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*Slavica Penev**
*Matija Rojec***

THE FUTURE OF FDI IN SOUTH EASTERN EUROPEAN COUNTRIES: MESSAGES FROM NEW EU MEMBER STATES

ABSTRACT: *This paper looks at the interlinking of inward FDI, EU accession, and transition-related structural reform processes, and identifies the largest lags of SEE-6 countries in EU accession and transition processes, whose removal would have a positive impact on inward FDI. The analysis is based on EBRD Transition Indicators, the World Bank Doing Business Index, and the World Bank Governance Index. We find an obvious correlation of inward FDI, transition, and EU accession processes of NMS-10 countries and claim that SEE-6 countries will broadly follow the same pattern: their relative position as FDI recipients will gradually improve along with the progress of EU accession and transition processes. The analysis identifies the following main gaps of the SEE-6 in these processes: (i) in terms of economic system development - enterprise restructuring and governance, and sectoral reforms in energy, infrastructure, capital markets, and private equity; (ii) in terms of the governance of economy and society at large - regulatory quality and rule of law; and (iii) in terms of the business environment - dealing with construction permits, enforcing contracts, and registering property. Progress in narrowing down these gaps would mean a step forward in EU accession and transition, and consequently an improvement of SEE-6 countries' positions as locations for inward FDI.*

KEY WORDS: *foreign direct investment, transition process, EU accession process transition countries*

JEL CLASSIFICATION: F150, F210, F230, P210, P300

* Institute of Economic Sciences, Belgrade, Republic of Serbia, E-mail: slavica.penev@ien.bg.ac.rs

** University of Ljubljana, Faculty of Social Sciences and Institute of the Republic of Slovenia for Macroeconomic Analysis and Development, Ljubljana, Slovenia, E-mail: matija.rojec@gov.si

1. INTRODUCTION

A remarkable increase of inward FDI has been one of the most outstanding features of the transition processes of former socialist countries. In the 1995-2010 period the share of inward FDI stock in GDP increased 4.4 times in NMS-10 countries (New EU Member States: Bulgaria, Czech Republic, Estonia, Latvia, Lithuania, Hungary, Poland, Romania, Slovakia, Slovenia) and 12.8 times in SEE-6 countries (South Eastern European states: Albania, Bosnia and Herzegovina, Croatia[1], Macedonia, Montenegro, Serbia) (Table 1). In circumstances of ongoing economic recession and financial crisis, with ever decreasing access to foreign loans, FDI may prove to be an even more important potential source of capital. Consequently, policy makers will have to put more effort into attracting strategic foreign investors.

Table 1: Indicators of the increasing importance of FDI for NMS-10 and SEE-6[1]/ countries in 1995-2010; period averages

	1995-1997	1998-2000	2001-2003	2004	2005-2007	2008-2010
Inward FDI stock as a share of GDP (in %)						
NMS-10	12.4	23.8	34.1	43.3	49.0	54.9
SEE-6	4.2	8.7	13.9	18.4	24.8	53.9
FDI inflows as a share of Gross Fixed Capital Formation (in %)						
NMS-10	18.4	23.1	21.7	26.7	29.7	15.6
SEE-6	4.2	11.7	15.4	14.3	16.2	36.9

Source: UNCTAD, 2011, Annex Tables 5 and 7; http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1.

[1] NMS-10 and SEE-6 averages are calculated as unweighted averages of individual countries.

This paper looks at inward FDI in NMS-10 and SEE-6 countries from the perspective of the EU accession process. The motivation behind this is two-fold. The first is the general theoretical premise that economic integration leads to increasing FDI inflows in member countries (Dunning, 1993; Baldwin, Francois and Portes, 1997; Rosati, 1998). The second premise says that the attractiveness of a country for inward FDI is co-determined by the quality of the business and investment environment in the broadest sense, which, in the context of transition countries, means successfully accomplishing transition reforms. Here EU accession is of relevance because it is nothing but a specific type of transition

1 Croatia has only been an EU member state since 2013: in the analysed period it was a candidate country.

process. The decision to pursue EU accession also means the decision to pursue a specific concept of transition reforms and a specific legal and institutional system. Thus EU accession accelerates inward FDI because transition countries become part of an economic integration and because transition reforms speed up. 2014 marks ten years since the Eastern Enlargement, making it possible to look at inward FDI trends in the NMS-10 in the pre- and post-EU accession periods, and consequently to forecast future FDI trends in the SEE-6, as also being in the EU accession process.

In this context, the objective of this paper is, first, to analyse the trends of inward FDI in transition countries - NMS-10 and SEE-6 – and the differences in the inward FDI dynamics of the NMS-10 and SEE-6 in view of the EU accession process, and, second, to see where are the largest lags of SEE-6 countries in EU accession and transition processes, the removal of which would eventually have a positive impact on FDI inflows. The analysis is based on UNCTAD data of FDI inflows, EBRD Transition Indicators, the World Bank Doing Business Index, and the World Bank Governance Index. By combining the three aspects of transition and EU accession processes – the transition reforms shaping the economic system, the governance capacity of a country, and the environment for doing business - which are of particular importance to a country's attractiveness as a location for FDI, the paper attempts to provide a complex view of the interlinking of the transition/EU accession process and the attractiveness of a country as an investment location.

We find an obvious correlation of FDI inflows and the EU accession process, with a gradually growing relative position of the NMS-10 as recipients of FDI in the pre-accession period, its peak in the accession year (2004), and a decrease in the post-accession period when, however, the relative position of the NMS-10 remains at a much higher level than in the pre-accession period. SEE-6 countries follow a similar pattern to the NMS-10 in the pre-accession period. This means that their relative position as FDI recipients is expected to further increase along with their EU accession and transition processes. Analysis of SEE-6 progress in accession and transition processes suggests that the largest lags and gaps of SEE-6 countries are (i) in terms of economic system development, enterprise restructuring and governance, and in sectoral reforms, i.e., electric power and sustainable energy, the water and wastewater sector, and capital markets and private equity; (ii) in terms of the governance of economy and society at large, in regulatory quality and rule of law, and (iii) in terms of the quality of the business environment, in dealing with construction permits, enforcing contracts, and registering property. Progress in narrowing down these lags and gaps would result in a step forward in EU accession and transition and at the same time an improvement of SEE-6 countries' position as inward FDI locations.

The paper is structured as follows. The introduction is followed by section two, which presents the conceptual framework and literature review, section three, which analyses inward FDI trends in NMS-10 and SEE-6 countries in view of EU accession process dynamics (pre-accession, accession, post-accession), and section four, which analyses SEE-6 countries' main lags in the transition and accession processes. Section five concludes.

2. CONCEPTUAL FRAMEWORK AND LITERATURE REVIEW

There are two aspects to the impact of the EU accession process on transition countries' FDI inflows and the position of these countries as investment locations. The first is the impact of regional economic integration on FDI inflow in general, and the second is the specific impact of transition countries' EU accession, related to the fact that for transition countries the EU accession process is also a process of transition from a planned to a market economy.

Economic integration and FDI. In the context of international business theory, Dunning (1993) claims that economic integration has positive primary and secondary effects on FDI inflows in the countries acceding to integration. Within the primary effects there are two reasons why FDI inflows in the integration area increase. The first is that the size of the market increases, which, due to economies of scale, leads to the replacement of existing exports with FDI, i.e., with local production. This is so-called defensive export-substituting investment, triggered by market-seeking motivation, which results in an increase of FDI inflows in the acceding countries. The second reason is that multinational companies (MNCs) reorganize their investments in the integration area due to new configuration of location advantages (new structure of costs, benefits, economies of scale) among member countries. Here, the consequence is an increase of FDI in some old and new member states, and a retreat of FDI from some others. A secondary effect of integration, which is of greater importance in the long run, is new investment opportunities arising from the restructuring of activities between countries, sectors, and firms, triggered by economic integration. The result is increased FDI inflows in acceding countries. The primary effects of integration are of a more short-term character, while the secondary effect comes into operation in the longer run and is potentially the most important.

In the context of international economics, Blomström and Kokko (1997) provide an alternative but very similar theoretical concept. They distinguish between the impact of regional integration (meaning reduction of trade barriers and investment restrictions) on FDI, which is mainly a response to reduced trade barriers (tariff-jumping FDI), and FDI that is primarily motivated by the need to internalize firm-specific intangible assets that cannot be traded efficiently in arm's length markets (dynamic effects of integration). For individual countries the overall impact of regional integration on FDI will differ for a number of reasons, but, all in all, regional integration enhances the attractiveness of investing in the region as a whole by creating a larger common market and contributing to improved overall efficiency and higher income levels in that market. The impact on FDI also depends on the type of regional integration, i.e., on the significance and nature of trade and investment liberalisation (Blomström and Kokko, 1997). Here, the relevant factor is that the EU is an especially 'strong' integration.

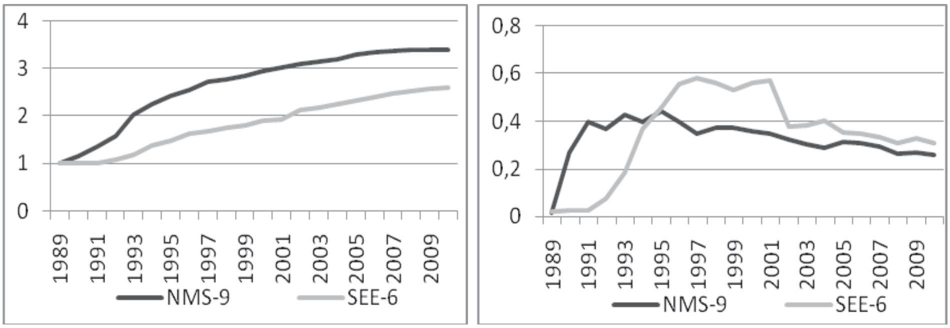
The transition/accession process and a country's attractiveness as an FDI investment location. A country's attractiveness to foreign investors is determined by primary structural factors (market size and growth, and quantity, quality, and price of factors of production), by the quality of the business and investment environment in the broadest sense, and by FDI policy as such (see Dunning, 1993). It is nothing but a successful accomplishment of transition reforms, which creates a friendly business and investment environment and so increases a country's attractiveness for FDI. EU accession and transition processes are two sides of the same coin. The fact that a transition country is in a process of EU accession means that the country is heading towards a specific type of market economy, i.e., to the EU type of market economy with its specific type of economic, legal, and institutional framework. It also defines the speed and timing of reforms. In this way many unknowns about the direction, intensity, and timing of reform are avoided and, as a result, transaction costs and foreign investors' perception of the risks are reduced. Reduction of risk and transaction costs, which is linked to the 'internal market' effect of a regulatory and institutional environment for firms in the whole territory of regional integration, increases investment opportunities and capital mobility within the integration area and makes integrating countries more attractive investment locations (Baldwin, Francois and Portes, 1997; Dunning, 1993; Dunning, 2004; Rosati, 1998).

In the above context, we suggest that the EU accession process has speeded up and converged transition reforms in the candidate countries as opposed to other transition countries. This makes the former a more attractive location for FDI than the latter. To measure the progress in transition reforms, Mrak and

Rojec (2012) suggest applying EBRD Transition Indicators of Stage 2 reforms, which include indicators of large-scale privatization, enterprise restructuring, competition policy, banking reforms and interest rate liberalization, security markets and non-banking financial institutions, and infrastructure reform. The Stage 2 structural reforms represent the core of the transition process, and it is here in particular that the EU accession process can make the highest contribution to speeding up the reforms. Figure 1 shows average transition indices and within-group standard deviations for Stage 2 reforms for the NMS-9[2] and SEE-6. Averages show the pace of reform, while standard deviations show whether the levels of transition reform tend to converge or not.

Figure 1: Stage 2 reforms Index[1]/ for NMS-9 and SEE-6 countries: Group averages and within-group standard deviations in 1989-2010

AVERAGES STANDARD DEVIATIONS



Source: Mrak and Rojec, 2013. Calculated from EBRD Transition Indicators by Country, http://www.ebrd.com/pages/research/economics/data/macro.shtml#ti

[1] Index ranges from 1 to 4.3, 1 meaning only the initiation of transition reforms and 4.3 meaning more or less the situation in advanced market economies. Thus, once a country approaches level 4, its institutional setting is near to that in advanced market countries (see EBRD, 1999).

Figure 1 shows that somewhere in the second half of the 1990s the NMS-9 reached a certain level of advantage over the SEE-6 at the level of Stage 2 reforms, which they have succeeded in maintaining. In other words, after gaining an initial advantage over the SEE-6, the NMS-9 countries keep the time advantage in Stage 2 reforms over SEE-6 countries. Standard deviations are much lower for the NMS-9 than for the SEE-6. This confirms our expectations that NMS-9 countries very much follow the same pace of reform, while until 2002 the pace of reform in SEE-6 countries shows much higher divergence. After 2002, which

2 The NMS-9 are the NMS-10 without the Czech Republic. The reason is that the EBRD does not publish transition indicators for the Czech Republic.

coincides with the intensification of the EU accession process, standard deviation started to decrease and now has arrived at a similar level to that of the NMS-9 countries. It thus seems that the EU accession process has given an important initial push to the Stage 2 transition reforms of the NMS-9 and somewhat later to SEE-6 countries, and has also made the pace and level of the latter's transition reforms converge.

In line with the above theoretical propositions, most of the analyses of the impact of EU accession on FDI inflows which had been made before or at the time of Eastern Enlargement (Barry, 2002; Dunning, 2004; Bevan and Estrin, 2004; Kaminski, 2001; Merlevede and Schoors, 2004; Hunya, 2003; UNCTAD 2003, 2004; Zakharov and Kušić, 2003) predicted an increase of FDI inflows in the NMS-10 in absolute and relative terms, in the short term and even more in the long term. For instance, in a study from 2003 the Economic Intelligence Unit predicted that FDI inflows in the NMS-10 would increase from 2.2% in 2000 to 3.2% of global FDI inflows in 2007. Today's data show that actual increase was even higher, i.e., from 1.6% to 3.7% (http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1). More precisely, these studies explicitly or implicitly forecasted the following effects of EU accession on FDI in the NMS-10:

- In all accession countries the value of FDI inflows increases, in absolute and relative terms; i.e., the prospect of EU membership and membership itself increase the attractiveness of acceding countries as investment locations, for both EU and non-EU investors.
- Most of the changes related to the systemic, policy, legal, and institutional approximation of the NMS to the EU framework has already happened before the actual accession. Along the same lines, MNCs tend to anticipate the future membership of a country by increasing FDI inflows before the actual accession. Thus, the effect of accession on increased FDI inflows has to a considerable extent already been absorbed before the accession. Bevan and Estrin (2004) and Güngör and Binatli (2010), who analyse EU accession within econometric models of the determinants of inward FDI, both claim that EU accession prospects have proved to be a positive and significant determinant of increased FDI inflows in NMS.
- However, only membership makes NMS an integral part of the internal market. Thus, the full impact of EU membership on the increase of FDI inflows happens only with actual membership.
- Accession of NMS to the EU brings changes in country distribution of FDI. MNCs may tend to rationalise production locations within the EU, to concentrate their activities in existing locations to exploit economies of scale,

or to relocate activities to new locations in NMS. NMS countries may be winners as well as losers in this restructuring, much depending on the nature of MNCs' activities and the relative comparative advantages/disadvantages of individual NMS.

- EU accession results in increasing divergence between the NMS-10 and other transition countries as far as FDI inflow is concerned, in favour of the former. Still, if the SEE countries follow the transition and EU accession patterns of the NMS they may also expect to have a similar pattern of trends in FDI inflow.

Studies on the impact of EU accession on FDI inflows carried out after the Eastern Enlargement in 2004 as a rule confirm the above findings by claiming that FDI inflows in the NMS increased after the accession (European Commission, 2006), that most of EU accession potential for FDI was tapped ahead of actual enlargement and that in the post-acquisition period FDI stocks in NMS remained relatively stable at already high levels (Breitenfellner et al., 2008), and that high levels of FDI attracted by the candidate countries can be attributed to their rapid transition and the fact that favourable evaluations of accession progress by EU authorities had a large impact on improving investor confidence (Ulyanchenko, 2010). Güngör and Binatli (2010) analyse EU accession within an econometric model of the determinants of FDI and claim that EU accession prospects have proved to be a positive and significant determinant of increased FDI inflows in NMS. Baharova (2005) agrees that positive announcements about EU enlargement have boosted FDI inflows to the most likely future members, but the proper way of thinking about FDI and EU accession is that FDI, EU accession, and catching-up reinforce each other.

3. FDI INFLOWS IN THE NMS-10 AND SEE-6 IN 1998-2010 FROM THE VIEWPOINT OF EU ACCESSION AND TRANSITION PROCESSES

In this section we look at what the actual data say about the above propositions. We analyse trends in FDI inflows in the NMS-10 and SEE-6 in the 1998-2010 period, i.e., the period before and after the Eastern Enlargement in 2004, and put them in the perspective of EU accession and transition processes. The period of 1998-2010 is further divided into the sub-periods of 1998-2000, 2001-2003, 2004, 2005-2007, and 2008-2010. The sub-periods are created so as to have two three-year periods before the NMS-10 EU accession, 2004 as the year of EU accession, and two three-year periods after the EU accession. Table 2 clearly indicates a remarkable increase of FDI inflow in these countries after 1998. From 1998-2000 to 2008-2010 annual average values of FDI inflow doubled in the NMS-10 and increased by 5.1 times in the SEE-6, while they decreased to 0.7 in the case of the EU-15.[3] We claim that such a pattern is also due to the fact that the EU accession process has fundamentally changed the position of transition countries in the considerations of MNCs and has reduced the perception of investment risk.

Table 2: FDI inflows in NMS-10, SEE-6, and EU-15 in 1998-2010; annualised sub-period averages in USD million

	1998-2000	2001-2003	2004	2005-2007	2008-2010
Bulgaria	792	1,273	3,397	8,038	5,125
Czech Republic	5,010	5,409	4,974	9,187	5,386
Estonia	423	586	958	2,464	1,703
Hungary	3,137	3,022	4,266	6,159	3,935
Latvia	372	230	637	1,564	568
Lithuania	597	450	774	1,620	949
Poland	7,705	4,804	12,874	17,819	12,739
Romania	1,372	1,498	6,436	9,257	7,443
Slovakia	1,023	2,629	3,030	3,567	1,721
Slovenia	154	765	826	915	733
NMS-10	**20,584**	**20,666**	**38,172**	**60,590**	**40,304**
Albania	77	173	346	415	1,022
Bosnia and Herzegovina	130	255	704	1,153	414
Croatia	1,152	1,458	1,179	3,445	3,224
Macedonia	151	222	324	407	360
Montenegro[1]	0	40	65	686	1,083
Serbia	92	712	958	3,091	2,081
SEE-6	**1,602**	**2,860**	**3,576**	**9,196**	**8,183**
EU-15	**473,696**	**298,226**	**182,938**	**579,248**	**333,665**

Source: UNCTAD, 2011, Annex Table 1: FDI inflows by region and economy, 1990-2010; http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1.

[1] Base year for Montenegro is 2002.

The above values do show a remarkable increase of FDI inflow in transition countries in 1998-2010, but do not tell much about the changes in the attractiveness of these countries as investment locations within the EU area. To

3 Due to the economic recession since 2008, the figures are much higher for the period 1998-2000 to 2005-2007, i.e., 2.9 times for the NMS-10, 5.7 times for the SEE-6, and 1.2 times for the EU-15.

indicate this, in Table 3 we present NMS-10 and SEE-6 countries' FDI inflow in terms of total EU-27 FDI inflow. We expect that FDI inflow in the NMS-10 and SEE-6 relative to FDI inflow in the EU-27 tends to increase with progress in transition and EU accession processes. The picture depicted in Table 3 is quite persuasive in showing the improvement of the attractiveness of the NMS-10 and SEE-6 as investment locations, and, in the case of the NMS-10, is linked to the EU accession process. The share of the NMS-10 in EU-27 FDI inflows increased from 4.1% in 1998 to 10.6% in 2010. The percentage constantly increased from 1998, to reach its peak of 17.1% in the year of EU accession (2004), and then to drop to 9.4% in 2005-2007 and 10.6% in 2008-2010. In spite of the drop after accession the level is still much higher than before. This pattern holds for all individual NMS-10 countries without exception. From the point of EU accession it is interesting that the relative position of the NMS-10 peaked exactly in the year of accession. This is in line with the proposition in the literature that foreign investors tend to anticipate the accession of individual countries, but it is still only membership that makes a country a real member of the internal market, with all its advantages. The picture of SEE-6 countries is slightly different. Their shares keep increasing in the whole 1998-2010 period without any real drop. If things go the same way as with the NMS-10 their shares may be expected to further increase until their EU accession.

Table 3: FDI inflows in NMS-10 and SEE-6 as percentage of total FDI inflows in EU-27 in 1998-2010; sub-period averages

	1998-2000	**2001-2003**	**2004**	**2005-2007**	**2008-2010**
Bulgaria	0.16%	0.40%	1.53%	1.25%	1.35%
Czech Republic	1.01%	1.69%	2.23%	1.43%	1.42%
Estonia	0.09%	0.18%	0.43%	0.38%	0.45%
Hungary	0.63%	0.94%	1.92%	0.96%	1.04%
Latvia	0.08%	0.07%	0.29%	0.24%	0.15%
Lithuania	0.12%	0.14%	0.35%	0.25%	0.25%
Poland	1.55%	1.50%	5.78%	2.77%	3.35%
Romania	0.28%	0.47%	2.89%	1.44%	1.96%
Slovakia	0.21%	0.82%	1.36%	0.55%	0.45%
Slovenia	0.03%	0.24%	0.37%	0.14%	0.19%
NMS-10	**4.15%**	**6.46%**	**17.15%**	**9.43%**	**10.61%**
Albania	0.02%	0.05%	0.16%	0.06%	0.27%
Bosnia and Herzegovina	0.03%	0.08%	0.32%	0.18%	0.11%

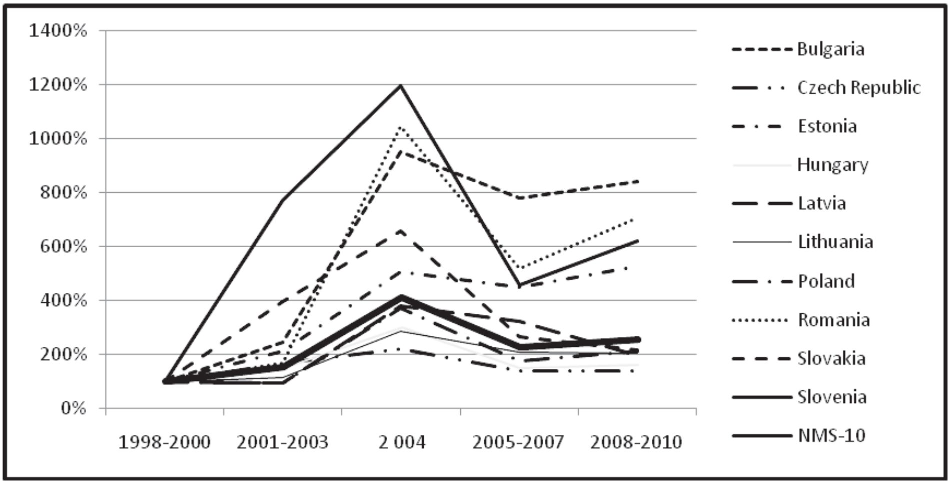
Croatia	0.23%	0.46%	0.53%	0.54%	0.85%
Macedonia	0.03%	0.07%	0.15%	0.06%	0.09%
Montenegro	0.00%	0.01%	0.03%	0.11%	0.29%
Serbia	0.02%	0.22%	0.43%	0.48%	0.55%
SEE-6	**0.32%**	**0.89%**	**1.61%**	**1.43%**	**2.16%**

Source: Calculated from UNCTAD, 2011, Annex Table 1: FDI inflows by region and economy, 1990-2010; http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1.

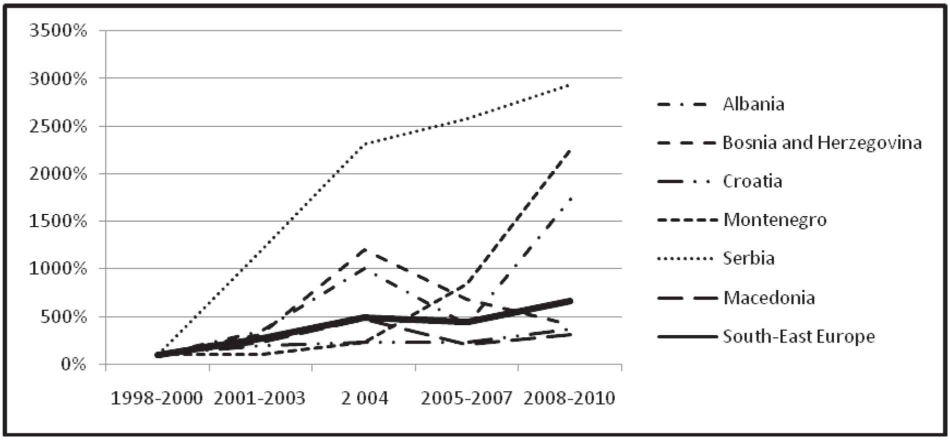
Figure 2, which depicts changes in the percentages of EU-27 FDI inflows in 1998-2010 (measured in index terms with 1998=100) of the NMS-10 and SEE-6, is very illustrative in exhibiting the above pattern. In all the accession NMS-10 countries the shares increase, peaking in 2004, and stay above the pre-accession periods, while SEE-6 countries are still on an upward trend. Taking 1998-2000 as the base period, the share of the NMS-10 in EU-27 FDI inflows had increased 4.1 times by 2004 and 2.6 times by 2008-2010. Respective figures for the SEE-6 are 5 times and 6.7 times. If the SEE-6 follows the NMS-10 pattern – reaching its highest share in the year of accession - they still have room to increase their shares in EU-27 FDI inflows.

Figure 2: Changes in percentages of NMS-10 and SEE-6 of EU-27 FDI inflows in 1998-2010; growth in index terms (1998-2000=100)

NMS-10 countries



SEE-6 countries



Source: Calculated from UNCTAD, 2011, Annex Table 1: FDI inflows by region and economy, 1990-2010 http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1.

To establish the link between FDI inflows and the transition process we calculate correlation indices between three-year sliding averages of FDI inflows as a percentage of total EU-27 inflows and three-year sliding averages of the second stage transition indicators for the NMS-9 and SEE-6. Table 4 shows a high level of correlation for all the NMS-9 and SEE-6 countries except Hungary and Slovakia.

Table 4: Correlation coefficients between three-year sliding averages of FDI inflows as a percentage of total EU-27 inflow and three-year sliding averages[1] of second stage transition indicators for NMS-9 and SEE-6 in 1998-2010

NMS country	Correlation coef.	SEE country	Correlation coef.
Bulgaria	0.949	Albania	0.883
Estonia	0.870	Bosnia and Herzegovina	0.697
Hungary	0.400	Croatia	0.900
Latvia	0.816	Macedonia	0.863
Lithuania	0.804	Montenegro	0.867
Poland	0.771	Serbia	0.986

Romania	0.869		
Slovakia	0.316		
Slovenia	0.589		
NMS-9	**0.874**	**SEE-6**	**0.979**

Source: Calculated from UNCTAD, 2011, Annex Table 1: FDI inflows by region and economy, 1990-2010; http://archive.unctad.org/Templates/Page.asp?intItemID=5823&lang=1 and EBRD Transition Indicators by Country, http://www.ebrd.com/pages/research/economics/data/macro.shtml#ti.

[1] Three-year sliding averages: 1998-2000,1999-2001, 2000-2002, 2001-2003, 2002-2004, 2003-2005, 2004-2006, 2005-2007, 2006-2008, 2007-2009, 2008-2010.

The above figures on FDI inflows in the NMS-9 and SEE-6 from the aspect of EU accession and transition processes show a high level of correlation between the two. There is no doubt that the speed and scope of the EU accession and transition process increase a country's attractiveness to foreign investors. Thus, the higher the speed and scope of the EU accession process in the SEE-6, the more attractive they are to foreign investors. Accordingly, in the next section we identify and analyse the main lags and gaps of SEE-6 countries in EU accession and transition processes. The removal of these lags and gaps would be a major step forward in increasing the attractiveness of SEE-6 countries to foreign investors.

4. THE MAIN FDI-RELATED LAGS AND GAPS OF SEE COUNTRIES IN EU ACCESSION AND TRANSITION PROCESSES

In this section we identify SEE-6 countries' main FDI-related lags and gaps in EU accession and transition processes, as reflected in EBRD Transition Indicators, World Bank Worldwide Governance Indicators, and World Bank Doing Business Indicators: i.e., the three aspects of transition and EU accession processes – transition reforms shaping the economic system, governance capacity of a country, and the environment for doing business - which are of particular importance to a country's attractiveness as a location for FDI.

EBRD Transition Indicators have been the most regularly used measure of reform in transition countries. Progress is measured against the standards of advanced market economies. Transition reforms along the lines of EBRD transition indicators may be conditionally divided into Stage 1 (price liberalisation, trade and foreign exchange system, and small-scale privatisation) and Stage 2 (large-scale privatisation, governance and enterprise restructuring, and competition policy) reforms. Apart from transition indicators, the EBRD also publish specific sectoral indicators for energy, infrastructure, and the corporate sector.[4] While Stage 1 reforms present the creation of basic conditions (stabilisation and liberalisation) for entering the transition process, it is the Stage 2 structural and sectoral reforms that represent the core of the transition process. Tables 5 and 6 show that SEE-6 countries almost achieved the level of the NMS-9 as far as Stage 1 reforms are concerned, but the gaps in the case of Stage 2 and sectoral reforms remain considerable. It is here that the main challenges remain for the finalisation of the transition process in SEE-6 countries. These challenges are not the same for all SEE-6 countries. Croatia as a new EU member state has made more progress in these three indicators than other countries in the region. It is followed by Macedonia and Albania, while the other three countries scored below the SEE-6 regional average.

Table 5: EBRD Transition Indicators[1], 2012

	STAGE 1 REFORMS			STAGE 2 REFORMS		
	Small scale privatization	Price liberal-ization	Trade & Forex system	Large scale privatization	Governance and Enter-prise restruc-turing	Competition Policy
Albania	4.0	4.3	4.3	3.7	2.3	2.3
Bosnia and Herzegovina	3.0	4.0	4.0	3.0	2.0	2.3
Croatia	4.3	4.0	4.3	3.3	3.3	3.0
FYR Macedonia	4.0	4.3	4.3	3.3	2.7	2.7
Montenegro	3.7	4.0	4.3	3.3	2.3	2.0
Serbia	3.7	4.0	4.0	2.7	2.3	2.3
SEE-6	**3.8**	**4.1**	**4.2**	**3.2**	**2.5**	**2.4**
NMS-9	**4.2**	**4.3**	**4.3**	**3.8**	**3.2**	**3.5**

Source: EBRD database, http://www.ebrd.com/pages/research/publications/flagships/transition.shtml

[1] Index ranges from 1 to 4.3, 1 meaning only the initiation of transition reforms and 4.3 meaning more or less the situation in advanced market economies.

Within Stage 2 reforms, SEE-6 countries obviously made much more progress in large-scale privatisation than in governance and enterprise restructuring. The discrepancy is partly the result of unsuccessful privatizations and lagging behind in the privatisation of enterprises in the infrastructure sector (especially in Serbia

4 Until 2010, EBRD transition indicators of Stage 2 reforms also included banking reforms and interest rate liberalization, securities markets and non-bank financial institutions, and infrastructure reform. As of 2011, the EBRD introduced the so-called sectoral indicators and, as a consequence, infrastructure, banking, and non-banking indicators were moved from transition to sectoral indicators (Sanfey, Zeh, 2012).

and Bosnia and Herzegovina). In a considerable number of privatised companies, new owners have not been willing to and/or capable of serious restructuring. Advancements in enterprise restructuring and governance are thus recognized as one of the main potential sources of future growth in the region, as well as opportunities to attract foreign investors. The progress of competition policy in SEE-6 countries registered the lowest scores among the Stage 2 transition indicators. All the countries have established EU-like legal and institutional frameworks in the area of competition, but a considerable implementation gap exists; i.e., additional efforts to increase the administrative capacity of the institutions are absolutely necessary (Penev, 2012).

The reason behind the EBRD's introduction of sectoral indicators was to overcome the main weakness of EBRD transition indicators; i.e., the fact that they take insufficient account of the institutional framework surrounding private sector development and creation of markets. Therefore the EBRD developed sectoral indicators for the corporate, energy, infrastructure, and financial sectors. Compared to transition indicators, sectoral indicators are more forward looking; i.e., they assess what needs to be done, in terms of changing the market structure and developing market-supporting institutions.

Table 6: EBRD sectoral indicators[1], 2012

		Albania	BiH	Croatia	Macedonia	Montenegro	Serbia	**SEE-6**	**NMS-9**
Corporate sectors	Agri-business	2.7	2.7	3	2.7	2.3	2.7	**2.7**	**3.3**
	General industry	2.3	2	3.3	3	2.3	2.7	**2.6**	**3.7**
	Real estate	2.7	1.7	3.3	2.7	2.3	2.7	**2.6**	**3.7**
	Telecommunications	3.3	2.3	4	3.7	3.3	3	**3.3**	**3.7**
Energy	Natural resources	2.7	2	3.7	2.3	3.3	2	**2.7**	**3.5**
	Sustainable energy	3.3	2	2.7	2.3	2	2.3	**2.4**	**3**
	Electric power	3	2.3	3	3	2.3	2.3	**2.7**	**3.4**
Infrastructure	Water and waste- water	2.3	2	3.3	2.3	2	2.3	**2.4**	**3.5**
	Urban transport	2.7	2.3	3.3	2.7	3	2.7	**2.8**	**3.5**
	Roads	2.7	3	3.3	2.7	2.3	2.7	**2.8**	**2.8**
	Railways	2	3.3	2.7	2.7	2.3	3	**2.7**	**3.4**

Financial sectors	Banking	2.7	2.7	3.3	2.7	2.7	2.7	**2.8**	**3.4**
	Insurance and other financial services	2	2.3	3	2.7	2.3	3	**2.6**	**3.3**
	MSME finance	2.3	2.3	2.7	2.3	2.3	3	**2.5**	**2.9**
	Private equity	1	1.7	2.3	1	1	1.7	**1.5**	**2.7**
	Capital market	1.7	1.7	3	1.7	2.3	2.7	**2.2**	**3.1**

Source: EBRD database, http://www.ebrd.com/pages/research/publications/flagships/transition.shtml

[1] Index ranges from 1 to 4.3, 1 meaning only the initiation of transition reforms and 4.3 meaning more or less the situation in advanced market economies.

Table 6 shows that the SEE-6, with the exception of Croatia, lag behind the NMS-9 in the reform of all four sectors. In general there are no big differences in the lagging of individual sectors; however, within sectors considerable differences exist. In the energy sector the biggest gaps are in electric power and sustainable energy, in the infrastructure sector the gaps are especially visible in the water and wastewater sector, while in the financial sector it is capital markets and private equity which lag the most.

The World Bank Worldwide Governance Indicators (WGI). Governance of the economy and society at large has become an increasingly important determinant of a country's attractiveness for FDI. The global economic and financial crisis has further highlighted the importance of the quality of regulations and regulatory reform, making them the focus of strategies for fighting the crisis. According to the WGI concept, governance includes the process by which governments are selected, monitored, and replaced, the capacity of the government to effectively formulate and implement sound policies, and the respect of citizens and the state for the institutions that govern economic and social interactions (http://info.worldbank.org/governance/wgi/index.asp).

Table 7: World Bank Worldwide Governance Indicators[1], 2012

	Voice and Accountability	Political Stability	Government Effectiveness	Regulatory quality	Rule of law	Control of corruption
Albania	0.01	-0.16	-0.28	0.17	-0.57	-0.72
Bosnia and Herzegovina	-0.14	-0.54	-0.47	-0.06	-0.23	-0.30
Croatia	0.48	0.56	0.70	0.44	0.21	-0.04

Macedonia	0.00	-0.44	-0.07	0.35	-0.24	0.02
Montenegro	0.23	0.56	0.13	0.01	-0.01	-0.10
Serbia	0.17	-0.22	-0.11	-0.08	-0.39	-0.31
SEE-6	**0.13**	**-0.04**	**-0.02**	**0.14**	**-0.20**	**-0.24**
NMS-10	**0.81**	**0.69**	**0.65**	**0.92**	**0.64**	**0.29**

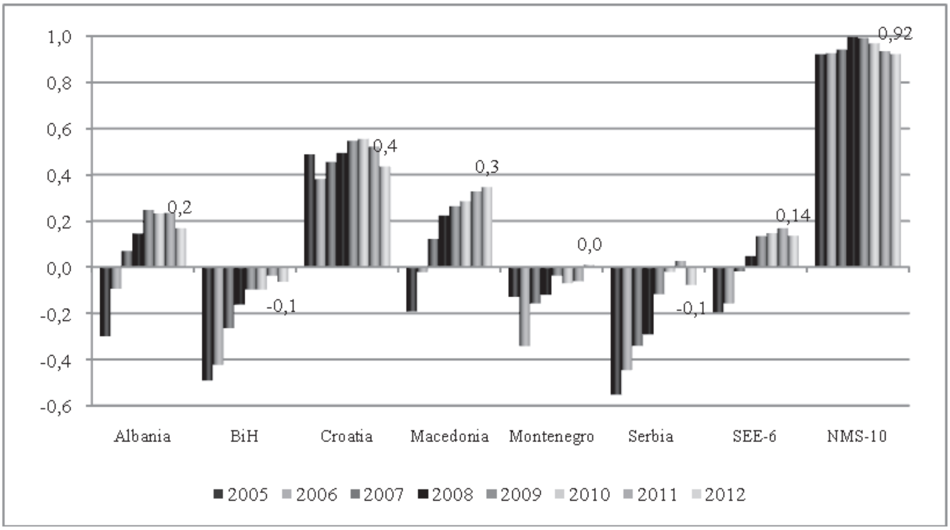
Source: World Bank Governance Indicators Database; http://info.worldbank.org/governance/wgi/index.aspx#home

[1] The values of indicators range from –2.5 to 2.5, with higher scores corresponding to better outcomes.

The World Bank measures the quality of six aspects of governance. The data in Table 7 indicate that governance is one of the main weaknesses of SEE-6 countries. SEE-6 countries show the worst performance in terms of control of corruption and rule of law, while they perform better in terms of regulatory quality, and voice and accountability. Both NMS-10 and SEE-6 countries perform best in regulatory quality. This is due to the EU harmonization process resulting in the drafting of a significant number of regulations that fulfil market standards. According to Busse and Groizard (2008) and Djankov et al. (2002), the legal and regulatory environment is one of the principal segments of the investment climate.

Further on, we look in more detail at developments in the rule of law and regulatory environment over the period 2005-2012. These are the two aspects of governance in which SEE-6 countries exhibit the highest lag behind NMS-10 countries and which are of major importance to foreign investors. In the last few years, SEE-6 countries have achieved notable improvement in regulatory quality. This improvement has been directly influenced by the progress each country has achieved in its EU accession process. Croatia, as a new EU member state, has achieved the biggest progress in the region, as is very advanced in the EU approximation process. Croatia is followed by Macedonia, which has been an EU candidate country since 2005, while other countries in the region lag behind.

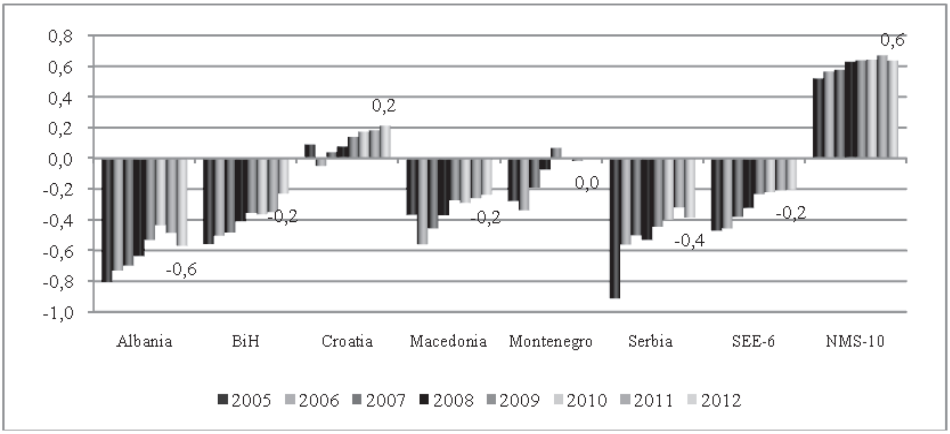
Figure 3: World Bank Worldwide Governance Indicators[1], 2006-2012, Regulatory quality



Source: World Bank Governance Indicators Database; http://info.worldbank.org/governance/wgi/index.aspx#home

¹ The values of indicators range from –2.5 to 2.5, with higher scores corresponding to better outcomes.

Figure 4: World Bank Worldwide Governance Indicators[1]/, 2006-2012, Rule of law



Source: World Bank Governance Indicators Database; http://info.worldbank.org/governance/wgi/index.aspx#home

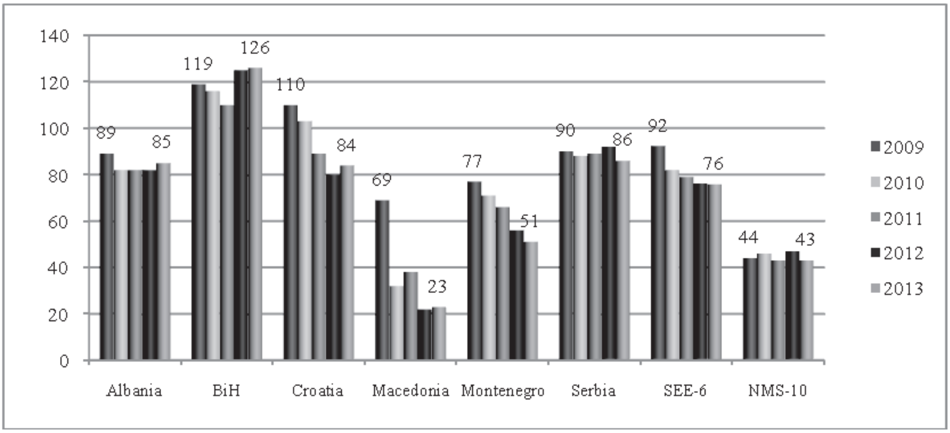
¹ The values of indicators range from –2.5 to 2.5, with higher scores corresponding to better outcomes.

Rule of law points to what extent the adopted legislation is in fact implemented in practice. The problem of implementation gap is very much linked to problems with building of institutional infrastructure and strengthening the existing institutional infrastructure. As depicted by Figure 4, in SEE-6 countries, progress in the implementation of laws, i.e., rule of law, significantly lags behind the achieved progress in regulatory quality. Croatia has achieved the biggest progress in securing rule of law, followed by Montenegro, while all the other countries lag behind.

The climate for FDI can be better explained by World Bank Doing Business Indicators. WBDB is a comprehensive analysis of regulations for and obstacles to starting, operating, and closing a business, which compares the ease of doing business in more than 180 countries around the world. It explains where a country ranks as far as the main elements of business environment are concerned.

Figure 5 compares WBDB Overall Ease of Doing Business rankings of SEE-6 and NMS-10 countries, as well as of individual SEE-6 countries. As expected, SEE-6 countries substantially lag behind NMS-10 countries; however, the lag is decreasing. More precisely, in 2009-2013 the average SEE-6 ranking improved from 92nd to 76th position, while the rank of the NMS-10 remained almost unchanged, going from 44th to 43rd position. In the analysed period Macedonia was the region's best performer - mainly due to successful implementation of extensive regulatory reform in the previous period - improving its rank from 69th in 2009 to 23rd in 2013. Macedonia is followed by Montenegro, which improved its rank in the previous five years, from 77th to 51^{st,} due to intensive reforms in several regulatory reform areas. Croatia (ranked 84th in 2013), Serbia (85th), and Albania (86th) are positioned in the middle of the list, significantly lagging behind the two most successful countries in the region and behind the NMS-10. Still, there is an important difference between them, as Croatia improved its rank from 103rd in 2010 to 80th in 2012, mostly due to the progress achieved in the 'starting business' dimension, while Serbia and Albania stagnated in the previous five years. Bosnia and Herzegovina ranked far below the rest, and even worsened its position, from 110th in 2011 to 126th in 2013.

Figure 5: World Bank Ease of Doing Business Rankings[1], 2009-2013



Source: World Bank Doing Business 2013; http://www.doingbusiness.org/rankings

[1] Ease of Doing Business Rank among 185 countries in 2013.

The Ease of Doing Business index is measured through ten different dimensions: starting a business, dealing with construction permits, getting electricity, registering property, getting credit, protecting investors, paying taxes, trading across borders, enforcing contracts, and resolving insolvency/closing business. Comparing SEE-6 with NMS-10 countries shows that the former lag behind most considerably in dealing with construction permits (average rank of SEE-6 152nd, compared to average rank of NMS-10 85th), enforcing contracts (92nd compared to 49th) and registering property (88th compared to 41st). In the 2009-13 period, SEE-6 countries recorded most progress in getting credit, protecting investors, and starting a business. There are considerable differences among SEE-6 countries in terms of different aspects of doing business (see Table 8).

Table 8: World Bank Doing Business Rankings per dimension, 2013

	Albania	Bosnia and Herzegovina	Croatia	Macedonia	Montenegro	Serbia	SEE-6	NMS-10
Ease of doing business	**85**	**125**	**84**	**23**	**51**	**86**	**76**	**47**
Starting a Business	62	162	80	5	58	42	68	77
Dealing with construction permits	185	163	143	65	176	179	152	85
Getting electricity	154	158	56	101	69	76	102	103
Registering Property	121	93	104	50	117	41	88	41

Getting credit	23	70	40	23	4	40	33	39
Protecting Investors	17	100	139	19	32	82	65	72
Paying taxes	160	128	42	24	81	149	97	90
Trading Across Borders	79	103	105	76	42	94	83	56
Enforcing Contracts	85	120	52	59	135	103	92	49
Resolving insolvency/ Closing business	66	83	97	60	44	103	76	56

Source: World Bank Doing Business 2013; http://www.doingbusiness.org/rankings

5. CONCLUDING REMARKS

A remarkable increase of inward FDI has been one of the most outstanding features of the transition processes of former socialist countries. In circumstances of ongoing economic recession and financial crisis with ever decreasing access to foreign loans, FDI may prove to be an even more important potential source of capital. Consequently, policy makers will have to put more effort into attracting strategic foreign investors.

Along the lines of existing theoretical and empirical literature on FDI and economic integration and, more specifically, on the EU accession and related transition processes, we claim that the attractiveness of SEE-6 countries as investment locations significantly depends on the speed and scope of their transition and EU accession processes. In this context, we analyse which are the most important lags of SEE-6 countries in EU accession and transition processes, the removal of which would eventually have a positive impact on FDI inflows. The analysis is based on EBRD Transition Indicators, the World Bank Doing Business Index, and the World Bank Governance Index. As Sanfey and Ceh (2012) claim, the available competitiveness and business environment surveys have limited value for analysts and policy-makers on an individual basis, but taken together they can provide a valuable instrument.

Based on the experiences of the NMS-10, we find that there is an obvious correlation of FDI inflow and EU accession process. We expect that in terms of FDI inflow SEE-6 countries will broadly follow the pattern of the NMS-10, meaning that their relative position as FDI recipients will gradually increase along with their EU accession and transition processes. In other words, the improvement of their attractiveness as investment locations will depend on how efficient they are in removing the largest gaps in their transition and EU accession processes. The analysis finds considerable differences among individual SEE-6 countries, but all in all puts forward the following gaps:

- In terms of economic system development, SEE-6 countries lag behind most in enterprise restructuring and governance, and in sectoral reforms. In the energy sector the biggest gaps are in electric power and sustainable energy, in the infrastructure sector the gaps are especially visible in the water and wastewater sector, while in the financial sector it is capital markets and private equity which lag the most.
- In terms of the governance of economy and society at large and in comparison to the NMS-10, SEE-6 countries exhibit the largest gaps in regulatory quality and especially in rule of law, the two aspects of governance which are of major importance to foreign investors.
- In terms of the quality of business environment, the most considerable lags are in dealing with construction permits, enforcing contracts, and registering property, which are obviously linked to regulatory quality and rule of law.

Progress in narrowing down these gaps would mean a step forward in EU accession and transition and, at the same time, an improvement in SEE-6 countries' attractiveness as locations for inward FDI.

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