# Why is there so little foreign direct investment in the Western Balkans?



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It is now more than quarter of a century since the demise of socialist economies in Europe was put in motion by the fall of the Berlin Wall. In many parts of Central and Eastern Europe, the transition from socialist planning to market capitalism is all but forgotten; for example in the bustling modern economies of the Czech Republic, Poland or the three Baltic states. The process of integration into the European, and the broader world economy, has been accelerated for many of the central European countries by early membership of the European Union. A key mechanism for this integration is trade and especially foreign direct investment.

However, the integration process has been much slower and less effective in South Eastern Europe (SEE), especially in the Balkans where economic growth, low employment and closer economic relationships with their richer Northern and Western neighbours remains elusive. We have explored the role of foreign direct investment in this unsatisfactory, and potentially politically destabilising, performance.

We first explore how much FDI there has actually been to South Eastern Europe (SEE); namely to Albania, Bosnia and Herzegovina, Bulgaria, Croatia, Macedonia, Montenegro, Romania and Serbia. In fact, foreign investors arrived later to most of SEE than to the other transition economies and the inflow of FDI to this region in the 1990s was low in comparison, probably because of the political risk and high economic instability in the region. Over the 1989-2000 period, the inward 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.

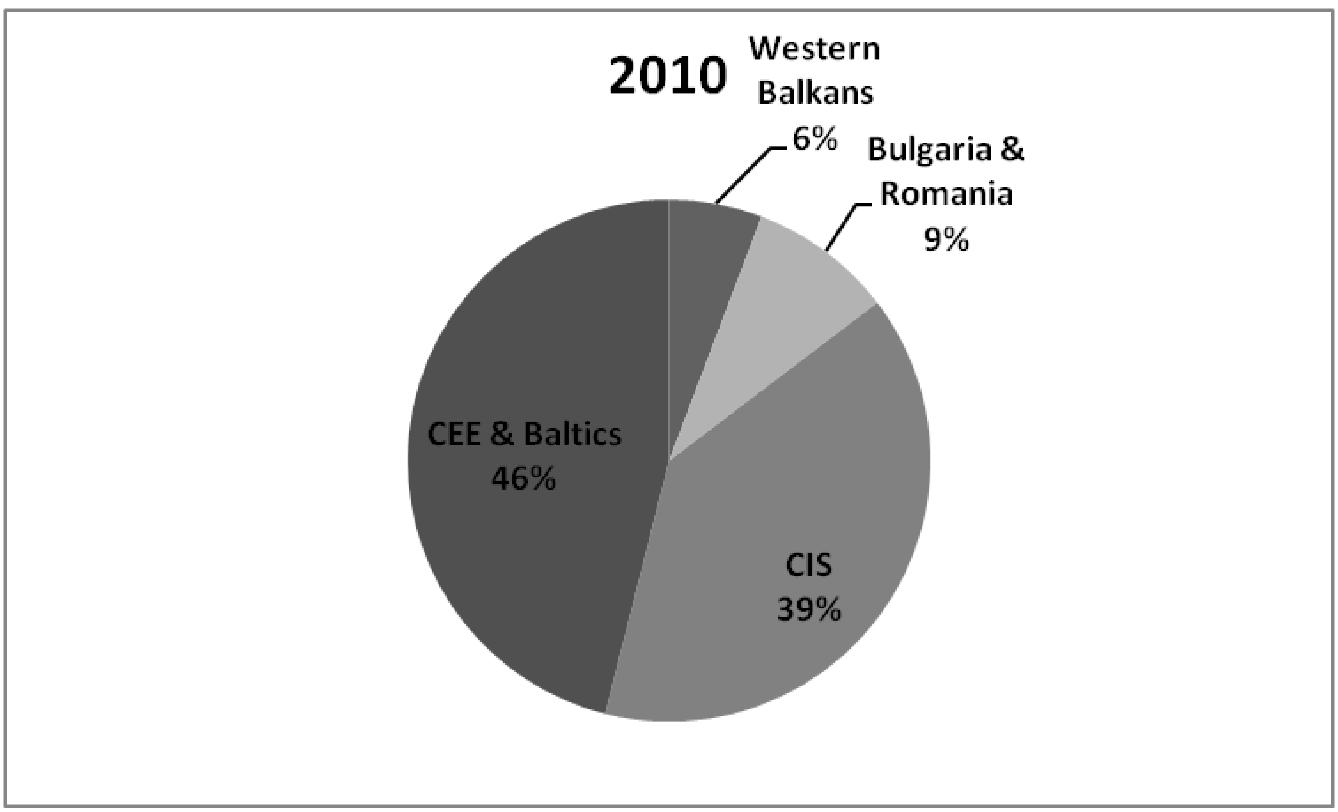
Perhaps as a consequence of the improving political and economic conditions, there was a marked increase in FDI to the whole SEE region after 2000. Even so, by 2010 the eight SEE countries had received only around a third of the volume of FDI that had gone to the eight Central European countries and the Baltics. The share of the eight SEE countries in total inward FDI stock in the transition region increased from 9.4 per cent in 2000 to 14.7 per cent in

2010 (of which 5.8 per cent in the Western Balkans and another 8.9 per cent in EU members, Bulgaria and Romania).

In terms of sectors, 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, but with substantial variations among countries. 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 favoured sectors of foreign investors in the region. Regarding manufacturing, there are even greater differences across countries. 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).

Using a gravity model of FDI to investigate the factors driving FDI into the Balkans, it is found that 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 geographic distance. However, there is always a negative Western Balkans effect in the estimates. Thus, we find that there remains an unexplained negative factor influencing FDI into the Western Balkans; the coefficient on the Balkans dummy variable is negative and significant. This result goes through even when a variety of additional control variables for labour costs, EU membership and institutional quality are taken into account.

### Figure 1. Inward FDI stock by transition regions, 2010 (shares, in percent)




Therefore our analysis shows 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; the Western Balkan economies are for the most part rather small and the GDP of the host economy has a significant positive effect on FDI. The fragmentation of the region, which has been exacerbated by events since the early 1990s, is clearly a factor militating against FDI.

- Secondly, their distance from the investing economies of Western Europe, and their remoteness from the EU and other major trading blocs, 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. 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.

However, even taking all these factors into account, our regressions confirm the view that there is a negative 'Western Balkans' effect on FDI. Once all the institutional variables are taken into account, the dummy variable for the Western Balkans is still 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 slow recovery of pre-transition GDP, 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.

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*Notes:*

- *This blog post is based on the authors' paper FDI into transition economies: Are the Balkans different?* (2014), *The Economics of Transition*, Vol. 22 (2), pp. 281-312.
- *The post gives the views of the author, not the position of LSE Business Review or the London School of Economics.*
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