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FOREIGN DIRECT INVESTMENT IN THE WESTERN BALKANS: PRIVATIZATION, INSTITUTIONAL CHANGE, AND BANKING SECTOR DOMINANCE

ABSTRACT: *The paper provides analysis of foreign direct investment (FDI) dynamics and its determinants for the group of countries lately referred to as Western Balkans (non-EU ex-Yugoslavia countries plus Albania). Due to vulnerable external positions and enhanced funding requirements related to the EU accession and catching-up, FDI is often highly welcomed by government officials in the South East European (SEE) countries. The notion that FDI is frequently accompanied by knowledge and know-how transfer makes this source of capital growth even more desirable than simple capital accumulation from frequently inadequate domestic savings.*

The analysis of the FDI determinants on the overall economy level conducted within

the panel data framework aims to provide the answer whether the same factors as in Central and Eastern European countries, now new EU member states, are relevant for the sampled countries. Due to data limitations and the frequent emergence of new countries in the region, the analysis does not extend to the early transition period. Since it entails the beginning of the financial crisis, the comparison of the results obtained with those of previous studies will enable the discussion of internal versus external factors of FDI attraction in the region.

KEY WORDS: *foreign direct investment, determinants, South East Europe, role of institutions, financial sector, privatization.*

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1. INTRODUCTION

For small open economies, without adequate sources of domestic savings, the requirement to attract foreign direct investment becomes one of the key preconditions for future economic growth. This might be particularly important for the transition countries of South East Europe which are aspiring to become EU members. The accession process itself incurs additional costs of catching up, and as the countries analyzed in this paper started their transition relatively later and facing greater difficulties than the more successful transition economies, the knowledge and technology transfer that might come through foreign investment seem to be almost as important as the capital. This paper analyzes the economies of South Eastern Europe, frequently referred to as the Western Balkan countries. The analyzed countries are: Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, Montenegro, and Serbia. The analysis covers the period 2000-2010, and excludes the early transition period, mostly due to the fact that previous to this date data for Serbia and Montenegro did not exist separately, as they were one political entity.

The notion that foreign direct investment is important for the group of countries is frequently addressed both in international literature as well as domestic literature in the analyzed countries. Kathuria et al. (2008), who focus their analysis on the group of five South East European countries (Albania, Bosnia and Herzegovina, the Former Yugoslav Republic of Macedonia, Serbia, and Montenegro), argue that since these countries are running large current account deficits, the most obvious reason for their low investment rates appears to be low domestic (private) savings. Therefore the need to attract foreign investors is evident, as without investment there could be no growth or catching up. The other reason is that foreign investors are assumed to increase the average productivity of the economic activity they invest in, and this in turn could foster new investment opportunities. Thus, the authors argue, even within the same level of current account deficits, countries with a higher share of FDI would have overall higher investment rates, which would improve the speed of catching up.

This preference for foreign sources of capital is clearly emphasized in South East Europe domestic literature. Žugić (2007) claims that there is a direct link between capital inflows, faster increase of gross domestic product, and export strategy of countries. This link, according to the author, is the reason why the strategy of export competitiveness should be precisely coordinated with the strategy for attracting foreign direct investment. In concordance with such views the

strategic document in Montenegro seems strongly oriented towards attracting foreign investors. This practice is widespread throughout the region.

In addition to strategic documents that advocate foreign direct investment, research also confirms the positive effects of foreign investment in specific countries. For example, Marić (2008) analyzes the effects of foreign direct investment on the firm level in Croatia and finds positive productivity increases. This still does not imply the causal relationship between foreign direct investment and productivity. The main reason is that the foreign investors in the countries in question were frequently engaged in privatization, and thereby a skimming effect is more likely to be significant. In addition productivity increases have been frequently accompanied by increased lay-offs, both in domestic and foreign-owned firms, which taken at the economy-wide level resulted in a jobless growth period, evident in many countries in the region.

Notwithstanding the political advocacy of investment promotion, the expected positive results might be missing. As OECD (2010) reports, all the SEE countries have institutionalized aspirations towards attracting more foreign investment, by establishing investment promotion agencies. The question remains whether they have been able to perform accordingly. The preliminary analysis of the available data is positive. The countries in South East Europe relied more heavily on foreign direct investment as a source of financing than some of the other transition countries. The available data shows that during the 2000-2008 period only Albania had approximately the same share of inward FDI in GDP as the average for the European Union. All of the other countries were able to attract more FDI than the size of their economies.

However, in order to evaluate the comparative success in foreign direct investment attraction, an insight into their structure is required. OECD (2010) states that the volume and quality of private investment is critical to the economies of South East Europe, emphasizing the need for greenfield projects and orientation towards export-oriented activities. The fact is that most of the FDI into South East Europe was related to the privatization process, in a similar way as happened in the transition countries of Central Europe. Therefore this relative success of FDI attraction in the region is connected with the period of analysis. Some of the countries in the sample analyzed in this paper only started their large privatization projects at the beginning of the 2000s, while at the same time similar projects have been completed in transition countries that have in the meantime become EU new members. The interest of foreign investors was thus related to the buying out of existing and potentially profitable enterprises,

and not by production creation motives. Whether such investment can also have favourable growth effects is an important question. If the structure of FDI in Western Balkan countries is less favourable than it was in the new member states prior to accession, then probably their road towards EU accession will also be more difficult.

This leads to the question of the determinants of FDI in the region, i.e. whether the privatization projects are the only attraction points of the sampled countries, or if there are other factors that could be related to the increase in foreign investment in the future. Since the determinants of FDI in SEEC have already been analyzed in the literature, the focus on this more recent transition period enables us to investigate whether the patterns of foreign direct investment in the region have changed.

The paper is structured as follows. The next section discusses the details of foreign direct investment in the region – home countries, economic activities, types of investment. Section 3 examines recent developments in FDI dynamics in the region. Section 4 presents the results of empirical estimation of the FDI determinants for the countries in the region. Section 5 investigates the influence of institutional changes on FDI attraction. The last section presents the conclusions.
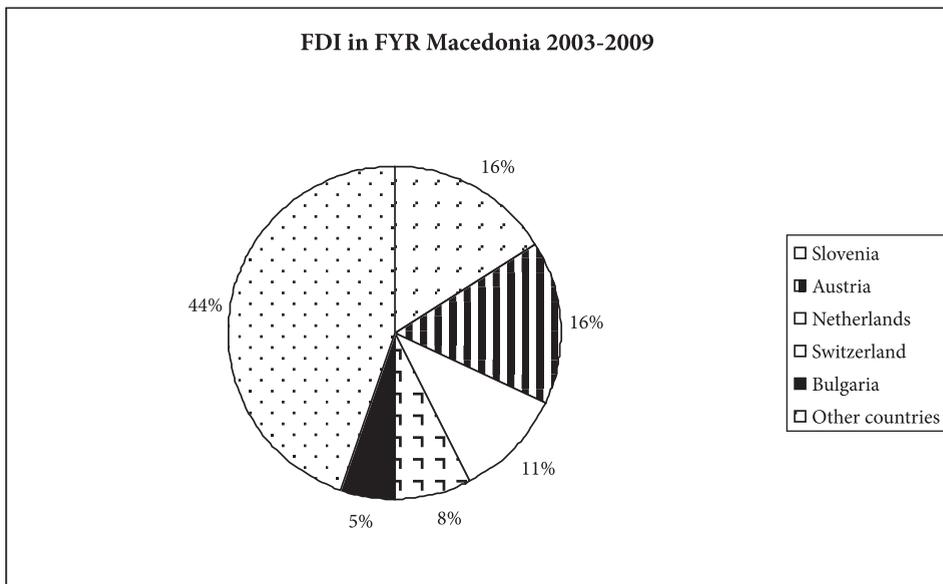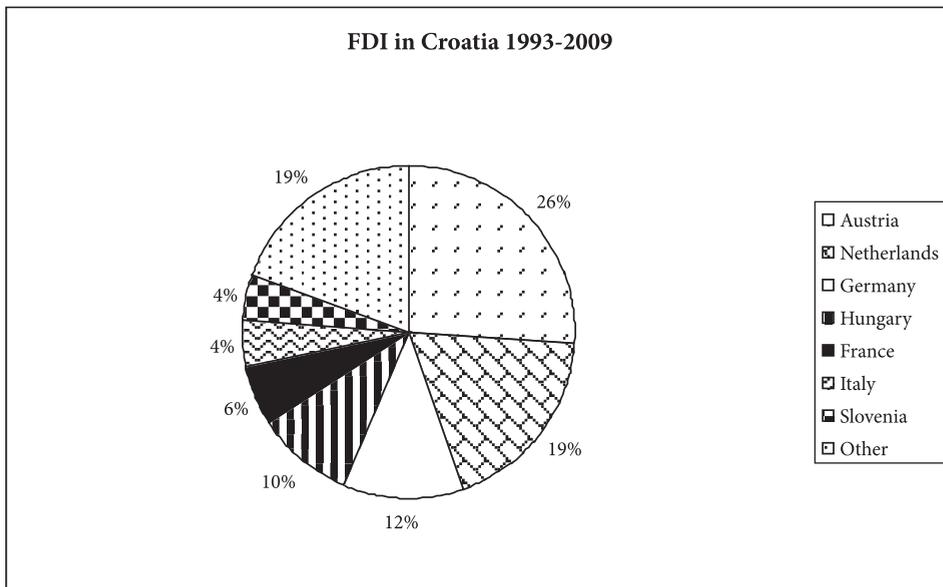
2. STRUCTURE OF FDI IN THE REGION

The countries in South East Europe have, similar to other transition countries, relied on foreign investors to bring the new capital which would induce economic growth and catching-up, but also improve existing business procedures, update frequently outdated technology, open new markets, increase the potential for trade, and bring technology and management know-how. These expectations were formed based on evidence from the literature and positive experiences in other countries. FDI is considered to positively influence welfare increases in the host country due to advantages related to the introduction of new technologies and innovation, new managerial techniques, development of additional skills (Caves, 1974, Perez, 1997), increased capital, job creation and improvement of working conditions, and the development of the industrial sector in the host country (Haddad and Harrison, 1993, Markusen and Venables, 1999). Due to these facts it can easily be understood why so many developing and also transition countries seek new ways to increase FDI inflow, in particular when the economic system is changing and the previous management methods are considered inadequate. The suggestion of management inadequacy is related to the perception that enterprises
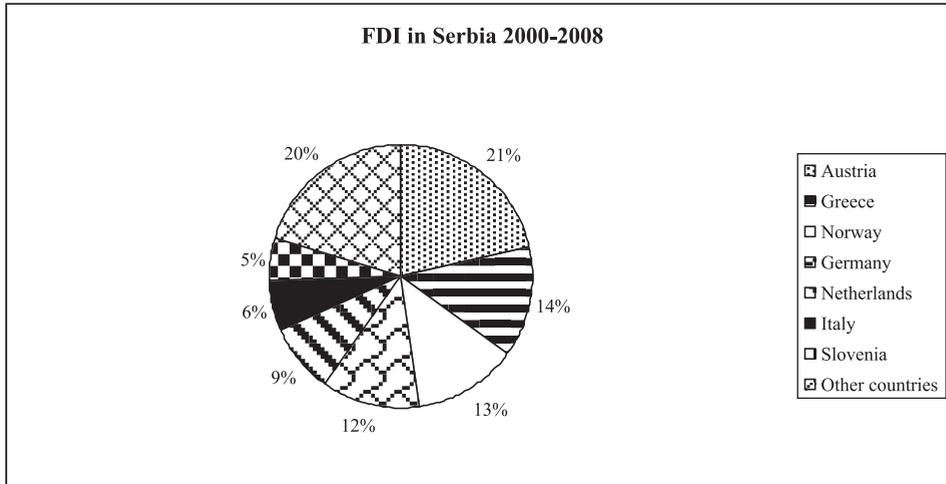
in transition countries were considered unprofitable, existing production did not match market demand, and available sources to create a better business environment were scarce.

In these circumstances foreign investors were expected to fill many of the existing gaps. Where did the investors come from? When the Western Balkans countries are analyzed according to the criteria of where the most foreign investment comes from, it can be noticed that the largest share is from the European Union. This can be attributed to at least three factors. The first is geographical proximity. The geographical factor is favourable for foreign investors relocating part of their production to countries were labour is less expensive than in their home country. The second motive for foreign investors might have been the possibility to expand their own market either by just organizing production in other countries (and thereby reducing the transport costs) or by using the organized production as a platform for market expansion to even further regions. This market expansion argument is related to yet another factor, which is the fact that all the countries in the region have made clear their intention to join the European Union. This implies that the investors would have the advantage of entering segments of the future common market prior to its actual integration. The third factor is related to the accession process, which gradually introduces a familiar business environment and familiar standards in South East Europe, thereby enabling foreign investors to have business conditions more similar to their own than in locations which are not so 'close to home'. The data in Figure 1 presents the origin of FDI in three selected countries.

The investing countries that have a large share of total FDI in the SEE countries presented in Figure 1 also have a substantial share in the remaining countries in the region. Fabris et al. (2008) report the structure of FDI in Montenegro by country of origin. During the period from 2001 to the third quarter of 2008, Montenegro's largest capital inflows came from Russia (13.4%), followed by Hungary (11.2%), United Kingdom (9.3%), Cyprus (8.6%), Switzerland (8.5%) and Austria (7.1%).

Figure 1: Structure of FDI in Croatia, FYR Macedonia, and Serbia, by country of origin

FDI in Croatia 1993-2009

19% 26% 4% 4% 6% 10% 12% 19%

Austria
Netherlands
Germany
Hungary
France
Italy
Slovenia
Other

FDI in FYR Macedonia 2003-2009

16% 16% 44% 11% 5% 8%

Slovenia
Austria
Netherlands
Switzerland
Bulgaria
Other countries

FDI in Serbia 2000-2008

Legend:
- ⊞ Austria
- ■ Greece
- ☐ Norway
- ⊡ Germany
- ☐ Netherlands
- ■ Italy
- ☐ Slovenia
- ⊠ Other countries

Sources: Croatian National Bank for Croatia; National Bank of the Republic of Macedonia for FYR Macedonia; National Bank of Serbia for Serbia.

The data for Bosnia and Herzegovina as presented by Ministarstvo vanjske trgovine i ekonomskih odnosa (2008), which is available for the May 1994 - 2007 period, reveals that the largest share of foreign direct investment came from Serbia (23.8%), followed by Austria (12.5%), Croatia (12.1%), Slovenia (8.7%), Russia (8.1%) and Lithuania (7.6%). It can easily be seen that the largest investment shares are coming from the same EU countries, which have recognized the potential of the region.

In addition to investors from EU countries, there is also increased intra-regional investment. Kathuria et al. (2008) report that intra-regional FDI flows are mostly concentrated in a few sectors (e.g. banking, retail, and energy). Previous analysis by country of origin has shown that Slovenia is frequently a major investor in the countries in the region and Croatia is also investing in other countries, so the investment wave seems to be spreading gradually south-eastwards. Although this cannot be substantiated by the country-level data there is anecdotal evidence that foreign investors from EU countries establish their subsidiaries first in the most westward country and than gradually spread their activities to the east.

The available data on the structure of FDI according to economic activity varies across countries. Furthermore, it is subject to frequent revisions. Therefore the data in Table 1 contains only the activities which are represented the most throughout the available period for each country. Even from such rudimentary analysis certain similarities can be noted.

Table 1: Structure of FDI according to economic activity in Bosnia and Herzegovina, Croatia, and Serbia

NACE	Activity	B & H 2004-3q 2009	Croatia 1993-2009	Serbia 2004-2009
65	Financial intermediation	33.12	35.32	30.53
51	Wholesale trade and commission trade	5.41	11.03	12.58
24	Manufacture of chemicals and chemical products		6.72	4.48
23	Manufacture of coke, refined petroleum products		6.68	
64	Post and telecommunications	17.98	5.38	14.65
70	Real estate activities		5.16	12.51
15	Manufacture of food products and beverages	5.72		4.73
24	Manufacture of basic metals	5.14		

Source: Central bank of Bosnia and Herzegovina, Central bank of Croatia, National Bank of Serbia.

The structure of FDI according to economic activity shows that financial intermediation is by far the leading economic activity of interest to foreign investors. The second place varies, with telecommunications and trade being very important, and different manufacturing industries, according to the structure of the specific economy. However the manufacturing sector as a whole falls strongly behind the service sector in attracting foreign investors. This story is repeated throughout the region.
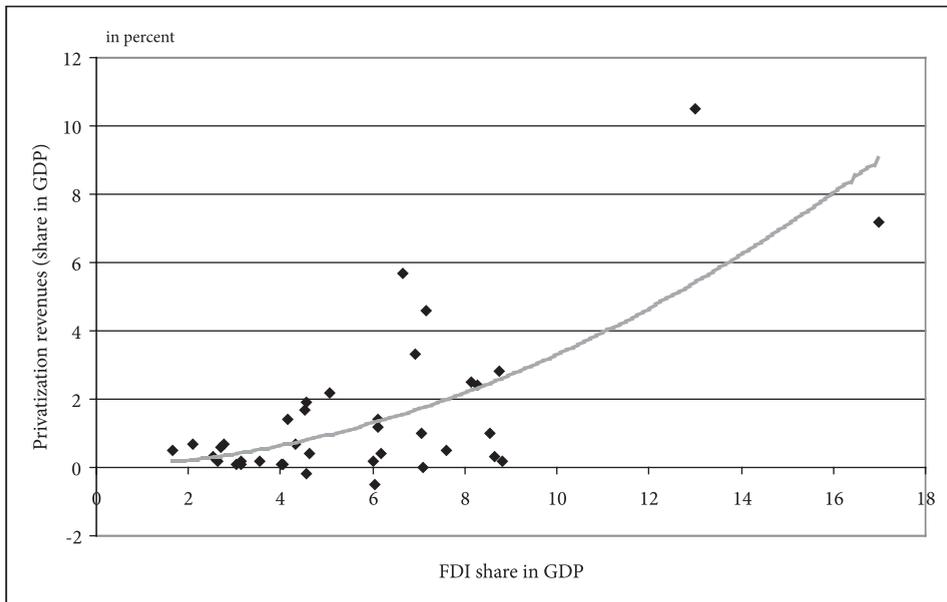
The central bank of FYR Macedonia also provides data on the structure of FDI according to economic activity, although detailed analysis is not available for all years in the period 2003-2qtr 2009 and is therefore not included in Table 1. The general conclusion from the available data is that in the analyzed period around 57% of FDI was directed towards services and around 25% towards manufacturing. For FYR Macedonia, mining and quarrying also played an important role. Within the service sector, the usual suspects – financial intermediation, telecommunications, and trade – were the main areas of increased interest to foreign investors.

In a similar way the Central Bank of Montenegro (2010) provides illustrative information on the structure of FDI inflows in its country. For this country there

is an even more pronounced service sector share - approximately 30% of FDI is related to real estate acquiring, which cannot be deemed to create a long term perspective for future growth.

The relative success of the Western Balkan countries in attracting FDI during the 2000s was probably more related to the fact that the large privatization processes in the new EU member states had already been completed, and based on the positive experienced the foreign investors had with those countries, they turned their focus to the new markets that were being privatized.

**Figure 2:** Foreign direct investment and privatization in South East Europe

Figure 2 is comprised of all available pairs of data in the period 2001-2009 for all the sampled countries, except Montenegro. It clearly points to the positive relationship between the privatization process in the analyzed countries and incoming FDI. However similar patterns were present in the transition countries of Central Europe, where the manufacturing sector was able to attract more foreign investors.

The inability of the manufacturing sector to be more efficient in attracting FDI has also influenced the relative competitiveness of the economies in terms

of the lack of new product creation and new market attainment. When taken individually trade diversification indices for most of the countries throughout the transition period were actually falling. If the countries had not at the same time run excessive current account deficits, this might have been interpreted as the consequence of repositioning their external position and specialization in certain product niches. However the fact remains that overall the Western Balkan countries at best actually stagnated in their external position, even though in each country there are positive firm-level examples.

Figure 3: Trade diversification indices and FDI
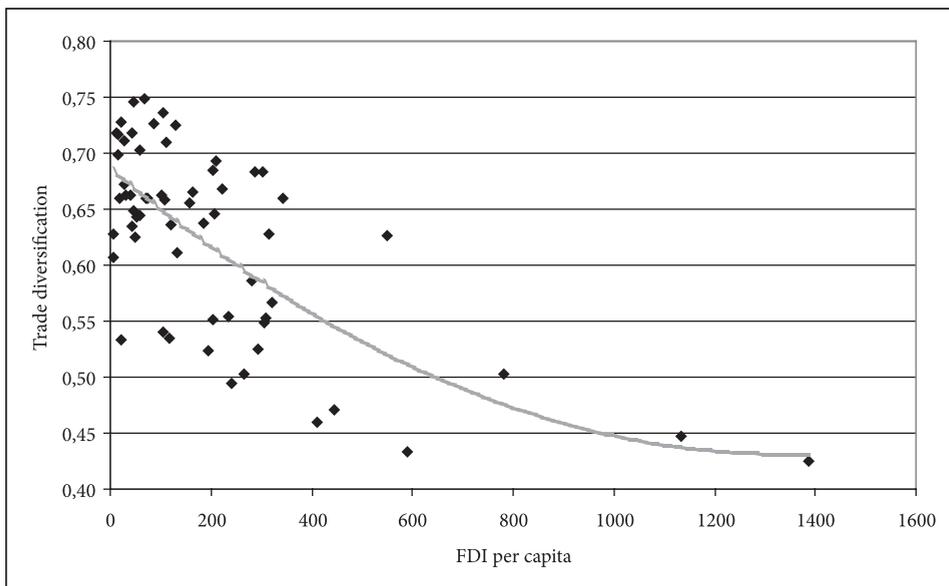
Source: UNCTAD.

The expectations of the effects coming to host countries from foreign investment were that they would help to organize new production processes and open new markets. Instead, as the data in Figure 3 reveals, the overall relationship between trade diversification and FDI is negative. Although the relationship should be taken with caution as there are many factors that could influence such results, it still points to the fact that the structure of FDI in the region during the 2000s can, from the perspective of the host countries, hardly be considered favourable.

Therefore the data presented so far and anecdotal evidence reveal that the transfer of technology, management know-how, increased export activity, and

similar preconditions for creating a stable path towards sustainable economic growth, have not been established either with or without help of foreign investors in South East Europe.

3. THE FINANCIAL CRISIS AND THE FDI

The nature of foreign direct investment assumes long-term engagement on the part of the investor. Accordingly the current financial crisis should have approximately the same effect on foreign investors already investing in the country as on domestically owned firms. There are many reasons why this might not be exactly so in the transition economies' practice. Foreign investors might have far better access to additional sources of financing, possibly in their home country; presumably at least the crisis did not have even larger impact there. They might be multinationals, able to disperse the overall risks in all their business operation countries. Their management might be better trained to deal with the crisis situation. Although based on these arguments there is no need for the crisis to adversely affect the investors already present in the country, the inflow of new foreign investment is expected to at least slow down during the recession.

We have already established that the analyzed countries require foreign direct investment, and that the structure of foreign direct investment in the previous period has not been favourable for the promotion of export-oriented activities that would lead to sustainable growth. The crisis might create additional problems, as it might increase the perceived risks of transition economies in general. The question is, therefore, whether the countries of South Eastern Europe are, in the light of the crisis, considered additionally risky by potential investors or as a desirable haven for scarce but still available funds.

As the data on the structure of foreign direct investment in the previous section has shown, most of the FDI comes from EU countries or the countries in the region. Since foreign investors have been faced with unfavourable conditions in their own home markets they have not been inclined to invest in the region, which is perceived as even riskier than their own home countries. The crisis did not have positive effects on FDI dynamics in the region. The results of these developments can be clearly seen in Figure 4.

Figure 4: FDI inflows in South-East Europe, 2004 - (I-IIIq) 2010
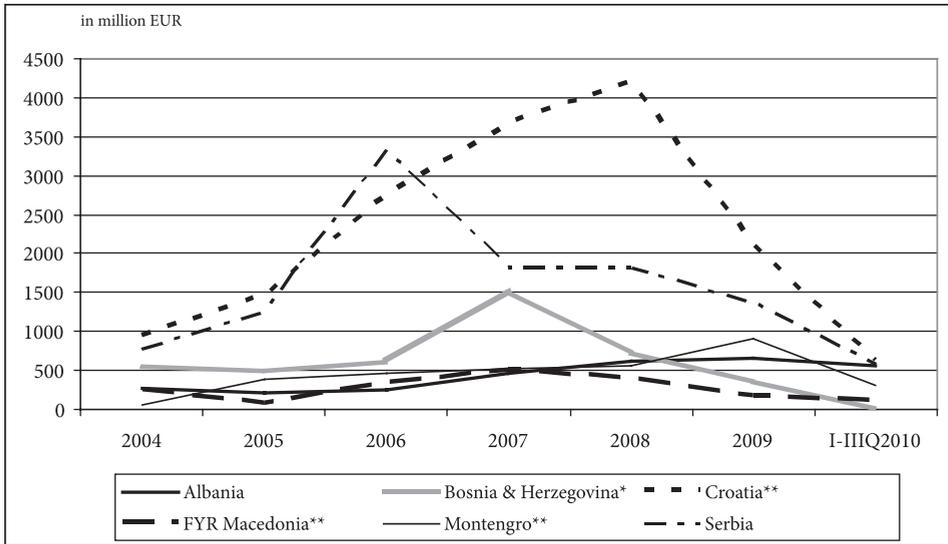
Source: Central banks of respective countries.

* Data for Bosnia and Herzegovina covers only first quarter. ** Data for Croatia, FYR Macedonia and Montenegro covers only 2 quarters of 2010.

OECD (2010) reports on decreasing FDI to South-East Europe, with the downfall starting in third quarter of 2008. Examples reveal that investors were not eager to participate in yet another round of privatizations (e.g. Serbia's public airline company, Croatian shipyards). The prospect of greenfield investment was even lower, which adversely influenced domestic construction activity and contributed to a significant decrease in overall economic activity. The lack of foreign direct investment certainly pointed once again to the inadequate domestic sources of capital for achieving sustainable economic growth.

The question remains of whether the analyzed countries are experiencing a larger decrease in FDI than other transition and developed countries. UNCTAD (2010) reports 39% global FDI decrease in 2009 and has approximately the same number for the region of South-East Europe and the CIS. The data for FDI inflows into the countries of the European Union showed a shrinkage of 'only' 29% for the same period, with Romania reporting a decline of 54%. For the analyzed countries as a group the decline amounted to 47%. The largest drop was recorded in the country that received most FDI in the previous period, Croatia, where the decline reached 55%. The next largest decline was in Bosnia and Herzegovina, reaching 50%,

following by FYR Macedonia (40%) and Serbia (25%). The remaining countries in the sample, Albania and Montenegro, actually recorded increases in FDI in 2009. However the Central Bank of Montenegro (2010) reports that the decline of FDI inflow which slowed down towards the end of 2009, continued into 2010 as well, and was approximately 8% lower for the first two months of 2010 in comparison to the same period in 2009. The first available indicators published for some of the other countries do not indicate a reversal of this negative trend. This is also confirmed by the first available data for the year 2010 for other countries presented in Figure 4, which show no positive signs.

The data shown in this section reveals that FDI in the region has been significantly affected by the crisis. The prospects of reviving the upward trend soon are nowhere evident on the horizon. At the same time sources of domestic capital seem inadequate, while the expected future costs of restructuring the economies are substantial.

4. DETERMINANTS OF FDI IN THE REGION – BANKING SECTOR DOMINANCE

This section turns its focus towards the empirical analysis of the FDI determinants in the countries in the region. Empirical analysis for the selected group of countries is always impeded by two factors – changing political conditions which influence the emergence of new countries and the lack of available data sources which would enable firm conclusions.

The determinants of FDI can be grouped into the categories of market-seeking, resource-seeking, and efficiency-seeking. Due to the fact that each individual country in the sample presents a rather small market (both in terms of population and in terms of potential consumer demand), the initial assumption was that the size of the market alone cannot be deemed as a crucial factor in attracting foreign investment. The resource-seeking motive can be substantiated for some countries, in particular those where manufacturing related to the availability of raw materials has a significant share in overall investment. However, since the majority of investments were concentrated in sectors such as financial intermediation or telecommunications, the predominant motive of foreign investors could be intuitively attributed to efficiency-seeking.

Formal analysis of the motives behind foreign direct investment according to these categories is not performed in this paper. The determinants are chosen rather arbitrarily, but influenced by previous discussion and existing literature.

The choice of independent variables is partially guided by the FIAS (2007) report. This report analyzed the attitudes of foreign investors towards the possibility of investing in South East Europe, where a wider group of countries is being considered, as well as the so-called Western Balkan countries. The results implied that, although the potential and resident investors had positive attitudes towards future potential investment in the region, they were in general not well acquainted with the economic situation in the countries.

The point on which foreign investors insisted most in the report was the overall improvement of the business climate, either by improving the adoption of EU standards and regulations or by general improvements in governance, rule of law, and corruption reduction. They were concerned with the overall political stability of the countries. This variable in the empirical model estimated in this section was associated with inflation, which, admittedly, can be interpreted only as macroeconomic stability.

The next point was the improved quality of life, including transport and information and communication technology (ICT) infrastructure, or even the educational system. In the empirical model this point is associated with the overall GDP per capita growth, which might also indicate for the foreign investors the potential for further development of the market.

Although in general the foreign investors did not stress the problem of the labour market, as they perceive the countries in the region as low cost countries, they did imply that in a few countries there is a need for more flexible labour market policies. To address this issue the average wage in the country was included in the estimation.

The last independent variable included in the estimation is related to the discussion of the role of the service sector, and in particular financial intermediation. The data has shown that foreign investors have been included in the privatization of the banking sector. However there is another argument for including the variable asset share of foreign-owned banks in the empirical assessment. The presence of foreign-owned banks might act positively on potential foreign investors, as they provide services to which the investors are accustomed in their home countries. The foreign-owned banks might also enable credit lines between home and host countries that particularly benefit clients who have business operations in both countries. The foreign-owned banks might also provide additional market information to potential investors in the region.

Finally, the explanation of the choice of dependent variable is due. Bellak et al. (2008) provide a survey of empirical studies of FDI, although for the group of Central and Eastern European countries, and what can be seen from in the overview is that the dependent variable in the model is usually FDI inflow or FDI stock in nominal terms. When empirical studies include the measure of the size of host country market on the right side of the equation, such as GDP or GDP per capita, the question of endogeneity immediately occurs. We have tried to alleviate this problem by choosing the FDI as percentage of GDP as dependent variable.

The analyzed period covers the years 2000-2008, for most of which the data were available. We have applied the panel data analysis method, using the unbalanced sample to obtain the estimated coefficients. The basic equation is as follows:

$$FDI = c + \alpha gdp + \beta inf + \gamma wage + \delta asset + \varepsilon \qquad (1)$$

The included variables were pre-tested in order to avoid the multicolinearity problems in estimation. Furthermore, unit root tests were performed in order to avoid possible spurious regression problems. The results of the unit root testing procedure are presented in the following table.

Table 2: Panel unit root tests of dependent and independent variable

Variable	Panel unit root test				
	LLC	Breitung	IPS	ADF	PP
FDI	-4.61***	-0.91	-0.99	24.78**	29.02***
GDP	-15.60***	-0.61	-2.36***	39.07***	45.71***
Inflation	-2.19**	1.74	0.37	11.96	36.62***
Bank asset	-13.05***	2.29	-1.39*	34.27***	37.83***
Wage	-1.75**	3.39	1.35	7.58	14.77

Source: authors' calculations.

Notes: reject the null of unit root at the level of significance *** 1%, ** 5%, * 10%.

Due to the small size of the sample, a variety of tests is presented. The further decision on specification was based on the results of the Levin, Lin and Chu test, which rejects the null of unit root for all analyzed variables. The choice of relying upon these specific test results is based upon Banerjee, Marcellino and Osbat (2005), who show that it performs rather well in small samples. Based on the results of unit root tests, all the variables have entered the equation in levels.

For the sample of countries, the fixed effects method is more appropriate than the random effects. This assumption was also formally tested by the LR redundant fixed effects test. The results of the estimation are presented in Table 3.

Table 3: FDI determinants in SEE countries – banking sector influence, estimation results

Regressors	Estimated coefficients
Constant	-13.35** (-2.33)
Wage	0.03** (2.31)
Inflation	-0.01 (-0.23)
GDP pc growth	0.03 (0.09)
Foreign banks asset share	0.14*** (3.77)
Number of observations	52
R-squared	0.74
LR – redundant fixed effects - Cross section/period F statistics - Cross section/period Chi-square	5.19*** 56.88***
Residuals normality Jarque-Bera	0.46

Source: authors' calculations.

Notes: Coefficients marked *** are significant at a level of 1%, ** at a level of 5%, * at a level of 10%, while t-values are presented in brackets below the regression coefficients.

Before discussing the results it has to be emphasized that they could be considered only indicative, as they are based on a very small sample size. The result that could probably be confirmed even without further evidence is the positive association between the share of FDI in the economy and the share of foreign banks' asset share. This is partially a direct consequence of the structure of the FDI in the analyzed countries. But it also relates to the results of Focarelli and Pozzolo (2001), who show that foreign banks prefer to operate in countries with a financial system that is relatively developed and not too concentrated. Our results also indirectly confirm that a developed financial sector is important for attracting FDI. The relatively 'good news' in this context is that during the financial crisis, in general the banking systems of the analyzed countries have managed to remain relatively stable. However, the 'bad news' is that the financial sector is already to

a large extent foreign-owned, and the positive effects on the FDI attraction in the future can only come as a result of other sectors' development.

The next significant variable in the presented results is the wage variable. At first glance it might seem strange that it has a positive sign. We offer an explanation that is related to the specificities of the labour markets in the region. The economic structure of the FDI data has revealed that FDI is not concentrated in the manufacturing sector, and lower wages cannot be the main attractor for FDI. The main attractor for FDI in the region has been the service sector. The service sector usually requires skilled labour, paying for this skilled labour above average prices, and its demand for skill drives the wage level of the workers upwards. These results are also in line with some previous research on the effect of FDI on wages in transition countries (Bedi and Cieślik, 2002). The result could be interpreted according to the assumption that foreign investors add to the pressures on the labour market, as their structure of demand differs strongly from the structure of labour supply. Furthermore the anecdotal evidence reports cases where foreign investors actually offer higher wages but manage to cover that differential by increased productivity, frequently achieved by better management and production organization.

The two remaining variables are insignificant, although they have the expected sign: higher inflation seems to have an adverse effect on foreign investors (as they might perceive a country with higher inflation as riskier). The higher GDP per capita growth rates can be a sign of an increasing market and increasing potential within a favourable business climate.

5. THE ROLE OF INSTITUTIONAL FACTORS IN FDI ATTRACTION IN THE REGION

We turn our attention to the additional set of possible FDI attraction determinants. There is no doubt that institutional factors play an important role in foreign direct investment attraction, and in particular in the transition countries. The investors address this as 'business climate', which comprises many individual factors. Many composite indicators, such as EBRD indicators, have tried to capture the changing business climate in the transition economies.

The available indicators usually measure different aspects of the market transformation process. For example, the Index of Economic Freedom comprises business, trade, fiscal, government spending, monetary, investment, financial, property rights, corruption, and labour components, all of which might be

deemed important for investment decisions. However the correlation between FDI in the analyzed countries and the index of economic freedom is not as high as might be expected, reaching only 0.24 for the period for which data is available.

Notwithstanding the initial evidence, the institutional setting was considered within the wider inspection of FDI determinants. The estimation strategy is the same one as in the previous section. The dependent variable is share of FDI in GDP[1]. The logic behind the independent variable selection follows. In addition to GDP per capita, which could be associated with a number of important points of attraction, from market potential to overall business conditions; three other dependent variables were included. Unit labour costs were considered to address the issue of labour factor attractiveness from a different perspective than in the Table 3 results. It is frequently argued that the investors not only consider the relative costs of the available labour force in the host country, but also its relative productivity. Thus if there is faster wage growth in comparison to productivity, leading to an increase in the unit labour cost, this should adversely affect the foreign investments inflows.

The inclusion of the real effective exchange rate growth (REER) refers to the external position of the economy risk, which is one of the indicators frequently considered to entail problems with the competitiveness of the overall economy. The investors are expected to be interested in this indicator, as the increase can signal the reduced competitiveness of the national economy, and the high volatility of the indicator overall macroeconomic instability. Finally, the inclusion of the World Bank monitored time to start a business indicator is included to cover the institutional dimension[2]. Even though the previous sections have shown that foreign investment was predominately related to the privatization process, i.e. foreign investors seldom started their own businesses, the indicator is expected to serve as a proxy for overall country effort to reduce red tape, which has been known to be significant in the analyzed countries.

Due to data availability the analysis covers Albania, Bosnia and Herzegovina, Croatia, FYR Macedonia, and Serbia. The length of the sample is also a consequence of the availability of data on institutional variables. Specifically,

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1   The estimates with FDI per capita as the dependent variable were also considered. However only partial data were available for Serbia and Montenegro, and this implied an even smaller sample so these results are not shown here.

2   Other indicators from the World Bank were considered. Their inclusion would either have resulted in a shorter sample or a smaller number of countries, or they did not have enough variability in the analyzed period to have any meaningful correlation with the FDI.

in our case we were able to include the 2003-2009 period in the analysis. The estimating equation thus looks as presented below.

$$FDI = c + \alpha GDP + \beta REER + \gamma ULC + \delta start + \varepsilon \tag{2}$$

Table 4: FDI determinants in SEE countries –
institutional factors, estimation results

Regressors	Estimated coefficients
Constant	8.06** (2.37)
Starttime	-0.12** (-2.12)
REER	-0.01 (0.10)
ULC	-0.01 (-0.13)
GDPpc	0.00 (0.58)
Number of observations	35
R-squared	0.57
LR – redundant fixed effects - Cross section/period F statistics - Cross section/period Chi-square	 2.29* 26.71***
Residuals normality Jarque-Bera	12.15***

Source: authors' calculations.

Notes: Coefficients marked *** are significant at a level of 1%, ** at a level of 5%, * at a level of 10%, while t-values are presented in brackets below the regression coefficients.

The results of this exercise reveal that of all the variables, only the business climate variable seems to be significant. This should be taken with caution bearing in mind that this result is based on a very small sample. It does, however, point to the importance of creating favourable business conditions for foreign investors by reducing unnecessary administrative procedures. These actions should also have a positive influence on domestic investors and act positively to release the existing entrepreneurial and investment potential.

6. CONCLUSIONS

The data presented in this paper confirms what the European Commission (2009) study has already stated. Foreign direct investment in the countries analyzed in this paper was biased toward the non-tradable sector and consumption. It was more frequently related to the privatization process, and repeatedly to service sector privatization, while the greenfield investment share was rather low. Privatization cannot be the orientation for future FDI attraction in the region, as the volume of the remaining available projects is, at least in some countries, relatively low. OECD (2010) reports that Croatia and FYR Macedonia began their privatization projects in the early to mid 1990s, while the other analyzed countries started to participate in the 2000s. The latecomers, like Serbia, still had few relatively large privatization projects to realize in the face of the coming crisis, although most of the projects had to be postponed for more favourable international conditions. However, in order to benefit from foreign investment, the structure of foreign investment should change towards export-promoting and technology-improving activities.

Analysis of the quantifiable determinants of foreign direct investment in the region also fits the overall picture which is biased towards the service sector. The argument for such development in the past could have been the relatively slow progress in government reform, which has created barriers to a different structure of investment. OECD (2010) reports that the countries have taken steps towards improving the overall business climate, which is also proven to be beneficial for FDI attraction as the preliminary analysis in this paper has revealed. However the progress of reform is uneven in the region. Although the countries in general form policies to attract foreign direct investment, the effects of the investment promotion activities are rather limited, as the structure of the investments has not been favourable to overall increases in the countries' productivity or exports. The potential positive effects of the improved business climate therefore remain to be assessed once the financial crisis is resolved.

This is strongly related to developments in the European Union countries, which taken together are the most important trading partner as well as the most important investor in the region. Due to the fact that the EU countries are still facing severe challenges, the issue of available funds for investing abroad remains unanswered. The short term prospects for FDI revival in South East Europe, strongly depend on the north west wind.

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APPENDIX – DATA SOURCES

Variable	Countries/periods	Source
FDI in percent of GDP; GDP per capita growth; Trade as percentage of GDP; Inflation (GDP deflator); Gross savings (as percentage of GDP), time to start a business	all the countries in the sample; throughout the analyzed period	World Development Indicators database
Index of economic freedom	all the countries in the sample	The Heritage Foundation
FDI per capita, Diversification indices of merchandise exports and imports	all the countries in the sample	UNCTAD
Average gross monthly wage	Albania, Bosnia and Herzegovina, Croatia, TFYR Macedonia, Montenegro 2000-2007; Serbia 2000-2001	WIIW database
	Albania 2008	Bank of Albania
	Bosnia and Herzegovina 2008	Centralna banka Bosne i Hercegovine (2009)
	Croatia 2008	Central Bureau of Statistics and Croatian National Bank
	TFYR Macedonia 2008	National Bank of the Republic of Macedonia
	Montenegro 2008	Central Bank of Montenegro (2010)
	Serbia 2002-2008	Statistical Office of the Republic of Serbia and National Bank of Serbia

Variable	Countries/periods	Source
Privatization revenues in percent of GDP	Albania 2003-2008, Bosnia and Herzegovina 2003-2004, Croatia 2003-2008, FYR Macedonia 2003-2008, Serbia 2003-2008	EBRD Structural indicators database
	Albania 2000-2002, Bosnia and Herzegovina 2000-2002, Croatia 2000-2002, FYR Macedonia 2000-2002, Serbia 2002	EBRD (2006)
Asset share of foreign owned banks	all the countries for the period 2003-2008	EBRD Structural indicators database
	all the countries except Montenegro for the period 2000-2002; Montenegro 2001-2002	EBRD (2006)