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Increasing the effectiveness of FDI as a driving factor in raising the level of competitiveness in the western Balkans

Abstract

A significant increase in the flows of foreign direct investment to the Balkans has had positive effects on the entire economic and political environment of countries in the region, increasing their level of competitiveness. Large demand in and high competition between Balkans countries has influenced the provision of better conditions for foreign investors. Nevertheless, the high levels of openness and the high dependence of this region on FDI have made western Balkans countries vulnerable during the current crisis. Policies towards the attraction of foreign capital should prefer productive, self-sustaining and competitive sectors, along with a strong financial and fiscal sector, so as to alleviate the effects of future crises. Factors of attraction are significantly different between sectors and should be taken seriously into consideration in the new development strategies of countries via a focus on the development of the respective sectors as well as on strategies for the attraction of foreign investment to the region.

Keywords: *development, competitiveness, FDI investments, western Balkans.*

Introduction

Economists and analysts are agreed that the 21st century would be a century of global competitiveness, which means that the problem of national competitiveness, in particular, is gaining in importance under the conditions of globalisation. The World Economic Forum has defined competitiveness as the group of institutions and regulations that determine the level of productivity of a certain country, or the ability of an economy to produce goods and services that pass the test of the international markets and which, in turn, have an influence on the increase in real income.

This means that the essence of the competitiveness of a certain country lies in its export performance, whether in goods or services. The problem of competitiveness is the common goal of all countries, in which less developed countries, or ones in transition, are faced with additional factors which inhibit the raising of the levels of competitiveness of their countries.

Western Balkans countries, after the destructive events of the last ninety years, have started on the political and economic rehabilitation of their countries. The impoverished and outdated technological structure of the regional economy demands its reconstruction, which leads to the serious problem of the lack of financial resources.

The processes of globalisation and liberalisation, along with the expansion of international capital, have influenced the economic system of western Balkan countries.

These countries, in accordance with generally-accepted theory and practice, have liberalised their markets, in terms of the trade in goods and services, and, through constant reforms, they have also gradually liberalised their financial systems. In conditions of high international liquidity, the inflow of foreign capital became a significant source of capital after 2000, which was more than necessary for western Balkan countries. The dominant form of capital inflow in the region has been in the form of foreign direct investment.

Along with international practice, we have had an increasing amount of academic research which has studied and proved there to be positive and significant relationships between FDI and economic development, growth rate, increase of exports, increase in competitiveness, decrease in unemployment… The impact of FDI in promoting the growth of host country exports and linkages to the outside world in most research studies has been clear. Many authors (Hecht, 2002; Longani and Razin, 2001; Mody *et al*. 2003) have found evidence that FDI inflows promote efficiency: the effect of FDI on GDP growth is higher than the effect of other inflows.

The major role of FDI in the transformation of host economies from being exporters of raw materials and foods to being exporters of manufactured goods and, in some cases, relatively hi-tech manufactured goods, is also evident in some cases. FDI affects not only an increase in exports and the introduction of new industries. Much of its impact stems from the transfer of knowledge of world markets and of ways of fitting into worldwide production networks, not visible in standard productivity measurements. Smarzynska has explored, and concluded that there is a positive correlation between, the productivity growth of domestic firms and the presence of foreign affiliates in terms of the transfer of technology, expanded domestic competition and export substitution with local products (Smarzynska, 2002). Smarzynska's conclusion is that the effect of FDI inflows on domestic investment and capital formation is significantly larger than other capital flows, since the unique gains from FDI in the host country lie in the expansion of domestic investment.

Other researchers (Lipsey, 2002; Borensztein *et al*. 1998; Mencinger, 2003) have found that FDI, by itself, has only marginally affected growth, while inward FDI could be favourable or unfavourable depending on the incentives offered by host-country policies, such as the level of education of a country's labour force (Shiells, 2003; Chen *et al*. 2008) or an adequate trade policy. The efficiency of FDI in promoting growth would be increased by an export promotion policy, but decreased by an import substitution policy (Busse, 2006).

The transition of central and east European countries was a fruitful ground for the wave of direct investment directed to these countries following the years in which foreign investment was restricted. Direct investment in these countries has generally been related to the extraction of natural resources or infrastructure projects in energy transportation, as well as to large privatisation transactions and debt/equity swaps to pay for energy supplies. After 1990, central and east European countries have lowered the barriers to FDI to varying degrees. Of course, many other developments have been taking place at the same time: an increasing openness to trade; the privatisation of previously government-owned production; and many other changes as these countries moved in various degrees from socialist to market economies and democratic government (Lipsey, 2006).

Despite a strengthening of macroeconomic performance on the basis of the different reforms, most central and east European countries have suffered from incomplete structural reforms and a lack of quality among institutions and in terms of infrastructure capacities. Countries that provide reliable and predictable legal systems and efficient public administration have received greater investment and profits, more so than countries with poor governance, which strongly indicates the importance of infrastructural and governance indicators (Wagle, 2011). Regarding infrastructure indicators, local financial institutions could play an important role in challenging FDI to raise economic development. The lack of development of local financial markets, on the other hand, can adversely limit the ability of an economy to take advantage of potential FDI spillovers (Alfaro *et al*. 2003).

In contrast to the initial beliefs that FDI incentives, like tax breaks or subsidies, could be one of the most important engines of FDI inflow, which have influenced the severe levels of tax competition between countries, research now shows that these may be more likely to fit badly with the comparative advantages of a host country and may be less likely to be associated with enlarged trade (Lipsey, 2006).

Numerous papers in the early 2000s have examined the interaction between FDI and trade (Lane and Milesi-Ferretti, 2004; Rose and Spiegel, 2004; Swenson, 2004). These research studies are built on the argument that larger FDI inflows will lead to a higher volume of trade and will bear benefits in terms of an increase in total factor productivity growth and in higher output rates. Some papers discuss the links between finance and trade in developing countries through vertical FDI; Gordon (2001) shows that vertical FDI from the OECD to developing countries has increased substantially in the last twenty years. This increase has run in parallel with a corresponding increase in trade flows. Others research studies argue that horizontal FDI refers to investments in production facilities abroad that are designed to serve foreign customers and through which affiliates can use 'export platforms' and accelerate exports (Helpman *et al*. 2003).

In addition, some of the papers indicate a complex two-way positive feedback between FDI and international trade, and have suggested a significant benefit associated with reduced trade restrictions (Aizenman and Noy, 2005). On the other hand, recently-developed papers (Mencinger, 2003, 2007; Cocozza, 2011; Kinoshita, 2011) show that FDI has influenced trade balances by affecting exports and imports; whether the effects of FDI on trade balances are positive or negative depends on the sectoral structure of FDI and the envisaged strong links between FDI and the manufacturing sub-account (Aizenman and Noy, 2005; Walsh, 2010; Mitra, 2010). One would expect positive effects as regards the trade balance if the major aim of FDI is to take advantage of cheaper labour in the host compared to the home country; and negative ones if the major aim of FDI is to acquire new markets (Mencinger, 2007). Overall, the short- and long-run impacts of FDI on current account deficits depend on the effects that FDI has on domestic savings and economic growth. Average current account deficits have increased, while trade deficits have been enhancing current account deficits in most central and east European and Balkan countries (Hunya, 2010; Becker and Weissenbacher, 2011).

Other countries have tried to replicate successful 'examples', mutually competing for international capital and demanding the opportunity for the greater and greater profitability of their investment. By a system of emulation, host countries have started to compete in providing the most favourable conditions for foreign capital, somewhat ignoring their own engines and factors of economic growth (Botrić, 2010). This did not look particularly dramatic in the period of the general euphoria in international capital markets. This kind of generally-accepted economic policy was applied by western Balkan countries.

The first effects of the inflow of direct capital were significantly positive for Balkan countries, leading to high (long-expected and necessary) growth rates, low inflation, increased employment and stability in the fiscal balance. However, in the period of expansion, these countries have pursued a deficit in the current account balance of payments. This did not represent a significant problem because the deficit was covered by a significant inflow of foreign investment. A constantly present problem in the balance of payments, especially in the trade balance, has been caused by the low level of competitiveness of these countries being treated as a short-term problem which will be removed in the medium- and long-term through a further inflow of FDI oriented towards export activities.

FDI flows and western Balkans countries

Western Balkan countries started the process of transition later than other countries, and face more challenges than the others. The necessary challenges reflect the political, institutional, economic and social environments, and demand urgent action and development based mostly on the import of capital than on establishing it from domestic sources. The changes that have been initiated assume particular importance given the European aspirations of these countries. The level of domestic savings in the Balkans is insufficient to finance the radical changes required and so foreign direct investment has played a most important role; indeed, FDI is crucial to the process of transformation and association of central and east European countries. The flow of FDI has been very generous to central and eastern Europe in the last decade, but only a small part has been directed towards south-eastern Europe.

The inflow of foreign direct investment in the 2004-2009 period is presented in Table 1.

Table 1 – FDI inflow in Balkans countries, 2004-2009 (€m)

	2004	2005	2006	2007	2008	2009	Per capita inflow, 2009	Per capita stock, 2009
Albania	278	213	259	481	675	698	219	800
BiH	567	493	611	1 517	725	361	94	1 500
Croatia	950	1 468	2 765	3 670	4 192	1 875	423	5 729
Macedo-nia	261	77	345	506	400	181	88	1 500
Montene-gro	53	384	493	673	625	944	1 498	5 233
Serbia	772	1 268	3 392	2 513	2 018	1 410	193	2 000
South-east Europe	2 880	3 903	7 864	9 360	8 636	5 469	255	2 500

Source: wiiw Database on Foreign Direct Investment 2010

The inflow of investment in the early '90s was insignificant but, with relative political and economic stability in the region, the inflow during the 1995-2000 period was much increased, reaching a level of $3-4bn at the level of the region as a whole (Bijelic and Jaćimović, 2011).

The expansion of capital flows across the world between 2005 and 2007/08 led to a large increase in the flow of capital to the countries of the region. The inflow of foreign direct investment was significant and had positive effects on the entire economic and political environment of the countries of the region. The single largest absorber of foreign capital was Croatia, as the most developed country in the region, and the one with the best integration results. However, a large inflow of foreign capital was also recorded in Montenegro, which had one of the highest per capita FDI inflows in Europe.

Before the crisis, all Balkan countries shared a common growth model, driven by strong capital inflows, rapid credit expansion and consumption-based booms in domestic demand. The sustainability of this model was in doubt even before the crisis, as it was leading to rising external imbalances[1] and vulnerabilities that were kept at bay only as long as abundant foreign capital remained available (Cocozza *et al*. 2011).

Beside the positive effects which the inflow of foreign direct investment had on macroeconomic indicators in all western Balkan countries (Hunya, 2010), the existence of a constant deficit is evident in the current account balance of payments of these countries, which continued to increase in the boom years. In 2009, this indicator was,

1 It is important to note that large and widening current account deficits seem to be specific to European transition economies, as these features do not generally apply to emerging market countries in Asia and Latin America that shared similarly fast growth rates in the 2000s.

for all countries, lower than in previous years, although this was more as a result of the forced adaption of these countries to the effects of the contemporary financial crisis, which can be seen in Table 2.

Table 2 – Current account deficits in western Balkans countries, 2004-2009 (€m)

	2004	2005	2006	2007	2008	2009
Albania	-340	-589	-471	-831	-1 370	-1 345
Bosnia and Herzegovina	-1 318	-1 499	-783	-1 190	-1 819	-840
Croatia	-1 433	-1 975	-2 717	-3 236	-4 338	-2 448
Macedonia	-362	-122	-23	-421	-853	-483
Montenegro	-120	-154	-531	-1 060	-1 564	-896
Serbia	-2 620	-1 778	-2 356	-4 614	-6 089	-1 743

Source: wiiw Database

This indicates that the significant inflow of capital in the region's countries has led to an expansionary external trading policy under which both imports and exports have increased strongly, a dynamic that was, however, more significant for imports. For most countries in the region, a rapid increase in imports has not been matched by a growth in exports. If we consider the current account deficit as a percentage of GDP, most countries had relatively modest (single digit) indicators in 2004, but this significantly deteriorated during the boom years before the situation was again reversed (i.e. back to the position where just two countries had single-digit values for this indicator), as Table 3 demonstrates.

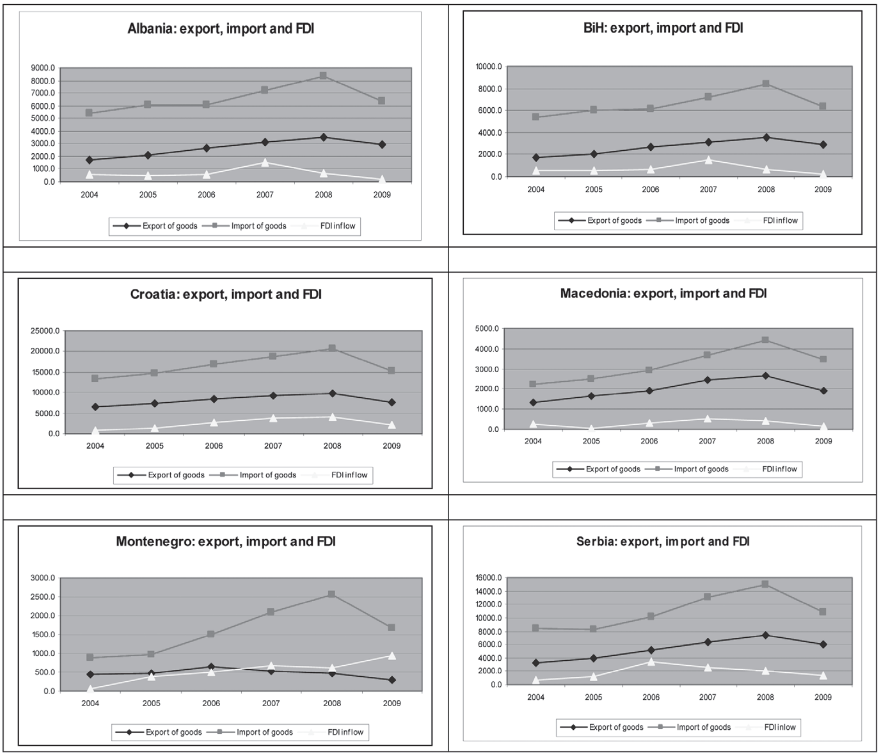
Table 3 – Current account as % of GDP

	2004	2005	2006	2007	2008	2009
Albania	-6	-9	-7	-11	-15	-15
BiH	-16	-17	-8	-10	-15	-8
Croatia	-4	-5	-7	-8	-9	-5
Macedonia	-8	-3	0	-7	-13	-7
Montenegro	-7	-8	-25	-40	-51	-30
Serbia	-14	-9	-10	-16	-18	-6

Source: wiiw Database

By detailed analysis of FDI inflows and exports and imports in the region's countries, we can see a very similar trend in these variables, which leads to the assumption that export and import trends in western Balkans are determined by the trends in FDI (Becker and Weissenbacher, 2011), as Chart 1 demonstrates.

Chart 1 Movements in exports, imports and FDI in countries in the region



Source: wiiw Database

This leads to the conclusion that the inflow of foreign investment in western Balkan countries has a significant influence as regards the increase in the import, but much less so as regards the export, activities of these countries. In particular, we should mention the case of Montenegro, which holds the regional record in terms of attracting per capita FDI, but which also records the highest current deficit, reaching an unbelievable 51 % of GDP in 2008. This confirms the research that shows that FDI in the tradable sector is associated with higher exports, whereas FDI in the non-tradable sector is associated with higher imports (Kinoshita, 2011). Regression results show that sufficient domestic scale, a good infrastructure, an educated labour force and deep trade integration are conducive to attracting FDI in the tradable sector. The initial conditions and fiscal policy do not generally affect the composition of FDI.

This indicates in conclusion that the inflow of foreign direct investment has stimulated domestic consumption to a greater degree than it has affected the growth in the competitiveness of exports, i.e. the value of exports, for all countries in the region. In other words, the region has serious problems in terms of the competitiveness of export manufactures, beside the significant inflows during the 2004-2009 period. The minor influence of FDI on the competitiveness of export manufactures can be explained by the sectoral structure of FDI. The process of privatisation has been the main engine for the inflow of foreign investment in the western Balkans region; this inflow has been predominantly directed into the service sector: banking; telecommunications; trading; energy; and, partly, into land and property. Investments in the industrial sector are significantly lower than the share of the service sector in foreign investment (see Table 4).

Table 4 – FDI inflow in western Balkan countries, by sector (€000)

	2006	2007	2008	2009
Albania	846	1 054	1 688	1 986
Mining	24	46	9	19
Manufacturing	120	135	224	320
Services	702	873	1 455	1 647
BiH	2 542	3 166	4 677	5 255
Mining	…	…	…	…
Manufacturing	623	760	880	1 000
Services	1 919	2 406	3 797	4 255
Croatia	20 782	30 611	22 827	25 407
Mining	618	711	950	1 084
Manufacturing	5 100	6 558	5 814	5 482
Services	15 064	23 342	16 063	18 841
Macedonia	1 769	2 098	2 545	2 969
Mining	39	45	51	168
Manufacturing	775	802	907	886
Services	955	1 251	1 587	1 915

	2006	2007	2008	2009
Serbia	3 516	2 270	1 842	1 410
Mining	2,0	24	20	405
Manufacturing	794	366	388	533
Services	2 718	1 880	1 434	473

Source: Country National Bank reports.

The structure of investment implies that the dominant inflow of capital into the region has been oriented more by the motive of providing quality international services to the domestic market, such as banking, telecommunications, the retail sector and land and property, and less in tourism and other export-oriented services. A small amount of investment is oriented towards the industrial sector, which influences the situation as regards exports and the level of export competitiveness; this has a similar effect on the economies of the countries of central and eastern Europe (Mitra, 2011).

This situation has been particularly worsened by the period of financial crisis, when the strong inflow of investment fell away and the deficit in the balance of payment current account was exposed to unforced adoption, affected additionally by low incomes from exports at a time of the existence of significant levels of import demand. The crisis has affected the external positions of all Balkan countries, particularly in terms of the raised levels of external debt (Mencinger, 2003); the external debt position is generally high, but particularly elevated in Croatia, Montenegro and, to a lesser extent, Serbia, and this has contributed to increased external financing requirements.

Conclusion

Factors of attraction are significantly different between sectors. These should be taken very seriously into consideration to play a role in new strategies of development for countries through an emphasis on the development of some sectors[2] as well as on strategies for the attraction of foreign investment in the region. Up to now, significant demand and high competition between Balkan countries have influenced how countries look to provide better conditions to the foreign investor, under which some local levers of development have become very sensitive. High openness and the high dependence of this region has made Balkan countries particularly vulnerable in this period of major crisis.

A decrease in the inflow of foreign direct investment has slowed down the economic development of Balkan countries and has had a strong influence in terms of slowing

2 The contemporary crisis has had an influence on an actualisation of the attitude that economic development can be based not only on the tertiary sector and that, to a certain degree, an industrial sector still has to exist.

the growth of the countries of central and eastern Europe.[3] The world economy might be recovering, but the international flow of capital remains slowed and most of the resulting problems are being felt in those countries which are more exposed to the inflow of foreign capital.

The greatest decrease in investment has been in Baltic countries, where investments decreased by 65 %. A very similar picture is found in Bulgaria and Romania, whereas the decrease in the inflow of investment in the Czech Republic and Poland was only 15 %. A decrease in the inflow of capital affects economic growth rates; these have been negative in Baltic countries, whereas in Poland, Slovakia and the Czech Republic they have been positive (Mitra, 2010).

This leads to the conclusion that countries which are less open and less dependent on foreign capital are confronted with fewer of the divisive effects of crises. This certainly allows us to realise that economic growth should not be tied to foreign investment, but that Balkan countries should learn from the experience of the 'new' member countries. The politics of the attraction of foreign capital should be directed towards productive and self-sustaining sectors, along with a strong financial and fiscal sector, as a means of alleviating the effects of future crises.

The strong inflow of FDI in the countries of the western Balkans in the period of international liquidity brought significant economic movements, as well as stabilisation and economic growth, but, at the same time, has hidden some structural imbalances in these countries. It is apparent that the period of economic and financial boom and the significant inflow of foreign capital, predominantly in the form of foreign direct investment, has influenced the need to resolve the development problems of this region.

The strategic determination of government and the political elites on opening up to economic and other forms of liberalisation, supported by the inflow of foreign direct investment, delivered positive results. Economic growth and overall expansion was such an influence that the one which is closer to conservative attitudes was in the minority. The only economic indicator which had a negative sign in most countries is the deficit in trading and in the current account balance. Insufficient exports and rising imports did not, in that period, worry policy-makers because it was financed mostly by capital inflows.

The constant presence of a current account deficit, predominantly caused by a deficit in the trade balance, at a time of the expansion of flows of foreign direct investment, has presented problems to most western Balkan countries. This implies a low competitiveness of the region's countries, which demands a quick response, but, in a period of economic boom, there was no political readiness in that period to resolve the serious and accumulated structural problems. The situation has made the balance of payments position (i.e. the deficit) even worse, under which the trade deficit has led to a severe crisis outcome in most of the countries of the region (Sanfey, 2010).

Major FDI inflows have affected the economic development of western Balkan countries in the short-term, but they have not affected the balance of payments position

3 These countries have experienced large inflows of FDI in period of transition, which were generator of changes, high growth and precondition of their development toward full membership in EU.

of these countries and neither have they influenced structural changes nor contributed to their export competitiveness. There could be some reasons for such an outcome, such as the inadequate foreign investment policies of all western Balkans countries and the poor sectoral distribution of foreign investments.

Firstly, domestic foreign policy has been oriented towards providing the best possible domestic conditions and benefits for foreign investors as a general means of attracting them in. Consequently, the region's countries are competing among themselves to provide the best possible conditions. Such policies have followed a lack of analysis on the effects of foreign capital inflows because, in general, the opinion is that every inflow of investment contributes to an increase in employment as well as to a better export position and improved economic competitiveness.

Secondly, the sectoral structure of the first wave of FDI in the region saw FDI go mostly towards the service sector (banking, telecommunications and land and property), rather than productive sectors, and was driven for the most part by privatisation. Service sector investments had the aim of capturing domestic markets rather than developing the domestic export sector and improving domestic competitiveness. These have shown that the structure of FDI in western Balkans countries was neither efficient nor sufficient to introduce sustainable domestic growth.

This identifies that domestic policies towards the attraction of foreign capital do have a role to play. Everyone is expecting a recovery of the international financial market, and a 'new' wave of investment, so it is a good time for the countries of the region to review and adjust their foreign investment policies towards more self-sustaining sectors. Factors of attraction are significantly different between sectors; these do need to be taken seriously into consideration and become more dominant in the 'new' development strategies of countries.

Alternative growth engines directed towards non-tradable sectors must also emerge as a means of achieving a transition to a more balanced and sustainable growth model that supports economic convergence towards the standards of the European Union. To this end, it appears crucial that ongoing external adjustment increasingly relies on export expansion and import substitution rather than on a restrained level of domestic demand. To this end, domestic and foreign investment must become focused on expanding the export base and, more generally, on improving the productive capacity of the supply side. This will contribute to increase both output and productivity while facilitating more sustainable external positions (Cocozza, 2011).

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