

Neshat Podvorica, MSc

Assistant and PhD Candidate
University of Prishtina “Hasan Prishtina”
Faculty of Economics
E-mail: neshat.podvorica@uni-pr.edu
Orcid: <https://orcid.org/0009-0008-0397-0578>

Avdullah Hoti, PhD

Full Professor
University of Prishtina “Hasan Prishtina”
Faculty of Economics
E-mail: avdullah.hoti@uni-pr.edu
Orcid: <https://orcid.org/0000-0002-5312-0300>

Petrit Gashi, PhD

Associate Professor
University of Prishtina “Hasan Prishtina”
Faculty of Economics
E-mail: petrit.gashi@uni-pr.edu
Orcid: <https://orcid.org/0000-0003-1772-7057>

FDI DRIVERS IN CENTRAL EUROPE, THE BALTICS, AND THE WESTERN BALKANS: THE ROLE OF MACROECONOMIC AND INSTITUTIONAL FACTORS

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Abstract

This paper investigates the role of the business environment on the inflow of foreign direct investments across Central Europe, the Baltics, and Western Balkan countries. It places particular emphasis on the macroeconomic framework and institutional quality of the countries in focus. The paper employs the two-step GMM method on a panel data over the period 2002-2022. Initially, the results suggest a path dependency in FDI inflows. Further, FDI inflows increase with economic growth, trade openness, and price stability. There is no evidence of a statistically significant relationship between FDI inflows and institutional variables. Broadly, findings indicate that, in order to promote foreign investment, governments should prioritize a stable macroeconomic environment, including price stability, as well

ensuring a proper integration into the global market. Further research is needed to examine the role of institutional setting in FDI inflows.

Keywords: *FDI inflows, macroeconomic stability, institutions, Central Europe, the Baltics, the Western Balkans*

1. INTRODUCTION

The business environment is a complex mix of market conditions, regulatory frameworks, political stability, and institutional quality. Strong institutions, such as clear property rights, an efficient legal system, and stable governance, provide a predictable and a level playing environment for businesses to thrive and grow. Institutions are so profound to the business environment that North (1990, 1) defines them as ‘the rules of the game of a society’. Governments across the globe have placed business environment reforms generally, and institutions reforms specifically, at the top of their policymaking agendas.

There is a significant body of literature that argues that Foreign Direct Investments (FDI) inflows hinge on the complexity of business environment, especially the quality of institutions (Contractor, Dangol, Nuruzzaman, & Raghunath, 2020; Paul & Jadhav, 2019; Yakubu, 2020; Adams, 2010; Asiedu, 2006; Chakrabarti, 2001). Foreign investors are sensitive to political stability, a country’s ability to implement public policies, the effectiveness of law enforcement mechanisms, inclusive decision-making, protection of property rights, the quality of public services, the development of the banking system, and the degree of trade openness.

FDI is a vital source of capital and expertise, generating spillover effects across various sectors and the broader economy (Alfaro, Chanda, Kalemli-Ozcan, & Sayek, 2004; Rodriguez, Siegel, Hilman & Eden, 2006; Caves, 2007; Buthe & Milner, 2008; Walsh & Yu, 2010; Stojčić & Orlić, 2016). This explains the efforts and resources directed at attracting FDI in the Central Europe, the Baltics, and Western Balkans countries since the fall of communism.¹ Obviously, the former group of countries, now part of the EU, have been much more successful in attracting FDI than the latter group due to their better initial conditions, proximity to the EU market, higher level of human resources, and more stable business and institutional environment.

As opposed to Central European countries and Baltics, Western Balkans devastated from wars and political instability throughout the nineties, is still perceived a high-risk region. As Uvalic (2010) and Demekas, Horvath, Ribakova and Wu (2005) argue, the region’s transition to a market economy and democracy has gone through more challenging circumstances compared to Central Europe and Baltic countries. Still, the region managed to attract significant foreign investments after political tensions subsided in early 2000. New investment opportunities

¹ Kikerkova (2017) provides an overview of policy measures implemented in North Macedonia to attract FDI.

started to emerge in the region largely triggered by the privatisation of the former socially/state owned enterprises (Pavlinek, 2015). In recent years, with the new trends of nearshoring and friend shoring, Western Balkans is becoming an important destination for foreign investors.

Central Europe, the Baltics, and Western Balkans countries exhibit similar economic growth rates, but with substantial differences in the level of per capita income. The current average per capita income in the Western Balkans in 2022 corresponds to the average per capita income in Central European countries in 2002 (World Bank, 2024). This gap in per capita level is explained partially by the inflow of foreign capital in Central European and Baltics countries, with FDI being the force behind the export-led growth. Regarding other macroeconomic factors, all three regions experienced moderate inflation up to the Covid-19 pandemic. Compared to Western Balkans countries, Central European countries exercise a greater degree of economic and institutional stability. The latter have stabilized their public debt levels at around 60 percent of GDP. Regarding trade relations, exports of Central Europe countries are significantly higher than those of Western Balkans countries, averaging around 60 percent and 40 percent of GDP respectively. Similarly, the share of imports is around 60 percent of GDP.

Due to the historical legacy, improving the business environment in the Western Balkans seems more challenging compared to Central European countries. Supported by a number of international organisations and institutions, the Western Balkans countries have sought to tone down political tensions and embark on a path of joining the EU. The latter has influenced institutional reforms across the board in these countries, helping to foster a favourable environment for FDI.

This study addresses two main research questions: first, what is the relationship between FDI inflows and key macroeconomic indicators such as economic growth, inflation, and trade openness? Second, how does institutional quality affect FDI inflows across Central Europe, the Baltics, and the Western Balkans? The advanced Arellano and Bond Generalized Method of Moments (GMM) technique is applied on a panel data for 17 countries for the period 2002-2022. As pointed out these countries share several common traits: a shared communist past; a transition process from centralized systems to market economies, often guided by similar policy prescriptions; and, comparable economies in terms of size. However, there are key differences between these countries that help us addressing the core objectives of this paper. Specifically, these differences lie in their institutional quality, macroeconomic framework, and, most notably, their EU status – while the Central European and Baltic countries are EU members, the Western Balkan countries are at various stages of the accession process. Overall, all these factors can help explain country and regional differences in FDI inflows over time. The findings show that while economic growth, inflation, and trade openness positively influence FDI inflows, public debt and institutional governance indicators show no significant impact. Notably, the Western Balkans underperform in attracting FDI compared to Central Europe and the Baltics, as indicated by a significant negative regional dummy.

This research contributes to the FDI and institutional economics literature by comparing FDI inflows across three different European regions indicating the influence of historical, institutional, and EU-membership related factors. Using the advanced Arellano and Bond GMM technique, it highlights the importance of macroeconomic drivers like growth, inflation, and trade openness, while questioning the role of institutional quality. Finally, it underscores the Western Balkans' persistent FDI underperformance, calling for targeted policy measures.

The structure of the paper is as follows. Section 2 provides a discussion of the theory and the relevant literature, highlighting key findings and addressing differences among them. Section 3 explains the data and methodology. Section 4 discusses results, while also offering a comparative analysis based on findings from the empirical literature. The paper concludes with a summary and proposals for further research.

2. LITERATURE REVIEW

A range of theoretical approaches has been developed to explain the determinants of FDI inflows. The most prominent strands of thought are the Douglas North's Institutional Theory and the Dunning's OLI Paradigm. First, North's Institutional Theory argues that both formal and informal institutions of a society, including laws, regulations, and cultural norms shape economic performance by influencing incentives and reducing uncertainty (North, 1990; 1994). Well-functioning institutions – clear property rights, contract enforcement, and transparent legal systems – reduce transaction costs and risks associated with investing in foreign markets.² Countries with strong and efficient institutions, which minimize transaction costs, ensure political stability, and provide legal protections, are more likely to attract sustained FDI.

Second, the other prominent theory is the "OLI paradigm", developed by John Dunning in the late 1970s. This framework continues to be highly influential in understanding why firms engage in FDI, highlighting the importance of firm-specific advantages (Ownership), the attractiveness of a particular market or region (Location), and the benefits of internalizing operations rather than outsourcing (Internalization). Dunning incorporated the role of institutions into the OLI paradigm, initially within the framework of location advantage and later extending it to other components (Dunning, 1998; 2004; Dunning & Lundan, 2008).

Based on Dunning's OLI paradigm and North's Institutional Theory, Sabir, Rafique and Abbas (2019) assert that FDI depends primarily on market size, macroeconomic stability and institutions. Therefore, based on the interweaving of

² The role played by institutions in reducing transaction costs provides the core to the Oliver Williamson's Transaction Cost Theory. In terms of FDI, the reasoning behind the latter theory is that the high-quality institutions that lower transaction costs create a more favourable environment for FDI. That is, the more efficient the institutional framework, the lower the costs and risks for investors investing abroad.

these two strands of thought, the role of institutional and macroeconomic indicators in inward FDI is addressed by a series of studies summarized below.

The evidence confirms the positive relationship between FDI and economic growth for many country groupings and in many regions (see Alfaro et al., 2004; Alfaro, Chanda, Kalemli Ozcan, & Sayek, 2010; Wijeweera, Villano, & Dollery, 2010; Krstevska & Petrovska, 2011; Herzer, 2012). Grosse and Trevino (2005) confirm this relationship for the Central and Eastern European countries. Malovic, Özer, & Zdravkovic (2019) report inconsistent findings for the Western Balkans countries. While, Todorov, Tsvetkov, Mirchova, and Durova (2022) find no significant relationship for the newly acceded EU countries.

Generally, there is an inverse relationship between the high inflation and FDI, since a high inflation creates uncertainty and increases operational costs (Alfaro et al., 2010; Bittencourt, 2012; Agudze & Ibhagui, 2021). However, Mason and Vracheva (2017) find that moderate inflation positively impacts foreign investments, particularly in developing countries. For industrialized countries, Agudze and Ibhagui (2021) report that on average an increase in inflation beyond 1.35 percent negatively affects FDI, whereas for non-industrialized countries this threshold is 6.63 percent. Regarding the Central Europe countries, Grosse and Trevino (2005) find insignificant relationship between inflation and FDI.

In an effort to enhance the business environment and attract FDI, countries concentrate on consolidating institutions, developing favourable tax policies, and stabilizing public debt (Caves 2007; Campos & Kinoshita, 2008). Gemmell, Kneller, and Sanz (2008) observe that competition among countries to attract FDI through tax reductions have implications for public spending and public debt. It is inconclusive whether public debt positively or negatively affects FDI, as the outcome depends on the economic policies guiding its use in the development process. Overall, as Reinhart and Rogoff (2010) in their seminal paper explain, high public debt can deter FDI by increasing the perceived risk of macroeconomic instability and raising concerns about future taxation or government default, making the investment climate less attractive to foreign investors. In line with this, Mah, Mukkudem, Petersen, Miruka and Petersen (2013) observe a negative relationship between public debt and FDI. However, Oche, Mah and Mongale (2016) find a positive relationship between these two variables.

Trade openness generally promotes foreign investments by reducing barriers and increasing market access. Adamczyk (2021) argues that eliminating trade barriers may reduce FDIs in the short term, whereas in the long term it increases productivity and therefore the inflow of FDI. The empirical investigations for Central Europe, the Baltic, and the Western Balkans countries provides interesting insights on the complex relationship between openness and FDI. Popescu (2014) shows that regional integration increases FDI, as documented by the increased FDI inflows in Central European and Baltic countries following the EU accession. While, Popovic and Eric (2018) emphasize that the EU's Stabilization and Association Agreement with the Western Balkans countries has

not increased the inflow of FDI. Estrin and Uvalic (2014), on the other hand, argue that FDI and trade openness are more complementary than substitutes for Central Europe and Baltic countries, although robust results have not been found for Western Balkans countries.

Positive relationship between the quality of institutions and FDI has been reported widely (Alfaro, Kalemli Ozcan, Volosovych, 2008; Lucke & Eichler, 2016; Oduola, Bello, & Popoola, 2022). Acemoglu, Johnson and Robinson (2005) emphasize that differences in institutions lead to completely opposite developments, as seen in the contrasting trajectories of many countries in the world, developed and developing. Adenuga (2023) concludes that almost all indicators related to the quality of institutions are positively related to FDI. This result is confirmed for Central European countries by Grosse and Trevino (2005). Brada, Kutan and Yigit, (2006) and Minović, Stevanović and Aleksić (2021) argue that political and institutional instability in Western Balkans countries has reduced FDIs.

The two key ingredients of the quality of institutions affecting FDI inflows are the control of corruption and contract enforcement. In the case of the former, it is not straightforward to estimate the impact of corruption on FDI, as there are no reliable instruments to measure corruption. Measuring corruption often relies on subjective perceptions (Lambsdorff, 2007; Svensson, 2005). Beyond this limitation, most studies report a negative relationship between corruption and FDIs (Wei 2000; Asiedu, 2006; Luu, Nguyen, Ho & Nam, 2019), with Grosse and Trevino (2005) and Popescu (2014) reporting similar outcomes for CEE countries. Broadly, the way corruption is perceived varies with the political regime, level of development, inclusiveness of marginalized groups, and the history (Kunicova & Rose-Ackerman, 2005; Salari & Noghanibehambari, 2021). In some other instances, the literature shows that corruption induces FDI inflows. For instance, Egger and Winner (2005) argue that some countries see corruption as a 'helping hand' for promoting FDIs, with Erum and Hussain (2019) reporting that corruption may not negatively affect FDIs in cases when investments depend on obtaining permits or licenses for operation.

Regarding contract enforcement, Contractor et al. (2020) argue that countries characterized by well-functioning contract enforcement mechanisms attract more FDI. In line with this, Asiedu (2006), Nunn (2007) and Javorick (2002) emphasizes that poor contract enforceability slows down foreign investments, especially in economic sectors that are contract-intensive, such as those where the intellectual property rights is paramount to their activities as well as in countries facing high degree of informality. Ahlquist and Prakash (2010) find that greater levels of FDI are linked to a low-cost contract dispute settlement environment. Therefore, Myburgh and Paniagua (2016) assert that, beyond the local judicial system, access to international arbitration is likely to enhancing FDI.

3. DATA AND METHODOLOGY

Our empirical investigation utilizes data from 17 countries between 2002 and 2022. The sample includes six Western Balkan nations – Albania, Bosnia and Herzegovina, North Macedonia, Montenegro, Kosovo, Serbia – eight Central European countries – Bulgaria, Croatia, Czech Republic, Hungary, Poland, Romania, Slovakia, Slovenia – and three Baltic states – Estonia, Latvia, Lithuania.

To analyse the factors influencing FDI inflows, we construct a model that considers both macroeconomic and institutional variables, alongside controls for various other factors. Specifically, the inward FDI, expressed as a natural logarithm of per capita FDI inflows in Euro (*lnfdiic*), is regressed against three groups of covariates, namely: (i) macroeconomic variables; (ii) institutional dimensions; and (iii) control variables. The latter group of variables control for a number of specific observed and unobserved effects impacting business environment. Variable definition and their respective sources are presented in Table 1.

Table 1 Definition of variables and data sources

Abbreviation	Definition	Source
<i>lnfdiic</i>	Natural logarithm of per capita FDI inflows, €	wiiw
<i>gdppch</i>	The annual real GDP growth	World Bank
<i>inf</i>	Changes in consumer prices, annual %	World Bank
<i>ggd</i>	General government debt as a share of GDP	IMF
<i>tradegdp</i>	Trade as a share of GDP	World Bank
<i>cc</i>	WGI control of corruption, index 0 – 100	World Bank
<i>ge</i>	WGI government effectiveness, index 0 – 100	World Bank
<i>psa</i>	WGI political stability and absence of violence, index 0 – 100	World Bank
<i>rq</i>	WGI regulatory quality, index 0 – 100	World Bank
<i>rl</i>	WGI rule of law, index 0 – 100	World Bank
<i>va</i>	WGI voice and accountability	World Bank
<i>pcl</i>	Composite PCA for six WGI indicators of institutional quality	n/a
<i>cur</i>	Dummy: 1 if the country uses €, 0 otherwise	n/a
<i>cri</i>	Dummy: 1 for years after the financial crisis of 2008-9, 0 otherwise	n/a
<i>cov</i>	Dummy: 1 for Covid-19 and post-covid years 2020 onwards, 0 otherwise	n/a
<i>eu</i>	Dummy: 1 for EU members, 0 otherwise	n/a
<i>region</i>	Dummy: 1 for Western Balkan countries, 0 for other countries	n/a

Our analysis incorporates several key macroeconomic variables, including annual real GDP growth rate (*gdppch*), a measure of economic performance and overall investment attractiveness. Next, the annual average inflation rate (*inf*) assesses the impact of price stability on FDI inflows. Further,

the public debt (*ggd*) accounts for the size/share of the public sector in the economy. Finally, the degree of trade openness (*tradedgp*) measures the integration of a country's economy in global markets.

A set of independent variables is included to account for the effect of various aspects of institutional quality on FDI. The variables include the six World Bank World Governance Indicators (WGI) dimensions of governance. As in Kaufmann, Kraay and Mastruzzi (2010), we introduce the following indicators: (i) control of corruption (*cc*), which expresses the perception of the extent to which public power is exercised for private gain, as well as the influence of the private sector on its functioning; (ii) government effectiveness (*ge*), which reflects the quality of public services, the stability of the public administration against political pressure, and its readiness and capacity to implement specific policies; (iii) political stability and absence of violence (*psa*), which measures the political stability of the country and the risks arising from various factors; (iv) regulatory quality (*rq*), which assesses perceptions regarding the government's ability to formulate and enforce effective policies that foster private sector growth; (v) rule of law (*rl*), which expresses the effectiveness of contract enforcement, the respect for property rights, trust in police and courts, and the perception of crime in society; and, (vi) voice and accountability (*va*), which measures perceptions of citizens' participation in selecting their government, and the freedom of expression, association, and media. All indicators range from 0 to 100, where higher values indicate higher degree of institutional quality.

A correlation matrix of institutional variables shows a considerable degree of association.³ This is not unexpected (Daude & Stein, 2007; Buchanan, Le, & Rishi, 2012; Sabir et al., 2019). To address this issue, two approaches were employed. First, the variables were included individually in separate econometric specifications (see results below). Second, the Principal Component Analysis (PCA) approach was applied, which involves constructing a single variable from multiple interrelated variables – six governance indicators – to identify effectively the relationships between the independent and dependent variables (Abdi & Williams, 2010; Cantah, Brafu Insaïdoo, Wiafe, & Adams, 2018; Greenacre, Groenen, Hastie, d'Enza, Markos & Tuzhilina, 2022). Initially, all six institutional indicators discussed above were standardized. The results show that the first variable accounts for more than 87 percent of the variance across all variables (with an eigenvalue of 5.234). The results for the first component (*pc1*) were then generated, with a minimum value of -4.72 and a maximum value of 3.95. The closer to the positive value of 3.95, the better is the performance of the country's institutions; and conversely, the closer to the negative value of -4.72, the poorer is the institutional performance in that country.

Finally, significant social, economic and political developments that occurred since 2002 are expected to influence FDI inflows. Therefore, specific control variables are introduced in econometric estimations to account for the following developments: (i)

³ See Table A1 in Appendix.

the 2008-09 financial crisis; (ii) the adoption of euro; (iii) EU accession; (iv) the Covid-19 pandemic; and (v) a regional dummy for Western Balkans.

The following table summarizes the descriptive statistics of the variables. It is important to note that some variables have fewer observations because certain countries did not have regular evaluations in the World Bank's WGI for specific institutional dimensions, especially in the early 2000s. This is especially the case for the Western Balkans countries. In the econometric estimation, a balanced dataset is being used.

Table 2 Descriptive statistics

Variable	Obs	Mean	Std. Dev.	Min	Max
<i>lnfdiic</i>	347	5.609	.884	2.197	7.754
<i>gdppch</i>	350	3.226	4.005	-15	14
<i>inf</i>	356	3.556	4.064	-2	23
<i>ggd</i>	350	42.097	20.291	4	107
<i>tradegdp</i>	351	112.236	32.757	54	204
<i>cc</i>	357	56.863	15.737	23	92
<i>ge</i>	350	61.909	16.522	12	90
<i>psa</i>	347	59.553	18.424	15	94
<i>rq</i>	349	68.453	14.538	28	93
<i>rl</i>	357	60.006	16.722	21	90
<i>va</i>	357	64.263	14.387	32	90
<i>cur</i>	357	.272	.445	0	1
<i>cri</i>	357	.667	.472	0	1
<i>cov</i>	357	.143	.35	0	1
<i>eu</i>	357	.543	.499	0	1
<i>region</i>	357	.353	.479	0	1
<i>pcl</i>	347	0	2.288	-4.721	3.959

The baseline econometric specification is shown in Equation (1), whereby: $\ln fdiic_{i,t}$ is the natural logarithm of FDI inflows per capita in country i at time t ; $gdppch_{i,t}$ is the growth rate of GDP; $inf_{i,t}$ is the inflation rate; $ggd_{i,t}$ is the general government debt as percentage of GDP; $tradegdp_{i,t}$ is the trade-to-GDP ratio; $pc_{i,t}$ represents the first principal component of institutional variables; u_i represents the unobserved country-specific effects; and e_{it} is the error term.

$$\ln fdiic_{i,t} = \alpha_0 + \beta_1 gdppch_{i,t} + \beta_2 inf_{i,t} + \beta_3 ggd_{i,t} + \beta_4 tradegdp_{i,t} + \beta_5 pc_{i,t} + u_i + e_{it} \quad (1)$$

We apply the Arellano-Bond estimator to analyse dynamic component within the model (Arellano and Bond 1991; Arellano and Bover 1995). The Arellano-Bond (1991) GMM estimator is designed to address potential endogeneity issues arising from the inclusion of lagged dependent variables as predictors, which can lead to biased and inconsistent parameter estimates in dynamic panel data models if not properly handled (Wooldridge, 2001). To overcome the latter issue, the Arellano-Bond (1991) utilizes lagged levels of the endogenous variables as instruments for differenced equations, thus accounting for unobserved individual effects and measurement errors. The model in Equation (1)

is further extended in Equation (2), whereby $lnfdiic_{i,t-1}$ is the lagged dependent variable, capturing the dynamic nature of the model.

$$lnfdiic_{i,t} = \alpha_0 + \alpha_1 lnfdiic_{i,t-1} + \beta_1 gdppch_{i,t} + \beta_2 inf_{i,t} + \beta_3 ggd_{i,t} + \beta_4 tradedgp_{i,t} + \beta_5 pci_{i,t} + \varepsilon_{it} \quad (2)$$

The Arellano-Bond estimation (1991) involves a two-step procedure. In the first step, an initial consistent estimate is obtained by applying a difference GMM estimator. In the second step, a robust weighting matrix is used to increase the efficiency of the estimator and correct for any heteroskedasticity present in the data. This approach allows to effectively model the relationship between FDI and its covariates while accounting for endogeneity and serial correlation.

4. FINDINGS

Several preliminary tests were conducted to identify the most appropriate econometric specification. The Arellano-Bond test is used in conjunction with the GMM estimator to detect first-order (AR(1)) and second-order (AR(2)) autocorrelation in the residuals after differencing the data. The null hypothesis for these tests is that the first-differenced residuals are not autocorrelated. A p-value of $AR(1) < 0.05$ indicates the presence of first-order autocorrelation, which is expected in dynamic models. Conversely, the null hypothesis for the AR(2) test is that no second-order autocorrelation exists in the differenced residuals. In our case, the p-value of AR(2) is greater than 0.05 across all models, indicating the absence of second-order autocorrelation. These tests confirm the robustness of the GMM model.

As pointed out, the Arellano-Bond GMM approach is particularly recommended for handling endogeneity problems, especially when addressing the role of institutions in FDI (Daude and Stein, 2007; Sabir et al., 2019). Both the Arellano-Bond test for autocorrelation and the Hansen test for overidentifying restriction were used to validate the instruments⁴ and the model specification. Our results show a p-value of the Hansen test above 0.05 for all models, suggesting that the null hypothesis of instrument exogeneity cannot be rejected. Furthermore, the results of Sargan test, with its smallest p-value of 0.729, also supports the validity of the instruments.

The econometric results are presented in Table 3. Overall, the results suggest that lagged FDI ($lnfdiic_{i,t-1}$), economic growth ($gdppch$), inflation (inf), and trade openness ($tradedgp$) have a positive effect on FDI. The coefficient related to government debt (ggd) is positive but not statistically significant in most specifications. None of the institutional quality variables are statistically significant.

⁴ Note that GMM estimators use internal instruments derived from the model itself. These instruments typically include lagged values of the endogenous variables (in level or difference form) that are assumed to be uncorrelated with the current error term but correlated with the endogenous explanatory variables. The use of such instruments allows the GMM estimator to provide consistent estimates by mitigating endogeneity issues.

Table 3 Two-step GMM estimates

Dependent variable: Natural logarithm of inward FDI in euros (<i>lnfdiic</i>)								
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
<i>lnfdiic_{t,t-1}</i>	0.597**	0.550**	0.526***	0.552**	0.459*	0.653***	0.541***	0.645**
	(0.247)	(0.220)	(0.185)	(0.229)	(0.235)	(0.214)	(0.187)	(0.294)
<i>gdppch</i>	0.042***	0.033	0.033**	0.040***	0.031**	0.034**	0.034**	0.032
	(0.013)	(0.021)	(0.014)	(0.013)	(0.014)	(0.017)	(0.014)	(0.021)
<i>inf</i>	0.029***	0.034***	0.028***	0.033***	0.037***	0.024*	0.029**	0.030**
	(0.009)	(0.011)	(0.010)	(0.009)	(0.014)	(0.013)	(0.011)	(0.014)
<i>ggd</i>	0.003*	0.004*	0.003	0.003	0.002	0.001	0.003	0.003
	(0.002)	(0.003)	(0.003)	(0.003)	(0.003)	(0.004)	(0.003)	(0.005)
<i>tradegdp</i>	0.005	0.005***	0.005***	0.004*	0.005***	0.004**	0.004***	0.004
	(0.003)	(0.002)	(0.001)	(0.002)	(0.002)	(0.002)	(0.002)	(0.003)
<i>pcl</i>	-	0.022	-	-	-	-	-	-
		(0.032)						
<i>cc</i>	-	-	0.003	-	-	-	-	-
			(0.005)					
<i>ge</i>	-	-	-	0.006	-	-	-	-
				(0.008)				
<i>psa</i>	-	-	-	-	0.005	-	-	-
					(0.007)			
<i>rq</i>	-	-	-	-	-	-0.003	-	-
						(0.017)		
<i>rl</i>	-	-	-	-	-	-	0.003	-
							(0.007)	
<i>va</i>	-	-	-	-	-	-	-	0.001
								(0.020)
Constant	1.373	1.652	1.707*	1.412	1.975*	1.641	1.645*	1.223
	(1.038)	(1.139)	(0.974)	(0.940)	(1.147)	(1.053)	(0.963)	(1.432)
Obs.	319	316	319	317	316	317	319	319
AR1	0.018	0.016	0.012	0.016	0.023	0.010	0.012	0.023
AR2	0.121	0.114	0.104	0.138	0.148	0.107	0.105	0.116
Hansen test (p-value)	0.138	0.122	0.144	0.117	0.110	0.111	0.147	0.153
Sargan test (p-value)	0.963	0.766	0.871	0.956	0.788	0.986	0.875	0.729
No. of control variables	17	17	17	17	17	17	17	17

Robust standard errors are in parentheses: *** p<.01, ** p<.05, * p<.1

The results for lagged FDI inflows (*lnfdiic_{t,t-1}*) show a degree of path dependency in FDI, indicating that past FDI levels significantly influence current level of FDI. The coefficient ranges from 0.46 to 0.65 and is statistically significant at the 1 percent level across all specifications. The path dependency of FDI inflows

indicates the importance of the established networks and local knowledge that foreign investors may gain, which makes it easier for them to continue investing in the same region. Additionally, the existing investors can signal to other potential investors that the market is attractive and stable, further reinforcing the investment trajectory. These results are in line with previous research (see Sabir et al., 2019).

The coefficient for annual real GDP growth (*gdppch*) is positive and statistically significant in all specifications, except in specification 8. Holding other variables constant, a one-percentage-point increase in the annual GDP growth per capita results in a 3.4 to 4.2 percent increase in the natural logarithm of FDI inflows. This suggests that higher economic growth rates signal a more conducive business environment and potential for expanding market, which can enhance investors' confidence and stimulate additional foreign investment. Similar findings have also been reported by Saini and Singhania (2018).

In the case of inflation (*inf*), positive and significant relationship is identified across all specifications. Specifically, a 1 percent increase in inflation is associated with an increase of between 2.4 and 3.7 in the natural logarithm of FDI inflows, depending on the specification. This suggests that higher inflation, while ranging within a controlled range, might not deter foreign investments. As Agudze and Ibhagui (2021) report, an inflation rate beyond the average of 6.63 percent in non-industrialized countries negatively affects FDI. In our case, as shown in Table 3, for the countries included in the analysis, we observe an average inflation rate of 3.556 percent. Similar to these findings, Mason and Vracheva (2017) find that maintaining a targeted inflation positively impacts foreign investments, particularly in developed countries.

Similarly, trade openness (*tradegdp*) is significant and positive in all specifications, except in specifications 1 and 8. A one percent increase in *tradegdp* leads to an increase of between 0.4 and 0.5 in the natural logarithm of FDI inflows. This positive relationship highlights the role of trade openness in attracting foreign direct investment, as such countries offer better opportunities for foreign investors to engage in cross-border trade and benefit from larger markets. These findings align with Sabir et al. (2019).

General government debt as a share of GDP (*gga*) is mostly insignificant, except in the first two specifications and only at 10 percent confidence level. The increase in government debt typically occurs for two reasons: first, when a country faces a crisis, budgetary expenditures need to increase; second, in the absence of private capital, the participation of the public sector increases. In the context of the latter, while high public debt can often be seen as a fiscal risk, this positive relationship might indicate that foreign investors view certain levels of government borrowing in the three analysed regions as a sign of active fiscal policies that could support economic growth and infrastructure development, thereby improving the investment environment.

The results show that the coefficients for all institutional variables are insignificant. This may result from a limited degree of variation in institutional

quality across the countries studied. Another factor could be that, in some cases – such as Serbia – investments may be driven by geostrategic considerations (Hake and Radzyner, 2019). Additionally, countries with well-established diasporas might experience investments that are less dependent on institutional quality (Central Bank of Kosovo, 2024).

Finally, a set of control variables was included to account for various factors that could influence FDI inflows (see GMM estimates in Appendix/Table A2). Among these, the coefficient for Western Balkans dummy is the only one found to be significant. Its negative value suggests that countries in the Western Balkans are expected to receive 2.297 percent less foreign investment per capita compared to the other countries studied.

5. CONCLUSIONS

This paper examines the impact of the business environment on FDI, with a focus on the macroeconomic framework, institutional setting, and other key factors affecting FDI inflows. It employs the two-step GMM method on a panel data from 2002 to 2022, covering 17 countries of Central Europe, the Baltics, and the Western Balkans. Findings show that economic growth, inflation, and the openness of the economy have positive impact on FDI. As for the public debt, no significant relation with FDI has been found. In the second group of variables, encompassing the institutional governance, no significant relationship is found either. Although the analysis does not produce statistically significant results, it remains an area that requires further consideration, particularly given its long-term importance for fostering a conducive business environment.

This research makes important contributions to the literature on FDI and institutional economics. First, it provides a comparative analysis of FDI inflows across Central Europe, the Baltics, and the Western Balkans, highlighting how historical, institutional setting, and EU prospects shape regional disparities in FDI inflows. Second, the paper employs the advanced Arellano and Bond GMM technique, offering robust insights into the role of macroeconomic factors – such as economic growth, inflation, and trade openness – in driving FDI inflows, while challenging the assumed significance of institutional governance variables. Third, it identifies the Western Balkans' consistent underperformance in attracting FDI compared to other countries in the sample, emphasizing the need for tailored policy interventions to bridge the gap with other transitional economies.

These findings carry important implications for policymakers in the Central Europe, Baltics, and Western Balkans regions. The strong positive relationship between economic growth and FDI inflows shows the significance of maintaining a stable and conducive macroeconomic environment to attract FDI. A similar conclusion can be drawn regarding the price stability as controlled inflation encourages investment by reducing uncertainty. This is especially relevant for countries that seek to boost growth through FDI. Additionally, the study highlights

the role of economic integration in global markets, demonstrating that countries more deeply embedded in international trade networks are more successful in drawing FDI. This indicates that greater efforts to remove trade barriers and enhance export capacity are vital components of an FDI-focused strategy.

While the study offers valuable insights on FDI determinants, the lack of statistical significance for the institutional variables calls for further investigation. In our case, one possible explanation for the insignificant results regarding institutional variables could be the limited variation in institutional quality across the studied countries and over the observed timeframe. Future research may need to focus on more granular institutional data that captures subtle differences in governance reforms. Another area for future research could be the role of informal institutions and non-economic factors, such as geopolitical considerations and diaspora-driven investments, which may influence FDI inflows in ways that traditional macroeconomic and institutional models do not fully capture.

For countries in the Western Balkans, as national governments continue to reform and integrate into global markets, their ability to attract sustained FDI will depend not only on short-term economic policies but also on building robust institutions. Going forward, policymakers in the region must continue to refine their strategies, balancing immediate economic priorities with long-term institutional development, to fully leverage FDI as a driver of growth.

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Appendix

Table A1 Pearson correlations matrix for the institutional variables

Variables	<i>cc</i>	<i>ge</i>	<i>psa</i>	<i>rq</i>	<i>rl</i>	<i>va</i>
<i>cc</i>	1.000					
<i>ge</i>	0.866	1.000				
<i>psa</i>	0.753	0.830	1.000			
<i>rq</i>	0.817	0.853	0.770	1.000		
<i>rl</i>	0.912	0.882	0.797	0.882	1.000	
<i>va</i>	0.902	0.869	0.817	0.851	0.892	1.000

Table A2 Two-step dynamic system GMM for control variables

	(1)	(2)	(3)	(4)	(5)
	lnfdiic	lnfdiic	lnfdiic	lnfdiic	lnfdiic
L.lnfdiic	.505**	.683**	.57***	.57**	.376**
	(.199)	(.327)	(.209)	(.258)	(.188)
gdppch	.027	.039**	.033*	.023	.038**
	(.02)	(.015)	(.018)	(.018)	(.019)
inf	.031***	.019	.03**	.022	.031***
	(.01)	(.03)	(.012)	(.017)	(.009)
ggd	.006*	.003	.004	.006	.002
	(.003)	(.004)	(.003)	(.005)	(.003)
trade GDP	.008*	.008	.007**	.01	.003
	(.005)	(.009)	(.004)	(.006)	(.004)
pcl	-.004	-.006	.149	-.411	.076
	(.046)	(.08)	(.236)	(.274)	(.048)
cri	-.181				
	(.2)				
cur		-.89			
		(1.591)			
eu			-.978		
			(1.722)		
region				-2.297**	
				(1.06)	
cov					.235
					(.163)
cons	1.574	.832	1.869*	1.793*	2.959**
	(1.04)	(1.847)	(1.09)	(1.021)	(1.182)
Observations	316	316	316	316	316

Robust standard errors are in parentheses. *** $p < .01$, ** $p < .05$, * $p < .1$

Mr. sc. Neshat Podvorica

Asistent i doktorski kandidat
Sveučilište u Prištini "Hasan Prishtina"
Ekonomski fakultet
E-mail: neshat.podvorica@uni-pr.edu
Orcid: <https://orcid.org/0009-0008-0397-0578>

Dr. sc. Avdullah Hoti

Redoviti profesor
Sveučilište u Prištini "Hasan Prishtina"
Ekonomski fakultet
E-mail: avdullah.hoti@uni-pr.edu
Orcid: <https://orcid.org/0000-0002-5312-0300>

Dr. sc. Petrit Gashi

Izvanredni profesor
Sveučilište u Prištini "Hasan Prishtina"
Ekonomski fakultet
E-mail: petrit.gashi@uni-pr.edu
Orcid: <https://orcid.org/0000-0003-1772-7057>

POKRETAČI INOZEMNIH IZRAVNIH ULAGANJA U SREDNJOJ EUROPI, NA BALTIKU I ZAPADNOM BALKANU: ULOGA MAKROEKONOMSKIH I INSTITUCIONALNIH ČIMBENIKA

Sažetak

U radu se istražuje uloga poslovnog okruženja u priljevu inozemnih izravnih ulaganja u Srednju Europu, Baltik i zemlje Zapadnog Balkana. Poseban naglasak stavlja se na makroekonomski okvir i kvalitetu institucija zemalja u fokusu. U radu se koristi GMM metoda u dva koraka na panel podacima u razdoblju 2002. – 2022. Inicijalni rezultati upućuju na ovisnost o putanji priljeva inozemnih izravnih ulaganja. Priljevi inozemnih izravnih ulaganja povećavaju se s gospodarskim rastom, trgovinskom otvorenosti i stabilnošću cijena. Nema dokaza o statistički značajnom odnosu između priljeva inozemnih izravnih ulaganja i institucionalnih varijabli. U širem kontekstu nalazi pokazuju da bi vlade trebale dati prioritet stabilnom makroekonomskom okruženju, uključujući stabilnost cijena, kao i osiguravanje pravilne integracije u globalno tržište, kako bi promicale inozemna ulaganja. Potrebna su daljnja istraživanja kako bi se ispitala uloga institucionalnog okruženja u priljevima inozemnih izravnih ulaganja.

Ključne riječi: *priljev inozemnih izravnih ulaganja, makroekonomska stabilnost, ustanove, Srednja Europa, Baltik, Zapadni Balkan.*

JEL klasifikacija: *E22, F21, F23, O52, Q43, P33.*