lehnert, 2013) which potentially contribute to the employment rate in the host economy, technology transfers, knowledge sharing and trigger other positive developments by also fostering stronger fair competition. Besides, it is found that FDI and trade can also shrink the inherent income gap in developing countries, thus helping further the advancement towards growth and welfare (Xu et al., 2021). Economic openness and well-targeted reforms increase

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the potential for FDI absorption by countries, hence bringing benefits in terms of human capital, research and development and productivity (Tuan et al., 2009; Ngowi, 2001). However, the share of FDI that comes to a host economy is determinative for the spillover effects. Developing countries are not very competitive when considering the attractiveness that business climate in these economies holds in the eyes of potential foreign investors; consequently, the weight of foreign capital flowing in such economies is sometimes insufficient for welfare goals (Dabour, 2000). Yet, it is to be underlined that the intensity of FDI flows has also to be complemented by certain factors in the business climate and governmental reforms of the host countries. Human capital is the foundation for the success of every business. Unless the staff is well equipped with technical skills, abilities, expertize and know-how, no business idea can survive. Unfortunately, in many developing countries this is what makes up the Achilles heel. Governments should seriously focus on reaching a certain level in the development of the domestic human capital so as it provides solid grounds to reap the benefits of FDI (Fadhil & Almsafir, 2015). What makes matters worse is that nowadays many such countries are suffering from a massive brain drain phenomena. As more and more young people look for a future in the labor markets abroad, it becomes tough to create the necessary, highly skilled workforce. International infrastructure and industrialization play a part as well. Unless the host country provides some necessary factors of success for FDI to be productive and profitable, fewer foreigners can take on such a risk. Infrastructure and industrialization are needed for FDI to thrive, as they facilitate the supply chain management and offer crucial efficiency benefits (Mollick et al., 2006; Khadaroo & Seetanah, 2009). Additionally, it is of utmost importance to understand that unless the markets are transparent and functioning on the basis of fair competition, foreign investments can even put domestic firms at a competitive disadvantage (Bjorvatn et al., 2001). A similar concern was raised by Alege & Ogundipe (2014). They underlined the fact that in the case of Africa for instance, FDI was resource-seeking thus unless they are complemented by adequate reforms and policies, rather than introducing growth and stability they will bring no real change for the countries. It is especially important to underline that, in a century when artificial intelligence and information technology are reaching unimaginable dimensions of advancement, it is critical for these countries to increase the attractiveness to foreign investors, thus embracing this era of change which can translate into operational flexibility, productivity and efficiency improvements, and better prospects for growth.

As presented above, FDI flows are defined by various factors, working independently, or even interconnected with each other. In the next sections, we will examine the literature studying FDI determinants, and then through a comprehensive empirical analysis we will identify the main driving forces of a financial, political, legal, and economic nature that support or hinder FDI.

2. Literature Review

The plethora of factors determining flows of FDI in an economy is thought to depend on the existing level of development of the host country. In their study, Saini & Singhania (2018) point out the fact that the relevant factors affecting the size and impact of FDI in the host countries will vary between developed and developing countries. Using both a static and dynamic approach, the authors conclude that in the case of developing countries trade openness is critical for FDI. In the same vein also goes the study from Khadaroo & Seetanah (2009). Using GMM estimates to account for time dynamics and endogeneity, authors conclude that one of the main drivers of FDI in the case of African countries is openness to trade, market size and education of the workforce. The impact of trade openness is critical especially if FDI is export-seeking. Hossain & Mitra (2013) carry out another analysis focused on African countries. Their study of 35 African countries over an exhaustive time period uncovered a long-

run, positive relationship between trade openness and FDI. Similarly, through targeted research on Nigeria, Oladipo (2013) supported the view that openness to trade encourages FDI. Also, the researcher found that a dynamic specification with respect to the dependent variable was necessary to understand the full scope of the interrelationships. The empirical analysis uncovered that only 10 % of current FDI are determined from the previous FDI in the case of Nigeria. This fact alone allows us to derive conclusions about investors' behavior, risk aversion and investment strategies. Another important factor which is frequently accounted for in the FDI regressions is GDP. Using GDP per capita as a proxy for market size Hossain & Mitra (2013) concluded that the former is not a key predictor of FDI flows. Contrary to this result, Ashurov et al. (2020) who studied a sample of Central Asian countries through one-step GMM estimation method, concluded that in fact a stable, up trending GDP is of critical importance to investors and thus to FDI inflows. Positive prospects of an investment becoming successful are often attached to an overall positive economic climate which shows signs of continuous growth and improvement. Kersan-Škabić (2015) studied the Southeastern Europe countries in an attempt to understand which macroeconomic and institutional factors determine inward FDI in this region. They analysis showed that GDP per capita had a positive, statistically-speaking significant impact on FDI flows in the case of Albania, Bosnia and Herzegovina, Croatia, North Macedonia, Montenegro and Serbia. Another comprehensive analysis having on focus developing countries is the one conducted by Majeed & Ahmad (2009). By examining 72 developing countries, authors found that their results were in line with the market-seeking behavior of corporates. That said, GDP, GDP growth and per capita income resulted to be significant from their regressive analysis and huge supporters of inward FDI. Inflationary pressures play a considerable role in shaping investors' decisions. As price level increases, purchasing power of money drops and uncertainty starts to spread, fewer investments are expected to be undertaken as costs rise thus shrinking future profits. Inflation is a sign of economic instability and poor monetary policy effectiveness. There are several studies hinting at a deterrent effect that inflation plays for FDI inflows. Majeed & Ahmad (2009) reach to the conclusion that inflation depresses FDI inflows. Nevertheless, there are also authors who find evidence in favor of a positive effect of inflation on FDI, even though it seems to be modest in terms of magnitude (Oladipo, 2013). In the case of China and India, inflation, as captured by CPI, seems to be insignificant in explaining the variability in FDI (Parashar, 2015). Not only macroeconomic factors, but also political arena affects the attractiveness of a region/country to foreigners. A tense, unstable political climate would discourage foreign investors from choosing a certain host economy for their planned business ventures. Tian et al (2017) investigated the potential relationship between FDI and political stability index. Their findings suggest a positive, yet peculiar impact of the former on the latter. Authors suggest that maybe a more comprehensive study would have allowed to check further such association. Corruption is another political factor that affects the level of investment by foreigners in a country. Hossain (2016) studied 48 countries by employing three different estimation methods. The results were consistent amongst the three, thus suggesting that corruption is inversely related to FDI inflows. Lastly, democratic countries are thought to support entrepreneurship, investments, fair competition, and business climate in general. Yet, in the case of Ukraine no such results were found. The democracy proxy turned out to be insignificant once other political and economic factors were controlled for (Cieślik & Gurshev, 2020). Along similar lines goes also Lajeunesse (2022). This study on upper-middle income nations supported the view of no direct, significant relation between indicators of democracy and FDI inflows. The last variable to be discussed is exchange rate volatility. This financial variable certainly is expected to shape to some extent inward FDI. Sharifi-Renani & Mirfatah (2012) carried out a cointegration analysis in the case of Iran. Their results hinted at a negative impact of exchange rate volatility on FDI inflows. Another study employing cointegration analysis comes from Kyereboah-Coleman & Agyire-Tettey (2008). Amongst the plethora of factors that authors considered was also exchange rate volatility as determined by ARCH and

GARCH models. The empirical analysis once more showed that the effect of volatility is negative. Kiyota & Urata (2004) go in similar lines. Examining the case of Japan authors' findings suggest that periods of high volatility of exchange rate discourage foreign investors from brining capital flows in the said host economy.

3. Data & Methodology

The empirical analysis employed in this paper builds on a balanced panel dataset covering the timeframe from 2011-2021 (inclusive) for a randomly selected sample of Balkan countries, namely Albania, Bosnia & Hercegovina, Bulgaria, Croatia, North Macedonia, Romania and Serbia. The data is collected per annum for the following: corruption index, democracy index, political stability index, real GDP growth rate, trade openness, inflation and exchange rate. On the other hand, FDI is captured as a percentage of GDP. The data sources are presented on Table 1, while the regression below is estimated using General Method of Moments (GMM), thus accounting for dynamism and endogeneity.

$$FDI_{i,t}= \alpha + \beta_1*Corruption\ Index_{i,t}+ \beta_2*Democracy\ Index_{i,t}+ \beta_3*Political\ Stability\ Index_{i,t}+ \beta_4*Real\ GDP\ Growth_{i,t}+ \beta_5*Trade\ Openness_{i,t} + \beta_6*Inflation_{i,t} + \beta_7*Exchange\ Rate\ Volatility_{i,t}+ \beta_8*FDI_{i,(t-1)}$$

Table 1. Regression Variables

Variable	Category	Source
Corruption Index	Political / Legal Proxy	Trading Economics
Democracy Index	Political / Legal Proxy	The Economist Intelligence
Exchange Rate	Financial Factor	Investing.com
Exchange Rate Volatility	Financial Factor	Author's Calculation*
FDI (% of GDP)	Financial Factor	World Bank
Inflation (%)	Macroeconomic Factor	World Bank
Political Stability Index	Political / Legal Proxy	World Bank
Real GDP Growth Rate (%)	Macroeconomic Factor	IMF
Trade Openness	Macroeconomic Factor	World Bank

Standard deviation of percentage changes of exchange rates of the national currencies to euro

Before estimating the final regression equation, we made sure that the model will be robust, thus meeting all assumptions and prerequisites. The following checks were carried out to ensure that we did not violate any assumptions: Philips Perron test for stationarity of the variables as well as correlation matrix to check for multicollinearity. The final model was also tested for any presence of endogeneity, yet there was no proof of any endogenous variable in the model; apart from the fact that past information in FDI appeared to be useful in explaining current FDI. Lastly, GMM was tested for 1st and 2nd order serial correlation. The results were in favour of no serial correlation of second order in residuals, thus GMM would be valid. In the next section, descriptive statistics, preliminary checks and GMM estimation output will be presented and commented accordingly.

4. Results

In this section, we will first present the preliminary robustness checks, specifically the one on multicollinearity and stationarity of the regression variables. The results from Table 2 below suggest there is no perfect correlation between regressors, as the correlation coefficient for each pair does not exceed 0.8.

Table 2. Correlation Matrix

	Corruption index	Democracy index	Exchange rate volatility	Inflation rate	Political stability index	Real GDP growth rate
Democracy index	-0.0958					
Exchange rate volatility	0.0097	0.0576				
Inflation rate	-0.0312	0.2630	0.3339			
Political stability index	0.5320	0.0167	0.0043	0.0847		
Real GDP growth rate	0.0413	0.1058	-0.2102	0.0866	-0.0141	
Trade openness	0.0415	0.1707	-0.1649	0.1890	0.0509	0.6332

Next, it is presented Table 3, which shows the results from Philips Perron Test. The trending behaviour of time series, and consequently of panel data as well might jeopardize the robustness of the model and reliability of results. Consequently, it becomes important to know whether stationarity prerequisite is met, hence mitigating any potential spurious regression problem which might otherwise arise. The rejection of the null hypothesis in favour of a unit root is checked at a 5% significance level, i.e. a 95 % confidence level.

Table 3. Unit-Root Test

Variable	Test	P-value (level)	P-value(difference)
Corruption Index	PP - Fisher Chi-square	0.0000	-
Democracy Index	PP - Fisher Chi-square	0.2026	0.0000
Exchange Rate Volatility	PP - Fisher Chi-square	0.0003	-
FDI (%)	PP - Fisher Chi-square	0.0000	-
Inflation (%)	PP - Fisher Chi-square	0.0004	-
Political Stability Index	PP - Fisher Chi-square	0.0372	-
Real GDP Growth Rate	PP - Fisher Chi-square	0.0000	-
Trade Openness	PP - Fisher Chi-square	0.3244	0.0000

In this study, one-step GMM is used. This methodology allows to account for dynamism in the model (with respect to the dependent variable), unobserved heterogeneity, as well as endogeneity in the regressors. The GMM estimation output is presented next, after ensuring its validity and proving the lack of second order autocorrelation in the residual series.

The final results allow to answer the main research question, hence the main macroeconomic, financial and political factors for higher FDI inflows will be highlighted; and the magnitude of impact will be interpreted accordingly. The estimation output will also show the degree of persistence of FDI over years as such capital flows are known to be irreversible.

Table 4. GMM Estimation Output

Dependent Variable: FDI				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXCHANGE_RATE_VOLATILITY__TO_EUR_	0.4975	0.4135	1.2032	0.233
DEMOC_IND	-0.0079	0.0088	-0.8912	0.376
CORRUPTION_INDEX*	-0.0022	0.0009	-2.5710	0.012
TRADE_PERC	0.0386	0.0264	1.4617	0.148
REAL_GDP_GROWTH_RATE____*	0.0015	0.0007	2.0324	0.046
POLITICAL_STABILITY_INDEX*	0.0190	0.0062	3.0674	0.003
INFLATION	0.0650	0.0989	0.6567	0.513
FDI__(-1)*	0.3969	0.1680	2.3623	0.021
C	0.1061	0.0395	2.6838	0.009
R-squared	0.5268			
Adjusted R-squared	0.4703			

Denotes that there is enough evidence to reject the null hypothesis with 95 % confidence level.

As the estimation output above suggests, the model helps to shed light on 52.68 % of the variability in inward FDI. In addition, we see that statistically significant variables alone, jointly speaking, provide an explanatory power of about 47.03 % over FDI inflows. Using any conventional significance level (1,5,10 %), it is noticed that the null hypothesis of no impact cannot be rejected in the case of exchange rate volatility, democracy index, trade openness, and inflation. On the other hand, individually speaking we see that corruption index, real GDP growth rate, political stability index and lagged FDI have a significant impact on the explained variable statistics-wise, ceteris paribus. For each change in the corruption index, FDI would tend to drop by 0.0022 % points ceteris paribus. For each percentage point change in real GDP growth rate, FDI would be expected to rise by 0.0015 % points ceteris paribus. For each change in the political stability index, we would expect inward FDI to rise by 0.0190 % points ceteris paribus. Moreover, dynamism in FDI is proved with 95 % confidence level. It appears that last year FDI accounts for 39.69 % of current FDI. It means that if at a certain point in time FDI inflows would rise by 1 % point, the next year it could be evidenced an increase by 0.3969 % points ceteris paribus.

5. Conclusions

Foreign investments are considered critical determinants of growth and welfare for the so-called transition economies. Balkan countries, which are at such stages of development, have attempted for years to establish persistent patterns of development by relying on internal and external sources of growth. In this paper, an important factor for growth is studied, FDI. We examine how FDI inflows are shaped by numerous political, macroeconomic and financial variables by relying on secondary data collected over 2011-2021 for a random sample of Balkan countries. The GMM method allows to account for simultaneity, dynamism and unobserved heterogeneity. The results suggest that prior knowledge of a certain market encourages investors to continue investing in it. The fact that FDI are undertaken over long-term horizons and that rates of return generally take years to be achieved, contributes to the persistence of FDI as shown by the statistical results. Additionally, the estimation output suggests that governments should understand that indeed FDI might support economic growth, but for a country to attract FDI a prior, satisfactory level of development is needed. Importance should be paid as well to the fight of corruption and political stability which are objectives that have for long been on target as they go in line with EU integration goal. The study offers an up-to-date, comprehensive analysis, which adopts an adequate methodology that matches the nature of interrelationships by contributing not only to academia, but also to decision-makers and other pertinent stakeholders.

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