Foreign Investments and Trade in the Western Balkan–Focus on Economic and Legal System

Danijela P. Jacimovic and Mijat XX Jočović
University of Montenegro/Faculty of Economics, Podgorica, Montenegro
Email: jacimda@hotmail.com, mijatj@ac.me

Abstract—**The high openness and high dependence of this region on foreign capital have made the Western Balkan countries vulnerable to capital volatility. The reduction of foreign capital imposed rapid adjustments in domestic demand that, together with a collapse in exports, resulted in substantial output declines. High competition between the Western Balkan countries favored investors and a race to the bottom in terms of regional investment conditions (taxes, subsidies) led to a situation that made regional development policies difficult.**

Index Terms—**FDI flows, trade, Western Balkans, regulatory reforms**

I. Introduction

Foreign direct investments (hereinafter: FDI), analysis of their effects, ways of attracting and removing obstacles for their bigger inflow are constant topic of numerous researches during the last decades. Also, this topic is still popular and challenging for theoretical analyses and empirical researches. FDI especially gains in significance in the period of the global crisis [1]. Namely, in the existing conditions of regulatory competitiveness and decline in number of quality investors, the practice shows that there are all forms of country's efforts against numerous limitations for foreign investments and no legal system is immune to them.

In numerous analyses that were carried out, and which were confirmed by the practice, there is a direct relationship between the FDI and economic growth [2]-[4]. With the beginning of the transition process of the whole society and privatization of the state property, FDI was regarded as the source of economic prosperity in the transition countries [5], [6]. FDI also became a means through which they didn't only achieve direct economic but also broader political, technological, social and cultural effects [7]. Relationship between trade and FDI's for most authors was clear. Researchers have argued that larger FDI inflows will lead to the higher volume of trade, and will benefit to the increase of total factor productivity growth and higher output rates, as well. Some others emphasize that effects of FDI in promoting growth would be positive in case of active export promotion policy and decreased by an import substitution policy [8].

Lately, it can be found more critical papers about relationship among FDI and trade flows pointing out that FDI have influenced trade balance by affecting exports and imports, whether the effects of FDI on trade balance are positive or negative depending on the sectoral structure of FDI [9]-[11]. Supposed strong links between FDI and manufacturing sub-account will produce positive outcome for the level of export [12]. One would expect positive effects on the trade balance, if the major aim of FDI is to take advantage of cheaper labor in the host compared to home country, and negative, if the major aim of FDI is to acquire new markets [9]. Overall short and long run effects of FDI on current account deficit depend of the FDI effects on domestic savings and economic growth.

II. Regional Economical FDI Effects

Regional globalization effects were significantly positive after 2000, regarding to dynamic growth rates, low inflation, increasing employment and stability in fiscal balance in all countries in the region. Inflow of foreign capital was insignificant in 1990s and early 2000s, and it was mostly caused by privatization process. Financial boom and increasingly competitive domestic financial markets, improvement of regulatory and structural reforms made the region favorable ground for attraction of intensive capital flows, in the period 2006-2009 [13]. The intensive FDI flows have accelerated trade dynamics of the region with increasing both, the export and import. Global economic crisis has affected the Western Balkan countries in 2009, via trade and financial channels [14]. Export was collapsing, capital flows and remittances were declining together with the loss of external financing, lower tax revenue, tightened domestic credit conditions and pressure to the exchange rates [10]. All regional countries are facing with the difficulties to finance their balance of payment and government balances, stroke with both effects: decreasing of FDI inflows and export revenues, during the crisis.

The purpose of this research is to flow up FDI flows and its relation to export and import of goods for the Western Balkan countries. We will compare FDI and trade dynamic of Western Balkan with the same indicators of CEE (Central East European). In the same time we will follow up the dynamic of these indicators, regarding the phase of European integration. For CEE

Manuscript received December 27, 2013; revised March 13, 2014.

doi: 10.12720/joams.2.4.301-305

countries period 1995-1999 we marked as "first five years of integration" what can be comparable with Western Balkan counties in period of 2006-2010, as this represents the same integration phase for both regions. The CEE countries indicators for the period 2000-2004 can be used for prediction of these flows for the late integration phase of the region. As we are comparing different countries in terms of population, economic performance and integration phase, the best way to compare the data is to use indicators as ratio to GDP. FDI inflows towards Western Balkan countries and CEEC, as FDI/GDP ratios are shown in the Table I.

TABLE I. FDI INFLOW AS A % OF GDP IN THE BALKAN COUNTRIES 2000-2010

				First five years of integration process				
WB countries	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Albania	4.0	4.7	3.2	3.6	6.1	7.6	8.2	9.2
Bosnia &Herzegovina	2.7	7.0	5.6	6.2	13.7	5.0	1.4	0.1
Croatia	4.9	2.9	4.1	7.1	8.6	8.9	2.6	0.7
Macedonia	6.0	6.0	1.7	6.8	8.5	6.0	2.7	3.2
Montenegro	0.0	3.2	21.2	22.9	25.1	20.3	31.7	17.9
Serbia	0.2	4.1	6.2	14.6	8.7	5.6	4.5	3
Average	**3.0**	**4.6**	**7.0**	**10.2**	**11.8**	**11.7**	**8.8**	**5.6**
	First five years of integration process				**Five years before accession**			
	1995	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2004**
CEEC								
Latvia	3.6	8.4	5.3	4.8	5.3	1.6	2.7	4.6
Estonia	5.3	5.3	10.3	5.3	6.9	8.6	3.9	8.0
Lithuania	1.1	3.5	8.2	4.4	3.3	3.7	5.1	3.4
Czech Republic	2.1	2.3	2.3	6.0	10.6	8.8	9.1	2.3
Hungary	10.5	8.8	6.9	6.7	5.8	7.4	4.5	2.5
Poland	2.7	3.1	3.7	4.3	5.6	3.0	2.1	5.0
Slovenia	1.3	2.2	1.3	0.6	0.8	2.0	7.4	5.4
Slovak Republic	1.0	0.9	2.4	1.4	6.7	5.2	12.0	5.4
Average	**3.4**	**4.3**	**5.0**	**4.2**	**5.6**	**5.0**	**5.9**	**4.4**

Source: WIIW, Database on Foreign Direct Investment 2010

The data in Table I, shows that the Region has started from very low level of FDI inflow in 2000, as a 3% of GDP. In the period 2006-2008 the FDI flows to the Western Balkan countries have tripled, compared to early 2000, but the impact of the crisis became more evident in the region during 2009 and 2010. This has resulted in strong downsizing of FDI flows in following years, reaching the level as of the begging of 2000. Taking into the consideration Central and Eastern European countries, we have found that in 1995 (at the begging of the transition/integration process) all countries started from the average of 3.4% of FDI to GDP and achieved the largest FDI inflow in the five years before accession, reaching the average of 6% of GDP.

TABLE II. EXPORT OF GOODS AS A % OF GDP 2000-2010

				First five years of integration process				
WB countries	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Albania	7.0	8.3	8.1	8.8	10.0	10.4	8.7	12.0
Bosnia&Herzegovina	20.5	20.8	23.5	27.3	27.8	27.9	23.8	20.2
Croatia	21.5	20.2	20.2	21.6	21.5	20.7	16.9	18.9
Macedonia	36.8	31.1	35.1	37.7	41.4	39.9	28.5	35.9
Montenegro	0.0	27.1	25.4	30.2	19.2	15.1	9.9	6.6
Serbia	6.9	17.3	19.7	21.9	22.2	83.6	19.0	21.3
Average	**15.5**	**20.8**	**22.0**	**24.6**	**23.7**	**32.9**	**17.8**	**19.1**
	First five years of integration process				**Five years before accession**			
	1995	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2004**
CEE countries								
Latvia	40.2	41.4	35.2	28.7	35.5	40.2	42.3	41.1
Estonia	44.9	45.4	48.0	44.1	58.2	53.9	47.6	46.5
Lithuania	27.6	29.4	29.2	26.0	26.6	26.9	27.2	28.1
Czech Republic	38.7	35.4	39.1	41.8	43.7	51.2	54.0	50.9
Hungary	31.9	40.9	48.5	52.3	60.8	58.2	51.9	51.0
Poland	18.4	19.6	18.9	17.9	21.0	21.9	23.5	28.1
Slovenia	44.5	41.5	42.0	39.0	44.7	46.0	45.2	44.4
Slovak Republic	44.3	38.6	47.9	50.1	28.5	59.9	58.8	65.7
Average	**22.2**	**22.0**	**24.6**	**25.1**	**28.6**	**29.7**	**29.2**	**30.0**

Source: WIIW and author's calculations.

It is interesting to stress out that Western Balkan countries in the same integration phase, but in period 2006-2010, during financial boom received three times bigger inflow of FI. Following the theoretical findings we can assume that strong DI inflow generated the strong trade and especially export flows. Table II shows export values for both Western Balkan and CEE countries.

Comparing the export figures of WB counties to CEEC countries, for the period "First five years of integration process" we found out that indicators were pretty much the same. Hence, we came to conclusion that FDI in Western Balkan wasn't export favorable like in CEE countries. For this purpose we will analysis the import dynamics for both regions. Table III presents import of goods data for the period 2000-2010.

TABLE III. IMPORT OF GOODS AS A % OF GDP 2000-2010

				First five years of integration				
WB countries	**2000**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**
Albania	29,8	30,0	30,6	31,9	36,9	37,8	35,3	39.7
Bosnia&Herzegovina	70.7	66,3	68,8	61,9	65,0	66,1	51,6	41.7
Croatia	36,6	40,7	41,3	43,0	43,5	43,5	33,3	33.0
Macedonia	56,1	52,2	53,5	57,4	61,2	66,0	51,5	59.0
Montenegro	0,.	52,0	53,7	69,7	78,0	82,6	55,9	29.7
Serbia	13,7	44,6	40,8	43,3	45,2	168,7	34,2	43.9
Average	**34,3**	**44,5**	**48,2**	**51,2**	**55,0**	**77,5**	**43,6**	**41.3**
	First five years of integration				**Five years before accession**			
	1995	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2004**
CEE countries								
Latvia	40,2	41,4	35,2	28,7	35,5	40,2	42,3	41,2
Estonia	62,5	67,7	68,0	58,6	72,1	66,3	62,8	65,4
Lithuania	39,3	43,0	46,6	40,6	40,0	42,9	42,9	50,4
Czech Republic	42,1	44,6	47,7	46,0	46,9	56,8	59,0	55,9
Hungary	35,1	43,7	52,4	56,7	67,0	62,3	55,0	57,6
Poland	19,6	25,8	26,4	26,9	28,2	26,0	27,2	34,5
Slovenia	49,5	45,3	45,7	44,6	50,4	49,1	46,3	51,4
Slovak Republic	45,4	48,2	58,5	55,4	62,9	70,0	67,5	69,1
Average	**41,7**	**45,0**	**47,6**	**44,6**	**50,4**	**51,7**	**50,4**	**53,2**

Source: WIIW and author's calculations.

The data in Table III shows that level of import of goods in Western Balkan region exploded in 2008 and after has adjusted to crisis circumstances. In the crisis time, balance of payment position for the most WB countries has been seriously worsen, mostly due to weak export performance [13], putting all countries in non sustainable economic position in long run. It gives fruitful ground further research exploration of future development strategies of the Region. The following and most important question is how to better manage FDI inflows and terms of business environment in next period (post crisis), regarding more sustainable economic development for host countries. In that context all regional countries should start working on adopting and adjusting their terms of business environment and the regulatory system, in other to enable bigger inflow of the FDI in tradable sectors.

III. REGULATORY REFORMS FOR BETTER MANAGING FDI AND SUSTAINABLE GROWTH IN REGION

The experience of transition countries in the previous period confirmed the necessity of constant changes of the regulatory frame. Still, it is important to point out that some regulatory changes in Region in the previous period often came across the review of the expert public in regards that they are in contrast to the constitutional system and existing legal frames, and in that way the discriminated domestic companies. The question of appropriate approach to the regulatory reforms in the area of FDI was analyzed in the professional literature. Namely, in the study of Alfaro and Charlton in which they researched the influence of the FDI on the economic growth, as one of the conclusions is that the constitutional and economic triggers of the foreign investment will not be justified unless the investment brings to the economic growth for all contract parties [15]. In other researches there is a need that countries offer careful support while working on managing constitutional policy in the area of the FDI. We can specially emphasize the fact that not all investments bring the same benefits, especially in cases when they bring to financial unpredictability, anti-market practices, abusing market prices, squeezing the domestic companies out or disproportions in the ownership [16]. All that was mentioned above can lead us to conclude that in inevitable liberalization of the legal frame, we should be careful and find the balance between the quality of law, its efficiency and following the benefits that are brought by the concrete investments to the country. It is the reinforcement of the monitoring of investment realization which is one of the trends in the direction of foreign investments after the economic crisis has been over. Namely, during the economic crisis, certain legal mechanisms of monitoring and supervising of realization of the FDI projects were developed. This is also a basic issue of the rule of Law - openness towards foreign investments does not mean tolerating contract obligations [17]. Such issues didn't get enough attention in Regional countries in the previous period.

One of existing issues is whether the existing regulatory reforms that were carried out quickly and without more detailed coordination represent a good way for long term sustainable growth. The literature that deals with the FDI in Western Balkan countries are not devoted to the detailed analyses of the legal frame of attracting the FDI. Another aim of this paper is to point out to the significance of the efficient functioning of the institutions of legal system for attracting the FDI in Region.

Based on the analysis of creating and functioning of the legal frame of FDI in Region in the previous period, we can conclude that there used to be objective obstacles for attracting a higher level of the FDI. The most significant obstacles for attracting the FDI are as follows:

- Historical legacy of legal system functioning without clear property holder
- Existing legal infrastructure and human resources that did not comply with the needs of social changes
- Incompleteness and inconsistency of the legal system in the beginning of the privatization
- Frequent changes of the legal regulations
- Absence of clear strategy in attracting foreign investments
- Especially lack of coordination in adopting regulation and adjusting its content
- Absence of sufficient degree of culture of law implementation
- Existing of various types of property
- Under-affirmation of the inviolability of private property
- Insufficient protection of creditors of contractual relations
- Underdeveloped corporate law with a big number of new institutions whose existence was imposed by the new Terms and Conditions

The biggest number of above mentioned obstacles comes from inherited fifty years of socialist system and some other from isolation, which was not easy to transform according to the principles of the European law that regional countries are striving to. Upon starting the transition process, a lot of time was needed in order to provide good quality of law and to create appropriate institutions which will obtain its efficient implementation in practice. Comprehensive social changes through which regional countries passed as a transition countries left consequences on their legal system.

Apart from inherited historical obstacles, we think that the slowness in implementation of the process of privatization and choice of certain privatization models significantly limited a bigger inflow of the FDI. According to some researches, business environment and the privatization are key factors for FDI development in transition countries [18]. The researches also confirm that specific choices of the privatization models as well as legal, political and economic environment represent significant factors which influence decision making upon the investment [19], [20]. Without any doubts, privatization of the state companies brought to the increase of foreign direct investments, and later the privatized companies influenced the productivity growth with their operation as well as creating the new system of values.

IV. Conclusion

It has become evident that Western Balkan countries need a different development strategy that is more oriented on actual development needs in the region. Balkan countries shared a common growth model, driven by strong capital inflows, rapid credit expansion, and consumption-based domestic demand booms. “The sustainability of this model was in doubt even before the crisis, as it was leading up to rising external imbalances and vulnerabilities that were kept at bay only as long as abundant foreign capital remained available” [10]. The drying up of foreign capital, forced significant corrections of the large and widening current account deficits that characterized the pre-crisis years [21]. Vulnerabilities of the region become more oblivious through the crisis time after 2008.

Against this background, the global crisis has in many respects represented a structural break with the past [10], 14], [21]. The biggest limitation of existing growth model is its weakness of these countries to utilize foreign capital into their productive capacity and export base. Future external adjustment should rely on export expansion based on increase of competitiveness of real sector and import substitution, rather than on a restrained domestic demand

The inflow of the foreign investments, that will bring long term sustainable development, should significantly depend on further improvement of the quality of law and its efficient implementation in practice, in the future period in Region. The authors support the creation of liberal environment for foreign investments, but at the same time they point out to the need of protecting the legal security in the whole system of foreign investments.

Without any doubts, the law with enough quality should monitor its appropriate implementation - i.e. the effectiveness of law as legal value. This discrepancy between legal and actual is especially expressed in the policy of attracting foreign investments. Regulatory competitiveness among transition countries influenced that the choice of the investor depended on the quality of the legal regulation at the beginning. Nowadays, it mostly depends on its implementation in practice because majority of transition countries liberalizes their systems both in a declarative and normative way, and adjusts them towards attracting direct foreign investments.

References

[1] L. Poulsen and R. Hufbauer, “Foreign direct investment in times of crisis,” *Peterson Institute for International Economics Working Paper*, vol. 11, no. 3, pp. 35-47, 2011.

[2] P. Loungani and A. Razin, "How beneficial is foreign direct investment for developing countries?" *Finance and Development*, vol. 38, no. 2, pp. 6-10, 2001.

[3] A. Mody, A. Razin, and E. Sadka, "The role of information in driving FDI flows: Host-country transparency and source-country specialization," *IMF Working Paper*, WP/03/148, pp. 1-45, 2003.

[4] C. Daude and E. Stein, "The quality of institutions and foreign direct investment," *Economics and Politics*, vol. 19, no. 3, pp. 317-344, 2007.

[5] H. P. Lankes and A. J. Venables, "Foreign direct investment in economic transition: The changing pattern of investments," *Economics of Transition*, vol. 4, no. 2, pp. 331-347, 1996.

[6] K. B. Smarzynska, "Does foreign direct investment increase the productivity of domestic firms," *WB Policy Research Working Paper*, no. 2923, pp. 1-37, 2002.

[7] A. Johnson, "FDI inflows to the Transition Economies in Eastern Europe: Magnitude and Determinants," *The Royal Institute of technology-Centre of Excellence Forstudies in Science and Innovation*, pp.1-45.

[8] M. Busse and J. Groizard, "Foreign direct investment, regulations and growth?" *The World Economy*, pp. 861-886, 2008.

[9] J. Mencinger, "Direct and indirect effects of the FDI on current account," *in Proc. 13th Workshop on Alternative Economic Policy in Europe*, Brussels, 2007, pp. 23-35.

[10] E. Cocozza, A. Colabella, and F. Spadafora, "The impact of the global crisis on South-Eastern Europe," *IMF Working Paper*, WP/11/300, pp. 1-35, 2011.

[11] Y. Kinoshita and N. F. Campos, "Estimating the determinants of foreign direct investment inflows: How important are sampling and omitted variable biases?" *BOFIT, Discussion Papers*, vol. 10, pp. 1-33, 2004.

[12] P. Mitra, "Capital flows to EU new member states: Does sector destination matter?" *IMF Working Paper*, WP/11/67, pp. 1-54. 2011.

[13] International Monetary Fund, "Europe strengthening the recovery," *Regional Economic Outlook*, pp. 1-89, 2011.

[14] P. Bijelic and D. Jacimovic, "Effects of the world economic crisis on exports in the CEEC: Focus on the western Balkans," *Economic Annals*, vol. 58, no. 196, pp. 71-98, January-March 2012.

[15] L. Alfaro and A. Charlton, "Growth and the quality of foreign direct investment: Is all FDI equal?" *CEP Discussion Paper*, no. 830, pp. 1-45, 2007.

[16] C. J. Wan, "Foreign direct investment: determinants, trends in flows and promotion policies, investment promotion and enterprise," *Development Bulletin for Asia and the Pacific*, vol. 3, pp. 99-112, 2003.

[17] K. Sauvant, "The regulatory framework for investment: Where are we headed? The future of foreign direct investment and the multinational enterprise research," *Global Strategic Management*, vol. 15, pp. 407-433, 2011.

[18] D. Holland and N. Pain, "The diffusion of innovations in central and eastern Europe: A study of the determinants and impact of foreign direct investment," *NIESR Discussion Paper*, no. 137, pp. 25-41, 1998.

[19] G. Roland, *Transition and Economics: Politics, Markets and Firms*, Cambridge, Massachusetts Institute of Technology, 2000.

[20] K. Carstensen and F. Toubal, "Foreign direct investment in central and eastern European countries: A dynamic panel analysis," *Journal of Comparative Economics*, vol. 32, pp. 3-22, 2004.

[21] J. Becker and R. Weissenbacher, "Growth models, FDI and crisis in central eastern and south eastern Europe," in *Proc. the Scientific Conference Development Potentials of Foreign Direct Investments: International Experience*, Belgrade, 2011, pp. 1-13.

Danijela P. Jacimovic was born in Podgorica, Montenegro on March 25, 1972. Her Ph.D degree in International finance was earned at the University of Belgrade, Faculty of Economics, Belgrade, Serbia and Montenegro at 2002. Master degree in International economics was earned at the same institution at 1997. Graduate studies finished at the University of Montenegro, Faculty of Economics, Podgorica, Montenegro, 1994. Her major field of study is international economics and international finance. Her current job is ASSOCIATE PROFESSOR at the University of Montenegro, Faculty of Economics and Faculty of Political Sciences, Podgorica, Montenegro, since 2008. Previous posts include position as Assistant professor at the same institutions for the period 2003-2008, and research assistant 1995-2003. She was one of the lectures at the summer school organized by Vienna University during 2006-2008 and Chevning fellows at the London School of Economics in 2003, 2004, 2006, 2010.

Mijat Jocović was born in October 5, 1980, in Bijelo Polje, where he finished primary and secondary school. He graduated from Faculty of Law in Podgorica, University of Montenegro. In 2004-2005, he enrolled graduate studies - master program in Business law course at the Faculty of Law, University of Belgrade. Master's degree of legal science he gained in September 2007 with master theses "Corporate Governance in Montenegro". In March 2011 at the Faculty of Law, University of Belgrade with honors he defended his doctoral dissertation on "Legal aspects of the prohibition on the use of privileged information on the securities markets". His major field of study is commercial law, corporate governance and the Foreign investment law. He is employed at Faculty of Economics, University of Montenegro since February 1, 2014. In June 2012, he was elected to the academic position of ASSISTANT PROFESSOR on subjects *Law, International Business Contracts.*