

# 11

## Are Foreign Direct Investments in the Balkans Different?

*Saul Estrin and Milica Uvalic*<sup>1</sup>

### 11.1 Introduction

The chapter examines whether there are specific features driving foreign direct investment (FDI) to the Western Balkan (WB) countries – Albania, Bosnia and Herzegovina, Croatia, Macedonia, Montenegro and Serbia – compared with other transition economies. Despite many positive developments during the 2000s, the Balkans may still face an image problem: for many potential foreign investors, the word Balkan ‘conjures up troubled images of war and conflict, rather than investment opportunities and economic potential’ (Cviic and Sanfey, 2010, p. 124). This chapter explores whether FDI into the Western Balkans has been lower than can be explained by the economic characteristics of the region, such as the smaller size of domestic markets and greater distance from the main investing economies. Our analysis confirms this view; FDI to the Western Balkans is driven by the same economic, geographical and institutional factors as other transition economies, but there is evidence of a significant negative regional effect.

We first provide, in section 11.2, a brief historical background and discuss the key characteristics of FDI inflows to the Balkan region during the 1990s and the 2000s. Although the primary focus is on the WB countries, Bulgaria and Romania are also occasionally considered. We go on in section 11.3 to test hypotheses about FDI on the basis of a gravity model. The conclusions in section 11.4 point to the main results.

<sup>1</sup> A longer version of the paper was published in *The Economics of Transition*, Vol. 22 (2) 2014. We thank John Wiley and Sons for granting a licence to publish this shorter version of the paper. The authors would also like to thank Jan Svejnar, Laza Kekic, Will Bartlett and participants of various conferences for useful comments on earlier versions of the paper, and Adeline Pelletier for excellent research assistance. Any remaining errors are our own.

## **11.2 Patterns of FDI in the Balkans**

Over the past twenty years there has been a flourishing literature about FDI in Eastern Europe, since foreign capital has played an important role in most countries during the transition to market economy. A number of studies have looked into the volume, forms, origins and destination of FDI by economic activity (for example, Lankes and Venables, 1996; Meyer, 1998; Estrin, Richet and Brada, 2000; Bartlett, 2008; Kalotay, 2010; Hunya, 2011, 2012). In addition, econometric papers have examined the locational determinants of FDI (for example, Bevan and Estrin, 2004; Bevan, Estrin and Meyer, 2002; Janicki and Wunnava, 2004; Dikova and van Witteloostuijn, 2007). However, there has been relatively little research on FDI into the Western Balkans.

Political and economic instability may explain why, in the considerable literature on FDI in transition economies, there has been little research specifically on the Balkans. From 1991 onwards, political events have had negative economic implications for the whole region. In particular, the disintegration of the Yugoslav federation led to the break-up of traditional economic links, a very deep recession, delays in economic reforms and later integration with the EU (Uvalic, 2010, 2012).

The papers that have focused on FDI in the Balkans are inconclusive as to whether there is a negative 'Balkans' effect on FDI. Christie (2003) finds FDI in the South East European (SEE) region is low relative to the Central East European (CEE) countries, but his analysis is incomplete since it excludes three Balkan countries. Brada, Kutan and Yigit (2006) find that conflict, instability and delayed transition have reduced FDI inflows in the Balkans and Demekas et al. (2005) also find actual FDI in most Balkan countries to be lower than potential. Only Kekic (2005) finds that the determinants of FDI to the Balkans do not differ from those in other transition regions. However, there has been a strong upsurge in FDI in most Balkan countries since 2000, which may have compensated for the earlier lack of FDI. Hence it is important to re-examine these issues taking into account more recent data.

### **Main features of FDI in the 1990s**

The Balkan region attracted little FDI during the 1990s. Even if we include Bulgaria and Romania in the Balkan region, 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; less than their share (7.7 percent) in total population of the transition region and much less than implied by their history. The situation improved after the signing of the Dayton Peace Accords in 1995, but over the whole 1989–2000 period, the inward

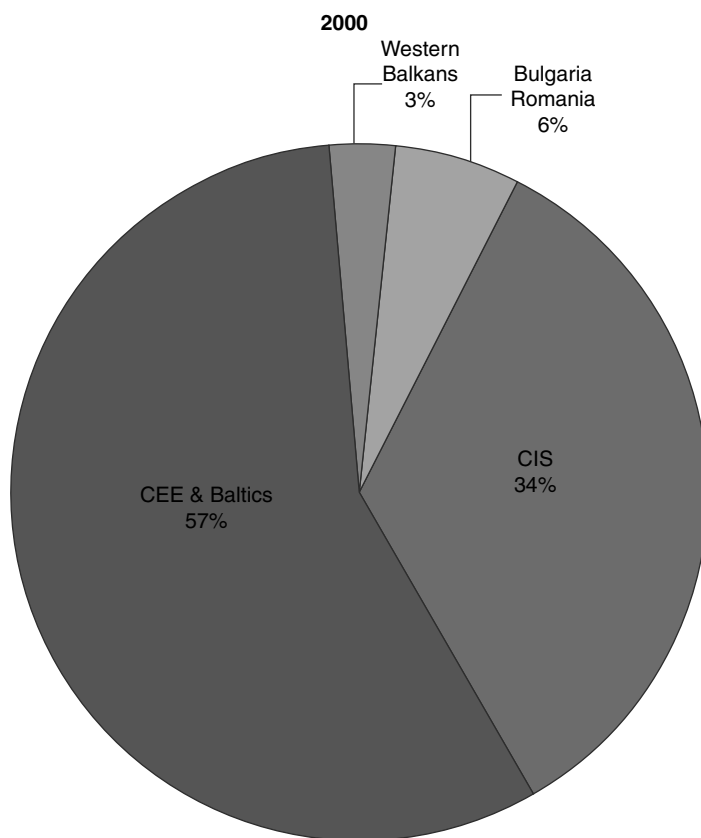


Figure 11.1 Inward FDI stock by transition regions, 2000 (shares, in percent)

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 11.1).

Romania has been the main recipient, as by 2000 it had attracted by far the most FDI in the Balkans, almost as much as all the other countries put together. In 2000, Bulgaria, Croatia and Romania accounted for more than 80 percent of the total inward FDI stock in the SEE region (see Figure 11.2).

### Upsurge of FDI in the 2000s

From the early 2000s, the Balkan countries greatly improved their economic performance and accelerated transition-related economic reforms. The international community also changed its policies towards the region after the end of the Kosovo conflict in mid-1999 with the launch of the EU Stabilization and Association Process specifically for the Western Balkans, offering them trade liberalization, assistance programmes, contractual relations and prospects of EU

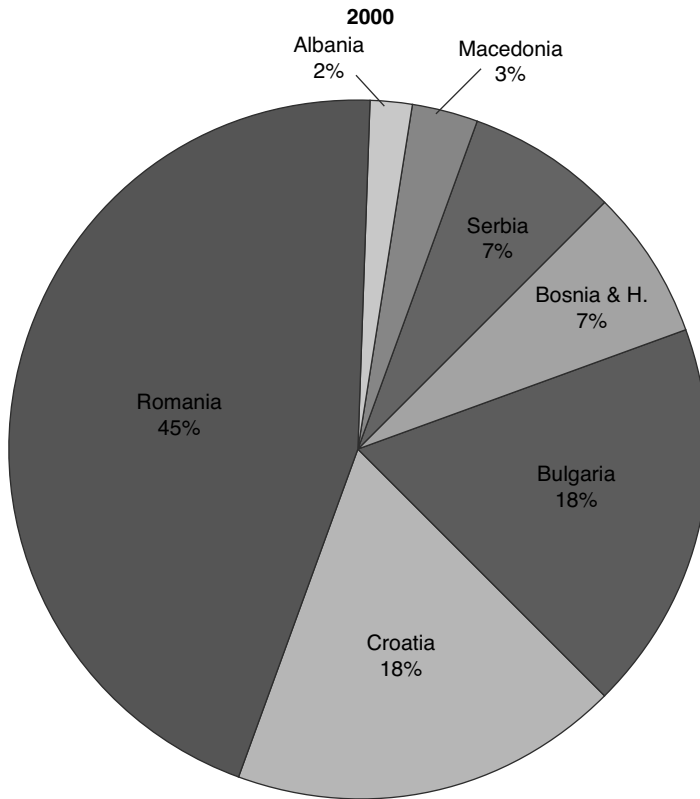


Figure 11.2 Inward FDI stock in SEE, by country, 2000 (shares, in percent)

membership. Perhaps as a consequence of the improving political and economic climate, there was a marked increase in FDI thereafter. Even so, by 2010 the eight Balkan countries (including Bulgaria and Romania) had received only around a third of the volume of FDI that had gone to the eight countries in CEE and the Baltics. The share of the eight Balkan countries in total inward FDI stock in the transition region increased to 14.7 percent in 2010 (5.8 percent in the Western Balkans and another 8.9 percent in Bulgaria and Romania, see Figure 11.3), by 2010 representing almost double their relative share in the population of the transition region.

However, intra-regional shares in FDI have not changed substantially (see Figure 11.4). Romania, Bulgaria and Croatia continued to be responsible for the bulk of total inward FDI stock in 2010 (78 percent), but Serbia has also attracted increasing FDI after 2003.

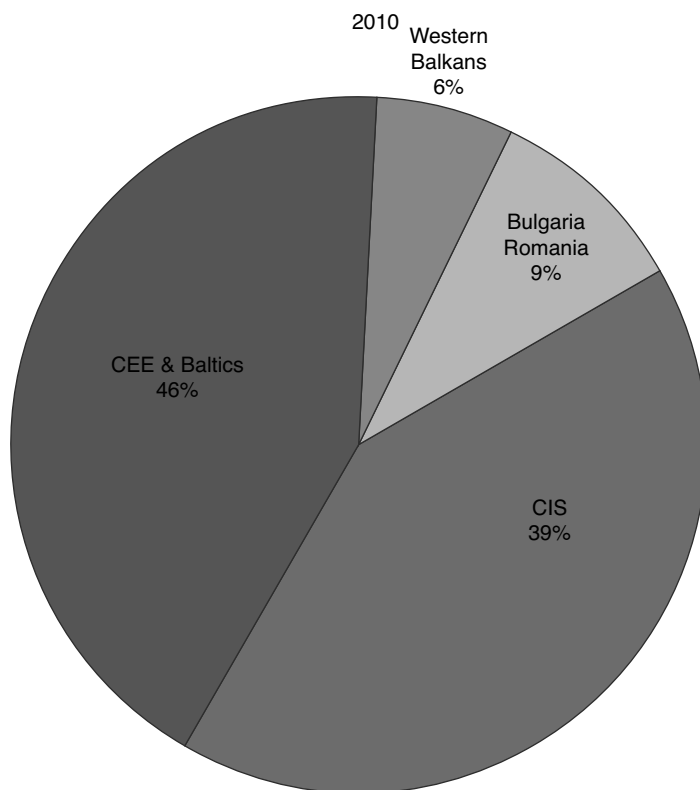


Figure 11.3 Inward FDI stock by transition regions, 2010 (shares, in percent)

In order to account for the very different sizes 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 11.5. Montenegro as the smallest SEE country is ahead of all the others in FDI per capita terms, followed closely by Croatia and Bulgaria. Although Montenegro in 2010–11 had the highest FDI stock per capita among all countries considered, 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.

#### **FDI by sector of economic activity**

Another interesting feature of FDI in the Balkans is its sectoral distribution. This issue is likely to be important in assessing the longer-term impact of FDI on individual economies, such as its contribution to the promotion of exports or to the generation of new employment. FDI by sector of economic activity based

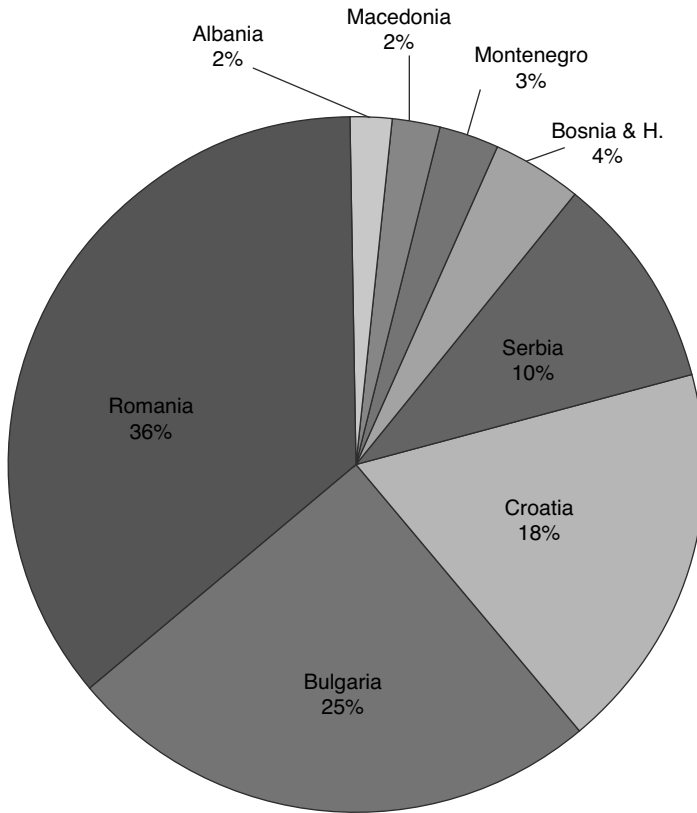


Figure 11.4 Inward FDI stock in SEE, by country, 2010 (shares, in percent)

on the WIIW database shows that by 2010, the service sector accounted for the largest part of inward FDI stock in all seven SEE countries, on average 62 per cent of total in the SEE region.<sup>2</sup> The service sector represented around 50 per cent of inward FDI stock in Macedonia and Romania, close to 60 per cent in Albania and Bosnia and Herzegovina, 68 per cent in Bulgaria and as much as 73 per cent in both Croatia and Serbia. Banking, telecommunications, real estate and wholesale and retail trade have been among the most favored sectors of foreign investors in the region. The only three countries that have attracted a considerable amount of FDI in manufacturing are Bosnia and Herzegovina (35 per cent of total), Macedonia (31 per cent) and Romania (32 per cent), which is in contrast to

<sup>2</sup> 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.

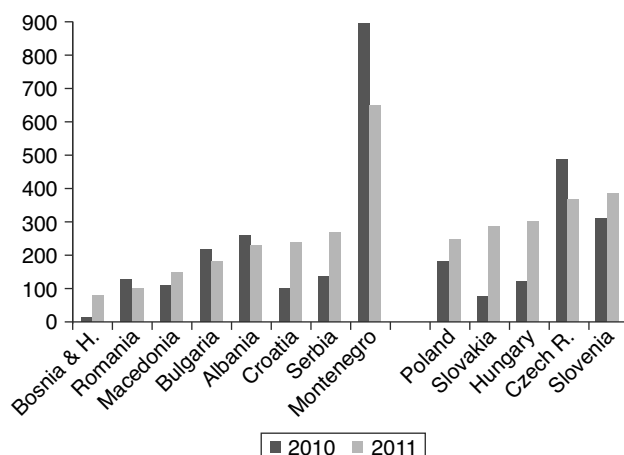


Figure 11.5 FDI stock per capita in SEE and CEE (million EUR), 2010 and 2011

the much lower shares in the other countries – 16 percent in Albania, 17 percent in Bulgaria, 20 percent in Serbia and 21 percent in Croatia.

How does this compare to the situation in the five CEE transition economies? The share of FDI invested in various services is slightly lower in CEE than in SEE – on average, 56 percent, but the variations within CEE have been much lower than within SEE. A share of FDI in services of a bit over 60 percent was registered only in Poland and Slovenia, but in as many as five Balkan countries. In the five CEE countries manufacturing accounts, on average, for 29.4 percent of inward FDI stock, compared to 24.7 percent in the seven SEE countries. Particularly three CEE countries have attracted substantial amounts of FDI in manufacturing: the Czech Republic (30 percent), Poland (32 percent) and Slovakia (36 percent). This probably helps to explain why FDI has been less an agent of structural changes in SEE than in CEE.

### 11.3 Determinants of FDI location in transition and Balkan economies

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 and 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 – determinant of FDI (Chakrabarti, 2001; 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 and 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, Estrin and Meyer, 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.

The four classic motivations for FDI (Dunning, 1993) – market seeking; efficiency seeking; resource seeking; and asset seeking – provide a further justification for the estimation framework. Market seeking FDI is driven by size and growth of the host economy market and probably played an important role in the investment into the transition economies, especially in the early years (Lankes and Venables, 1996; Bevan and Estrin, 2004). The size of the economy is captured by the GDP of the host economy, and this variable is sometimes 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 FDI source economy provides a larger domestic market for investing multinational enterprises; this argument provides a basis for the inclusion of the source economy GDP in the estimating equation. Distance between the source and host economies is an indicator of the transactions cost of doing business through foreign investment, and the quality of institutions in the host economy is a further indicator of the cost side of the investment opportunity.

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. Membership of free trade associations and economic communities also reduce cross border transactions costs and we therefore also control for the announcement of EU membership in our empirical work. 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 and Brada, 2000). However, low wages are a two-edged sword for foreign investors; low wages might reduce labour costs but they also limit domestic demand in the host economy. Thus efficiency seeking investors will be attracted by low labour costs; market seeking investors will favor countries with high and rising wage payments.

The third motivation, resource seeking, is quite a distinct one, of relevance to multinationals in the resource sector. 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, but is not obviously relevant for transition economies, especially the Balkans. However, the privatisation process has created a specific asset seeking explanation for FDI in transition (see Estrin et al., 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 privatisation 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.

We use this empirical framework to explore the factors influencing the locational choice of FDI from developed Western economies to transition economies,

including the Balkans, Central and Eastern Europe, the Baltic States and the rest of the former Soviet Union. Our hypothesis about the impact on FDI of being located in the Balkans is tested by the sign and significance of a dummy variable for the Western Balkan countries within a common estimating equation.<sup>3</sup> We therefore estimate an equation of the form:

$$\text{FDI}_{ij} = f(\text{GDP}_i, \text{GDP}_j, \Delta\text{GDP}_j, \text{distance}_{ij}, \text{wages}_j, \text{resources}_j, \text{institutions}_j, \text{EUmembership}_j, \text{Western Balkans}_j) \quad (1)$$

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 (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 ( $\Delta GDP_j$ ) 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, Estrin and Meyer, 2004). After some experimentation, we decided to use two indicators of institutional quality, namely investment freedom (*invtfreedom*) and a quality of property rights protection index (*propertyrights*), derived from the Heritage Foundation's Index of Economic Freedom. In addition, we take into account FDI opportunities from privatisation using the EBRD's large scale privatisation index (*ti\_ls\_privatisation*). In controlling for EU membership, we follow Bevan and Estrin (2004) in focusing on the announcement effect (*eu\_announcement*). 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 Balkans dummy, resources and the EU announcement dummy) to address potential questions of endogeneity.

<sup>3</sup> We also explored the impact of a Baltics dummy to see whether this fairly isolated regional cluster has special characteristics similar to the Western Balkans, distinguishing them from Central and Eastern Europe and the rest of the former Soviet Union. The results are reported below.

Table 11.1 FDI Inflows to transition economies, 1990–2011

VARIABLES	–1	–2	–3	–4	–5	–6
	m1 logfdi	m2 logfdi	m3 logfdi	m4 logfdi	m5 logfdi	m6 logfdi
Loggdpi_lag1	1.08*** (0.04)	0.14 (0.11)	0.19* (0.11)	0.34*** (0.11)	0.17 (0.12)	0.37*** (0.12)
Loggdpi_lag1	1.40*** (0.03)	1.93*** (0.04)	1.93*** (0.04)	1.93*** (0.04)	1.93*** (0.04)	1.93*** (0.04)
Logdistanceij	–2.92*** (0.06)	–4.08*** (0.08)	–4.07*** (0.08)	–4.06*** (0.08)	–4.07*** (0.08)	–4.06*** (0.08)
Logwagesi_lag1		1.25*** (0.26)	1.26*** (0.26)	1.27*** (0.31)	1.68*** (0.31)	1.25*** (0.31)
Westernbalkans		–4.07*** (0.27)	–3.97*** (0.27)	–4.08*** (0.43)	–4.50*** (0.47)	–3.94*** (0.47)
Resources		0.05*** (0.01)	0.04*** (0.01)	0.06*** (0.01)	0.02** (0.01)	0.06*** (0.01)
eu_announcement		2.16*** (0.42)	2.03*** (0.42)	3.34*** (0.49)		3.27*** (0.49)
gdpi_growth_lag1		2.06** (0.91)	1.88** (0.91)	2.68*** (0.97)	2.70*** (0.97)	2.62*** (0.97)
ti_ls_privatisation_lag1			0.22** (0.11)	0.20* (0.11)	0.24** (0.11)	0.18* (0.11)
Propertyrights_lag1				–0.00 (0.01)	–0.02* (0.01)	–0.01 (0.01)
Invtfreedom_lag1					0.02* (0.01)	0.01 (0.01)
Constant	1.32*** (0.47)	3.57** (1.49)	2.79* (1.51)	0.88 (1.57)	2.09 (1.60)	0.47 (1.58)
Observations	15.978	6.451	6.451	6.322	6.322	6.322
R-squared	0.26	0.38	0.38	0.38	0.38	0.38

The correlation coefficients between the independent variables suggest 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 privatisation. Thus there is some evidence that institutional quality drives EU membership rather than the converse.

To address these problems, we estimated a horse race over the entire sample period (1990–2011) to explore the effects of collinearity on our results, by adding one or several variables at a time. Selected regressions are reported in Table 11.1; results on the key variables of interest are not affected by changes in specifications. Column 1 provides the basic model formulation, in which FDI

from around the world into the transition economies is explained by the GDPs of the home and host economies and the geographic distance between them. As expected, the estimation describes very well the FDI inflow process; FDI is positively and significantly related to the GDP of the host and source economy, and negatively related to their distance apart.<sup>4</sup>

Column 2 reports an expanded specification which takes account of wages, resources, and GDP growth, as well as the Western Balkans and EU dummies. The additions leave unchanged the main results concerning the gravity model. We also find that FDI is higher in transition host economies where wages are higher, which suggests that market seeking motivations may dominate efficiency ones in this region. This is consistent with the finding that only a minority of FDI to the transition economies is into the manufacturing sector, where FDI is likely to be driven especially by cost considerations. The importance of market seeking motivations is also underlined by the positive significant effect of the lagged GDPj growth variable. There is support for resource motivations as a driver of FDI into the transition economies, indicated by the positive significant coefficient on the resources variable. We further confirm the significant positive impact of the announcement of future EU membership for the host economy on FDI inflows, previously identified for an earlier period by Bevan and Estrin (2004). Thus for the transition economies there is a strong and highly significant EU announcement effect. This might suggest that FDI inflows to the Western Balkans would be lower because no country has been admitted to the EU.<sup>5</sup> However, even with all these controls we find that there remains an unexplained negative factor influencing FDI into the Western Balkans; the coefficient on the Balkans dummy variable is always negative and significant.<sup>6</sup>

It is possible that the negative Western Balkans effect on FDI could in fact be explained by less attractive assets in the region or weaker institutional arrangements. Thus in columns 3, 4 and 5 we first expand the model by adding a variable to control for asset motives, namely privatisation, and then include two institutional variables one at a time (property rights in column 4; investment freedom in columns 5 and 6). Because of potential collinearity we report the fullest specification both including (column 6) and excluding the EU announcement effect

<sup>4</sup> If the Western Balkans dummy is added to the basic specification in column 1, it is negative and significant and the other coefficients are almost completely unaffected. This and all other unreported regressions are available from the authors on request.

<sup>5</sup> The last year covered by our data is 2011; since then, only Croatia has become an EU member state on 1 July 2013.

<sup>6</sup> The results are not affected if a Baltic dummy is added to the specification in column 2; the dummy variable is negative and significant but much smaller than the Western Balkans dummy (-1.07 as against -4.95). Thus the group of Baltic states also receives less FDI, controlling for other factors, than CEE or the former Soviet Union, but not as less as the Western Balkan economies.

(column 5). As expected, privatisation has been a significant factor motivating FDI into the transition economies; the coefficient is positive and significant in all specifications where it is included. Thus, successful policies to carry out large scale privatisation are associated with increased FDI in the transition economy region. However, there are only weakly significant effects from the other two institutional variables and these are sensitive to model specification. In column 4 the property rights variable is insignificant, and in column 6 both property rights and investment freedom are insignificant. However, we see from column 5 that this effect is perhaps related to EU membership; when the EU variable is excluded the two institutional variables become weakly significant, though property rights with a negative sign. There are several interpretations of these results: one is that the EU only permits countries to join if their institutions are relatively good. A second is that the announcement of EU membership is associated with improvements in institutional quality in candidate economies.

Columns 3 to 6 represent a variety of specifications of the FDI inflow process to transition countries with all of the main variables discussed 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 6 inclusive that the Western Balkan 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 privatisation and non-membership in the EU is taken into account, the Western Balkans countries still receive less FDI than would be expected on the basis of the size and location of their economies. The result is not sensitive to specification, either reported or further unreported tests.<sup>7</sup> These include estimating columns 4 and 6 to include a Baltic dummy variable (which is negative, weakly significant and smaller than the Balkan dummy) and estimating the same specification using a random effects model.<sup>8</sup>

#### 11.4 Conclusions and policy implications

A key policy question is whether FDI in the Balkan region has been influenced primarily by exogenous, predetermined, factors such as the size of the economies, the level of development and their geographical position, or by endogenous, policy-induced measures (see Demekas et al. 2005). What can or cannot governments do to attract more FDI? This is a key issue for the current debate on the 'new growth model', since the expectations after 2009 across the

<sup>7</sup> We wished to explore whether the negative Western Balkans effect held equally in the sub-periods identified above. However, given the use of lags for our independent variables, the degrees of freedom were too few to generate reliable or robust estimates.

<sup>8</sup> It is not possible to test our main hypothesis using a fixed effects formulation. However, when a fixed effect specification is used, country specific dummies for the Balkan countries are typically negative.

Balkan region have generally been overly optimistic regarding the speedy return of FDI. Given the present unfavorable global climate for FDI, exhausted privatisation opportunities in most Balkan countries and still unsettled political issues, the return of large amounts of FDI is unlikely in the short run.

Our findings indicate 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 policy stance and institutional environment has also had an important role to play. The Balkan countries have not exploited the opportunities offered by privatisation adequately and have failed to improve their institutions, including the protection of property rights or the investment climate, to levels attained by other more advanced economies. This has been an important failure which has cost the countries dear in terms of FDI foregone. FDI to the Balkan countries could therefore be further increased by more adequate government policies, but this would imply grasping the nettle of deep rooted institutional reform.

We find that the levels of FDI to the Western Balkan economies can be explained by three categories of factors. The first is the size of the domestic economies; these economies are rather small and GDP of the host economy has a significant positive effect on FDI. The fragmentation of the region, which has been exacerbated by events since 1990, is clearly a factor mitigating against FDI. Secondly, their distance from the investing economies of Western Europe, and their remoteness from the EU, summarized in our framework by the distance variable, which is always negative and significant in our equations. There are no simple policy solutions to geographic issues but distance can be offset by greater trade, regulatory and institutional integration. 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 confirm the view that there is a negative 'Western Balkans' effect on FDI. We observe that once all the institutional variables are taken into account, the dummy variable for

the Western Balkans is 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 an 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 Balkan 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 chapter are therefore mutually supportive.

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