

# The Role of FDI in the EU Accession Process: The Case of the Western Balkans\*

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## Abstract

The countries of the Western Balkans are less developed and more backward in terms of transition than Central and Eastern European countries. Per capita GDP of the CEE economies is two to three times higher than in the Western Balkans (with exception of Croatia). Furthermore, foreign capital inflows into the Western Balkans are much lower than into the CEEC. Positive effects of FDI for the host country have been pointed out in numerous theoretical and empirical studies and are widely acknowledged: the transfer of technological know-how, the implementation of advanced management structures and the modernisation of the manufacturing sector strengthen the economy's competitiveness, facilitate access to western markets and stimulate growth.

The authors of this paper underline the importance of high FDI inflows as they are crucial for the successful transition and especially for the catching-up process of the Western Balkans while trying to reach the levels of the most advanced transition economies. The central question is how a higher level of FDI flows into the Western Balkans could be reached. The notable FDI performance of CEEC during their preparation for the EU accession in the last decade and the experience of earlier EU enlargements (e.g. the so-called "Southern Enlargement" and the EU accession of Ireland) demonstrate that economic integration can increase FDI inflows. The Western Balkans follow a specific process of economic integration. On the one hand, intra-regional integration aims at normalizing the economic relations after the period of disintegration during the nineties and helps to create a common market. On the other hand, the regions aspire to access the EU, as it has been demonstrated by the EU membership application of Croatia. The authors of the paper analyse whether these economic integration processes that advance simultaneously could have an impact on FDI inflows comparable to the FDI attraction experienced in advanced Central and Eastern European countries, Spain, and Ireland.

**Keywords:** FDI, Economic Integration, EU-Accession, Transition, Western Balkans

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## **Introduction**

In May 2004, ten countries will join the European Union (EU). What is striking is the fact that the economic and political systems of eight of these countries had been organized according to the principles of socialism, meaning government ownership and a one-party system, until only fifteen years ago. Although the initial reasons for the Central and Eastern European countries' (CEEC<sup>1</sup>) EU integration process are likely to have primarily been of political nature, the decisive factor for admission into the EU is compliance with the following economic criteria: the implementation of a market economy and the ability to withstand competition pressure within the single market. A success determining factor of the CEECs' transition process is the high inflow of foreign capital, having a significant positive impact on the economic development of the CEE accession candidates through high privatisation revenues, transfer of know-how, implementation of developed management strategies, and spillover effects. The successful transformation of the CEECs can serve as an example for the effects of a prospective EU accession: The CEE region is – from an economic point of view – already integrated in the EU.

At the Council in Thessaloniki in June 2003, the European Union held out the prospect of accession to the countries of the Western Balkans.<sup>2</sup> With regard to the future economic and political development in the region, this confirmation is of enormous significance. Definitely, the EU integration will speed up the transition process in the Western Balkans. The ability of these countries to attract foreign direct investment (FDI) will be crucial for the catching-up to the most developed transition economies. The aim of this paper is to examine the interdependencies of the EU integration process and FDI inflows into the Western Balkans' region.

## **Basic Indicators and the Transition Progress in South Eastern Europe (SEE)**

The literature on transition distinguishes between two groups of transition countries: the CEECs and the SEECs.<sup>3</sup> In general, the CEECs have reached a much higher level of development than the SEECs. While the CEECs have been able to establish market economies operating quite successfully, the SEECs have considerably fallen behind in their economic performance. Even though the population of SEE is only 30% smaller than the population of CEE, its GDP accounts to less than one third of the GDP of CEE. Per capita GDP of the individual CEECs is between two to

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<sup>1</sup> Czech Republic, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia.

<sup>2</sup> The Western Balkans or SEE-5 countries are: Albania, Croatia, Bosnia & Herzegovina, Macedonia and Serbia & Montenegro.

<sup>3</sup> SEE (or SEE-7) countries are: Western Balkans, Bulgaria and Romania.

three times higher than that of the SEECs.<sup>4</sup> With the exception of Albania, the real GDP of the SEECs is lower than that prior to reforms. In contrast, the CEECs have exceeded this level by far. However, taking into account the basic indicators of the Western Balkans (table 1), it becomes evident that this region is by no means a homogeneous entity. The economic indicators differ significantly among the countries. Croatia resembles a CEEC with regard to its economic performance, whereas the remaining four countries are clearly falling behind.

Table 1: **Basic Indicators 2002**

	Population persons mln	GDP EUR mln	GDP pc EUR	GDP pc USD at PPP	real GDP 1990 = 100
Albania	3.1	4,908	1,583	4,000	123.3
Bosnia & Herzegovina	3.8	5,574	1,467	6,400	-
Macedonia	2.0	3,916	1,958	6,520	87.3
Serbia & Montenegro	8.3	14,000	1,687	4,500	52.8
Western Balkans without Croatia	17.2	28,398	1,651	5,065	73.9
Croatia	4.4	23,820	5,414	10,030	92.9
Western Balkans (SEE-5)	21.6	52,218	2,418	6,076	83.6
Bulgaria	7.8	16,668	2,136	8,250	87.9
Romania	22.4	48,384	2,160	6,590	92.3
Eastern Balkans	30.2	65,052	2,154	7,019	91.2
SEE-7	51.8	117,270	2,263	6,626	88.0
Czech Republic	10.2	73,855	7,241	15,740	107.2
Hungary	10.2	65,852	6,456	13,550	115.6
Poland	38.6	199,549	5,170	10,510	146.5
Slovakia	5.4	25,144	4,656	12,820	111.6
Slovenia	2.0	22,367	11,184	18,530	127.4
CEE-5	66.4	386,767	5,825	12,210	130.4

*Source: own calculations on the basis of wiiw database*

A picture similarly diverse emerges if one takes a look at the progress of transformation in this region. This progress can be measured by a variety of EBRD indicators which attempt to evaluate the outcomes of reforms in different areas such as enterprises, markets and trade, financial institutions, and infrastructure. Certain parts of the evaluated areas either display no or rather small cross-country differences at all.

<sup>4</sup> With the exception of Croatia.

Table 2: Progress in Transition in SEE, mid-2002

Country	Enterprises				Markets and Trade			Financial Institutions		Infra-structure
	Private sector share of GDP	Large-scale privatization	Small-scale privatization	Governance & Enterprise restructuring	Price liberalization	Competition policy	Trade & foreign exchange system	Banking reform & interest rate liberalization	Securities markets & non-bank financial institutions	Infra-structure reforms
Albania	75%	2+	4	2	3	2-	4+	2+	2-	2
B & H	45%	2+	3	2-	3	1	3	2+	2-	2+
Croatia	60%	3	4+	3-	3	2+	4+	4-	3-	3-
Macedonia	60%	3	4	2+	3	2	4	3	2-	2
S & M	40%	2	3	2	3	1	3+	2+	2-	2
Bulgaria	70%	4-	4-	2+	3	2+	4+	3+	2+	3-
Romania	65%	4-	4-	2	3+	2+	4	3-	2	3

Source: EBRD (2002)

In the areas of small-scale privatization, trade, and the foreign exchange system, all countries exhibit scores ranging between 3 and 4+ which is a fairly good result. In particular, in the category of price liberalization all countries yield the score 3. Regarding the areas of large-scale privatization, competition policy, governance and enterprise restructuring, securities markets and non-bank financial institutions, and infrastructure, the EBRD-indicators report either no or just a comparably small progress. Only Croatia achieves a considerably good result in the subsection of banking reforms (4-). In contrast to the discussed indicators, the subcategory “private sector share of GDP” displays a notably large scope among the different countries. The private sector share of GDP varies between 40% (Serbia & Montenegro) and 75% (Albania). It is, however, striking that Croatia outscores the two candidate countries Romania and Bulgaria in at least a few areas, even though these two countries in turn outperform the other four countries in the Western Balkans. Nevertheless, Croatia’s advanced position according to the EBRD indicators cannot compensate the deficit of the rest of the region. As a result, if one compares the overall scores of the Western Balkans and the CEEC, it becomes evident that the Western Balkan countries are substantially lagging behind in terms of transition progress. Hungary, for example, has only three out of nine areas in which it has received a score of 3 or 3+.<sup>5</sup> The EBRD transition indicators serve as a means to evaluate the progress achieved towards establishing a market economy. These indicators are easy to interpret and provide a possibility to compare progress of transformation in different countries.

<sup>5</sup> In the remaining six areas Hungary was evaluated with a 4-, 4 or 4+. See EBRD (2002), pp. 20-21.

## FDI and Transition

Between the average transition score and the FDI performance of a country (FDI per capita), a strong correlation can be proven, especially when the GUS countries that are rich in natural resources are excluded.<sup>6</sup> A comparison of the FDI inflows into the CEEC and the SEEC underlines this very clearly (table 3):

Table 3: Basic FDI Indicators in SEE and CEE

	FDI stock (USD mln.)		FDI per capita (USD)		FDI stock (% of GDP)		FDI inflows (USD mln.)	
	1996	2001	1996	2001	1996	2001	1996	2001
Albania	291	800	89	233	10.9	19.1	90	200
Bosnia & Herzegovina	-	470	-	125	-	10.2	-	130
Bulgaria	446	3,997	53	504	4.5	29.5	109	689
Croatia	874	6,703	195	1,530	4.4	33.1	516	1,502
Macedonia	40	824	20	403	0.9	24.0	11	442
Moldova	117	609	27	167	6.9	41.2	24	149
Romania	1,234	7,698	55	343	3.5	19.4	263	1,137
Serbia & Montenegro	-	1,155	-	139	-	11.0	-	165
SEE-8	3,002	21,100	33	377	3.3	2.6	1,013	4,414
Czech Republic	8,572	26,764	832	2,604	14.9	47.2	1,428	4,916
Hungary	14,961	23,562	1,470	2,311	33.1	45.4	2,275	2,443
Poland	11,463	39,000	297	1,010	8.0	22.1	4,498	8,000
Slovakia	2,046	6,000	380	1,115	10.0	29.3	358	1,475
Slovenia	1,998	3,400	1,006	1,709	10.6	18.1	194	442
CEE-5	39,040	98,727	587	1,485	13.6	30.5	8977	17276

Source: *The Vienna Institute for International Economic Studies (WIIW)*<sup>7</sup>

In fact, FDI inflows are higher in those countries successful in implementing market economic reforms: The CEEC have been able to attract by far more FDI than the SEEC. The interaction of FDI and the progress of transformation is not only limited to the impact of the latter on the former; both processes are strongly inter-related. On the one hand, market economic reforms and a satisfying macroeconomic performance guarantee a solid basis for profitable investment and – as a result – raise the attractiveness for foreign investors. On the other hand, the increased FDI inflows can speed up the transformation process tremendously and decisively. This is shown by the example of the development of FDI inflows in the CEEC.

Before the fall of the Berlin Wall in 1989, FDI into socialist countries were limited to joint ventures with state owned enterprises. At that time, the stock of investment in CEE consisted of a

<sup>6</sup> The GUS countries demonstrate high FDI inflows although they show little success in the transformation process. See Falcetti et al. (2003), p. 16.

<sup>7</sup> See Hunya (2002)

mere 0.1 % of the world's investment stock.<sup>8</sup> After 1989, foreign capital began to flow into the region. During the initial phase of transformation, public inflows dominated the entire flow of capital. However, after the market economic reforms were able to register an improvement, the public flows resided. Since 1992, private flows of capital started to surmount the flows of public capital and FDI inflows into the CEEC increased rapidly thereby. Until 1998, there was a flow of 74.4 billion USD of FDI into all Eastern European transition countries, a share of 67 % went to the CEEC (50.5 billion USD).<sup>9</sup> The FDI flows into CEE concentrated on very few countries. At the beginning of the transformation process, a significant part of the foreign capital entered in the framework of privatization. Thus the countries that quickly decided to sell state possessions to foreign investors profited most by high FDI inflows, i.e. especially Hungary, but also Poland which chose the direct sale as the privatization strategy at an early stage. More than half of the entire FDI designated to the whole region went into these two countries.

In spite of the difficulties during the first half of the nineties linked to the voucher-privatization, the Czech Republic evolved to the third largest recipient of foreign capital flows in the region. The proportion of the CEE-3 countries during the first decade of transition rose to as high as 78 %.<sup>10</sup> In the case of Poland, apart from the privatisation strategy the size of the local markets contributed to the beneficial FDI performance. Besides the low cost of labour, it is also the geographic closeness to the EU core countries that accounts for the high FDI inflows into the CEEC. Especially Hungary and the Czech Republic, by focussing on EU markets, have attracted a large amount of the export oriented FDI appearing mostly in the form of Greenfield Investments. In comparison, Slovenia remained far behind its potential as far as the amount of FDI inflows is concerned. One reason for this development is the heritage of the Yugoslavian workers' self-management which decisively influenced the Slovenian privatization strategy.<sup>11</sup>

## **The Role of FDI for the Transition Economies**

For the recipient countries it is not the amount of FDI that plays an important role, but its contribution to the economic development. Doubtlessly, the inflow of foreign capital has positive effects. FDI closes the gap between low domestic savings and the enormous need for investment. Foreign investment does not only increase production in the real sector, but also facilitates the necessary economic modernization and the transfer of know-how. FDI are responsible for yet

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<sup>8</sup> See Bandelj (2002), p. 4.

<sup>9</sup> See Zakharov and Kusic (2001), p. 11.

<sup>10</sup> The so called CEE-3 countries are Czech Republic, Hungary and Poland. See Kaminski (2001), p. 31.

<sup>11</sup> In Slovenia, management-buy-out was the predominant privatization method. Foreign investors were often excluded from privatization.

another positive effect in the domestic economy; more enterprises can profit from the investments, i.e. sub-contractors and -suppliers. Furthermore, international production creates additional employment in the recipient countries. The role of FDI for transformation countries will be demonstrated in detail by the example of CEE below.

The flow of capital created by FDI provides the recipient country with new technology and investment goods. Thus the competitiveness of goods and services produced in the country will improve, leading to higher sales on international markets. Foreign capital does not only supply modern technologies but also advanced management techniques. Positive effects often emerge through investors who train and continue to train their employees in order to improve the expertise of human capital.

The positive effects of FDI are not limited to FDI destined firms themselves. Positive spillover effects for domestic companies and branches can be expected. These effects are realized when domestic firms profit from foreign investors' knowledge in the fields of technology and marketing. Such positive spillover effects can be demonstrated by the example of the car industry in Eastern Europe. The cooperation of Volkswagen AG and Skoda provides hundreds of sub-contractors with modern technology and a better technical standard. 70% of the components for the Skoda production come from Czech contractors. Suzuki and General Electric have decided to modernize sub-contractor firms in the Czech Republic.<sup>12</sup> Spillover effects to human capital appear when skilled management staff from foreign owned companies decides to work in domestically owned enterprises.

FDI are believed to have a positive impact on growth. A study on the influence of foreign direct investment on the Polish economy shows that there is a distinct positive correlation between the amount of FDI and the growth of GDP. The analysis concludes that FDI were responsible for 39 % of the growth rate in Poland during the period of 1991 to 1995.<sup>13</sup> Although this study refers exclusively to data of the Polish economy, the positive consequences of foreign direct investment for the economic process may be transferred to the remaining reform states. In the Czech Republic, companies with foreign participation could easier stand the recession in the end of the nineties than firms solely dependent on domestic capital. This is why the Telecom monopolist SPT with up to 33.5 % of strategic foreign investments, was very successful in 1999 whereas other large state-owned enterprises suffered great losses.<sup>14</sup> The work productivity is also positively affected by FDI inflows. In Hungary, work productivity increased by 6 % between 1992 and 1995 in firms that had been privatized by the means of foreign capital, whereas the increase was only 3.2 % in state-

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<sup>12</sup> See Protsenko (1999), pp. 33-34.

<sup>13</sup> See Kusic (1997), p.403.

<sup>14</sup> See Katzmann (1999), p. 2.

owned companies.<sup>15</sup> These examples demonstrate clearly the positive impact of FDI on economic development in the CEEC.

FDI also facilitate access to new markets and might thereby contribute to rise export incomes in the recipient countries. At the beginning of the transformation process, CEEC were rather limited to get a hold on Western markets due to the lack of sufficient marketing experience as well as the insufficient quality of their products. Modern technologies and advanced management techniques were hence introduced by foreign investors and helped to raise the competitiveness of Eastern European products. At present, many Hungarian firms produce exclusively for the export to the EU. In 1998, the proportion of firms with foreign participation in foreign trade in Hungary reached 75 %.<sup>16</sup> The above mentioned Czech car producer Skoda, which has belonged to the German Group of VW since the beginning of the nineties, exported roughly 80% of its entire production as early as 1999, the largest amount went to developed industrial countries. During the socialist era, Skoda cars had often provoked smiles in the West. The Hungarian pharmaceutical group Pharmavit sells its products to 14 countries world-wide. This could have hardly been possible without the take-over by Bristol-Myers Squibb in 1996.<sup>17</sup>

FDI are an important source for financing performance balance deficits and thereby improve credit liability in the recipient countries which in turn facilitates access to other financial sources. The positive correlation of the EBRD indicators with the FDI inflows could be – as we have already mentioned above – interpreted as follows: the countries that experienced high FDI inflows in the earlier phase of transition are more advanced in the implementation of reforms leading to a market-based economy than countries with lower FDI inflows. The advanced reformist countries comply faster with the two economic criteria<sup>18</sup> for the EU accession and can start the integration process earlier. That explains the role of foreign capital in the EU integration process: FDI significantly contribute to the compliance of economic conditions for EU membership. This has already be evident in the South expansion of the EU. At the end of the 1970s and in the beginning of 1980s, foreign capital played an important role in the modernization of the Spanish economy, what facilitated the preparation for the EU membership. The announcement of a membership perspective could contribute to the increase of FDI inflows into the regions to be integrated. The influence of economic integration on FDI flows will be presented below both from a theoretical and an empirical perspective.

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<sup>15</sup> See Accenture (2002), p. 25.

<sup>16</sup> See Kaminski (1998), p. 24.

<sup>17</sup> See Fiess and Fugazza (2002), p. 7.

<sup>18</sup> These economic criteria are: the establishment of a market economy and the capacity to withstand the competitive pressures and market forces within the EU.

## **Economic Integration and FDI Flows**

Even though political considerations often precede Regional Integration Agreements (RIA), it is obvious that economic considerations are the driving forces behind them: Countries join a RIA because they expect economic advantages from the cooperation. In the short term, it is expected that integration stimulates inter-regional trade and investment; long-term expectations amount to an increase of growth rates by combining larger markets, intensified competition, and a more effective resource allocation.

Earlier theoretical and empirical literature on FDI tends to view cross-border trade and capital movements as two possibilities to serve foreign markets which exclude each other. This point of view is based on the existence of tariff barriers in trade causing import substitutive investments. Therefore, an abolishment of tariff limitations is to reduce FDI flows and stimulate repatriation of foreign owned assets. There is a similar relationship between FDI and non-tariff barriers: the weakening or even the abolishment of non-tariff barriers stimulates export but reduces FDI inflows. RIA can change the regional production structure and thus entail the move of investments from one country to another. This kind of influence on intra-regional FDI flows is called “investment diversion”.<sup>19</sup> As a result, intra-regional net FDI inflows may increase in some member countries but decrease in others.

There is justification to expect gains from interregional FDI flows. FDI inflows from countries outside the RIA are supposed to increase when the average protection level (external tariffs, etc.) against third countries rises as a result of the RIA. Foreign capital inflows also increase as result of the extension of domestic markets in the recipient countries. The integrated common market will be large enough for multinational corporations (MNCs) to establish new affiliates which would not have been profitable before the RIA. An increase of FDI inflows are unlikely to be equal in the integrated region: countries offering the most favourable locational advantages will gain higher profits from this development than other new RIA members. Such an “investment creation” is a reaction to trade diversion caused by the RIA.<sup>20</sup> It is, however, also possible that a RIA reduces investment flows outside the integrated regions. When the FDI structure of integration consists of horizontally organized affiliates in several countries of a region, such a structure is likely to be suboptimal after the RIA has been introduced. After the integration the network of affiliates may be rationalized. Some countries might experience a disinvestment because foreign MNCs move their business activities to other countries within the RIA. But in general, arguments for an increase of FDI inflows from outside the RIA into the integrated region seem to prevail.

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<sup>19</sup> See Blomström and Kokko (1997), p. 6.

<sup>20</sup> See Di Mauro (2000), p. 6.

Undoubtedly, a significant part of foreign direct investment is resulting from tariff-jumping motives. However, the point of view that avoiding trade barriers is *the* main motive for FDI becomes more and more questionable. Recent theoretical FDI and MNC literature claims another motive to be responsible for direct investment: the exploitation of firm specific intangible assets. To explore new markets in which local firms have better knowledge concerning consumer preferences, markets, and business practices, an internationally engaged corporation needs to own some specific intangible assets if it wants to compete successfully. Technological expertise and marketing know-how are examples belonging to them intangible assets. The effective use of intangible assets makes companies internalize their international operations by establishing foreign affiliates instead of exporting or licensing. From this point of view, FDI can be expected even when formal trade barriers between countries do not exist. The importance of the internalization motive for FDI explains the fact that worldwide FDI inflows take place between OECD countries where tariff and non-tariff barriers are relatively low. In projects undertaken to make use of intangible assets, the economic integration in form of trade liberalization does not create incentives to reduce investments or repatriate capital. The reduction of trade barriers can moreover vitalize overall FDI flows among trading partners when multinationals are not hindered to operate in an efficient way across borders. As a result, interregional net FDI inflows may increase in some member countries. This argument is often applied for vertical integrated FDI.

Economic integration can also generate various dynamic effects that influence FDI flows. The analysis of economic impacts of the EU's Single Market has shown that this integration process has led to a medium- and long-term increase of growth rates in the participating economies. This above average growth makes the total region more attractive – not only for domestic but also for foreign investors. In many cases inter- as well as intra-regional FDI is an important catalyst for dynamic integration effects. Higher FDI inflows vitalize competition pressure which in turn motivates local producers to apply efficiency enhancing strategies. Moreover, FDI promotes – either directly or through spillover effects – technology transfers. As it has been explained, MNCs compete successfully with already established domestic firms because they own firm specific intangible assets. It has been shown in various studies that these advantages of MNCs can also be transfer to local enterprises. This is done by demonstration effects, technical support of suppliers, or the training of workforce that might be employed by domestic firms later. Spillover effects cause sustainable higher growth rates and 'dynamic' advantages that result from economic integration.<sup>21</sup> By means of creating larger markets, economic integration leads to stronger growth of enterprises. Larger companies are more likely to invest in research and

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<sup>21</sup> See Fies and Fugazza (2002), p. 6.

development, supporting the creation of new intangible assets. In addition, enterprises in a new economic environment are motivated to enter strategic alliances or to merge with other companies and can thus increase or improve their competitiveness.

The analysis of static and dynamic effects of RIA on FDI flows shows that the establishment of an RIA tends to attract more investments than the several national markets. The predominant static effect is the internalization by use of the firm specific intangible assets. The most important dynamic effect is the increased attractiveness of an integrated region for investors, hence leading to additional intra- and inter-regional FDI flows. Giving a definite statement about the development of FDI in each particular country is difficult. Whereas some countries will experience a boom of foreign investment due their advantages (i.e. concentration of enterprises in the same branch, size and amount of potential suppliers, higher qualification of employees), net FDI outflows are likely to be registered in other countries. The Southern partners benefit from the positive impact of the economic integration on FDI flows as result of the North-South-integration (RIA among the developed and developing countries, i.e. Eastern enlargement of the EU, accession of Mexico to NAFTA), whereas in the case of the South-South-integration (RIA among developing countries, i.e. CEFTA, MERCOSUR), the effects are rather meagre.

### **FDI Inflows into the Western Balkan Countries**

The Western Balkan countries have received significantly less FDI than the CEECs. The political and economic uncertainties in the Balkans undermined the attractiveness for international investors: FDI inflows were generally very low until 2000 with the important exception of Croatia, receiving higher amounts of FDI from 1997 onwards. During the first half of the 90s (1989-1996), the cumulative net inflows into four<sup>22</sup> Western Balkan countries have amounted to only 900 million USD what corresponds to 2.1% of total FDI inflows into 27 transition economies. During the period between 1989 and 2001, SEE-5 have reached a share of only 6.3% (9,170 million USD).<sup>23</sup> Note that more than half of the cumulative FDI inflows in the Western Balkans have been destined to Croatia. Albania, Bosnia and Herzegovina, Macedonia, and Serbia and Montenegro have recently gained more stability. However, as shown above, the transition to the market economies is still incomplete and the majority of foreign investors still avoids these countries. The composition of FDI inflows into the Western Balkans is disappointing. FDI are mainly attracted through privatisation issues and have prevailed the market-seeking nature. For example, one-third of FDI in Croatia in 2000 and two-thirds of the inflow in Albania in the same year were generated

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<sup>22</sup> Data for Bosnia & Herzegovina are not available over this period.

<sup>23</sup> See Uvalic (2003), pp. 475-476.

by sales of a bank and the award of a mobile telephone license. The sale of the state's stake in the Macedonian national telecom operator in 2001 generated as much FDI as the preceding ten years.<sup>24</sup> There is a small share of export-oriented foreign investment in the region, FDI into greenfield investment and existing private companies is still low. The general investment environment remains risky, and therefore FDI cannot play the important role in the catching-up process of the Western Balkans.

Concerning per capita FDI, a big difference can be observed among the SEE-5 countries. Croatia has by far been the major recipient. During 1989-2001, it has attracted per capita FDI of 1,315 USD, which is comparable to that of the CEECs and is three to ten times higher than in other countries of the Western Balkans.<sup>25</sup> Among the investing countries, the EU member states increased their share over the last few years, nevertheless it is still smaller than in CEECs. The exception is Albania where almost all FDI come from Greece and Italy. These two neighbour-countries play an important role also in other countries of the Western Balkans. Austria and Germany have as well a significant share of FDI inflows into the region. The importance of EU's FDI in the Western Balkans will increase with the accession of Hungary and Slovenia, both countries that have been investing and will continue to invest into the region. The significant part of investments comes from outside of the EU, especially from the USA, Turkey, Kuwait and tax haven countries such as Cyprus or Lichtenstein. Other investments are either of Western Balkan domestic or of Russian origin.<sup>26</sup>

Regarding the structure of FDI, there is not much difference between the CEEC and the SEE-5: the most attractive sectors are manufacturing (with the clear dominance of domestic market oriented industries like breweries and tobacco), financial intermediation, the trading sector, telecommunication, and transport. Investments in these sectors contributed significantly to the efficiency of resource allocation, but only insignificantly to the generation of sustainable growth. For example, the share of foreign owned banks in the Western Balkans – especially in Croatia – is higher than in CEE. But their contribution to the growth of output has been rather modest: “the banks are ready to finance consumption, but to a much lesser extent investment”.<sup>27</sup>

The question is how a higher level of FDI flows in the Western Balkan can be reached. The region is making efforts to attract foreign investment. Success will depend on the improvement the overall climate for private activity (private sector development, the legal and regulatory framework for business, progress in privatisation, development of small- and medium-size enterprises,

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<sup>24</sup> See IMF and Worldbank (2001), p. 20.

<sup>25</sup> See Uvalic (2003), pp. 476.

<sup>26</sup> See Hunya (2000), p. 9.

<sup>27</sup> See Gligorov et al (2003), p. 28.

financial intermediation, etc.) and the deepening integration in the EU. The notable FDI performance of the CEECs during their preparation for the EU accession in the last decade and the experience of the earlier EU enlargements (e.g. so called “Southern Enlargement” and EU accession of Ireland) demonstrate that economic integration can contribute significantly to an increase of FDI inflows.

### **Empirical Evidence on the Impact of EU Integration on FDI Flows**

The impact of EU integration on FDI flows has been researched in numerous empirical studies.<sup>28</sup> After the foundation of the EU, a notable increase of intra- and inter-regional FDI flows was observed among the member countries. Ireland experienced a real FDI boom after its EU accession in the year 1973, US investments playing a significant role. Many US multinationals chose Ireland as their starting point to expand in Europe. FDI contributed significantly to economic growth above average and export performance, the reduction of unemployment, and the development of the high-tech sector.<sup>29</sup> Another story of success is the accession of Spain to the EU in 1986. The way of this country, from a backward, closed economy to one of the furthest developed market economies in Europe, is often called the “Spanish Economic Miracle”. The high FDI inflows resulting from the EU integration process have been responsible for the strong economic performance of the country. FDI inflows were especially intensive between 1988 and 1992, when they reached an average of 2 % of the BIP.<sup>30</sup> After Austria, Finland and Sweden had joined the EU in 1995, they became more attractive to foreign investors and are still the main destination for FDI in the EU.<sup>31</sup>

The EU integration process positively affected FDI flows into CEE candidate countries during last years. FDI inflows into these countries increased sharply since 1994, after the public commitment of the EU to eastern enlargement made by member-states at the Essen European Council (1994). Bevan and Estrin (2000) analyse the impact of these issue on FDI flows into the CEECs and find out that the Essen Council announcement was associated with a significant increase of FDI received by MOE-3 countries – the possible candidates for EU accession. The decision of the EU to open the negotiations with five CEE applicants (1997) led to an increase in the growth rate of FDI to the most successful applicant countries.<sup>32</sup> Claessens, Oks and Polastri (1998) examined capital flows to 21 transition countries over the 1992-96 period and determined

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<sup>28</sup> See Blomström and Kokko (1997) for an overview.

<sup>29</sup> See Barry (2002).

<sup>30</sup> See Barrios et al. (2002), p. 3.

<sup>31</sup> See Galego et al. (2002), p. 6.

<sup>32</sup> See Bevan et al. (2001), pp. 1-3.

that “the possibility of EU-accession has been an important determinant of private flows, especially FDI”.<sup>33</sup> Countries that applied for EU membership attracted more FDI. Kaminski (2001) underlines that the “EU factor” explains the high level of FDI inflows into CEECs compared with FDI received by the former Soviet republics, the members of CIS. But the EU integration factor played a significant role only in countries that early opted for radical economic reforms.<sup>34</sup> FDI in CEECs will grow further after their accession to the EU and will continue to play an important role in the catching-up process to the most developed EU member-states economies.

### **The EU Integration Process in the Western Balkans and Possible Implications for FDI Flows into the Region**

The Western Balkans follow a distinct path on their way to the EU: on the one hand, the intra-regional integration normalizes economic relations between the countries within the region after the disintegration period in 90s and helps to create a common market.<sup>35</sup> On the other hand, the Western Balkans aspire their EU accession. The EU is committed to the Stabilization and Association process for the region adopted in 1999 and consists of a Stabilization and Association Agreement (SAA).<sup>36</sup> The region does not present itself homogeneously regarding European integration: While the EU integration process in Macedonia and Croatia runs forward, the remaining Western Balkan countries stay at the beginning of this process. Actually, SEE-5 and the EU have following relations:

- SAAs: Macedonia and Croatia;
- Cooperation Agreement: Albania, SAA negotiations in progress;
- No contractual relations: Bosnia and Herzegovina, Serbia and Montenegro.<sup>37</sup>

The EU was the largest trade partner for the SEE-5 countries in 2002. Of all these countries Albania had the greatest EU share both in the export (92%) and in the import (71%) sector. At the same time Bosnia and Herzegovina had the smallest share with only 35% and 38%. If one considers absolute figures trade seem to fade a little. In 2002 the volume of exports to the EU amounted to 2,581 million USD for Croatia, to 928 million USD for Serbia and Montenegro, to 565 million USD for Macedonia and finally to 533 million EURO for Bosnia and Herzegovina.<sup>38</sup> Compared to the exports of Slovenia (a country with a population of only 2 million people) in the

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<sup>33</sup> See Claessens et al. (1998), p. 22.

<sup>34</sup> Vgl. Kaminski (2001), p.38.

<sup>35</sup> The European Union defines regional integration as a condition for a possible EU accession of the Western Balkan countries.

<sup>36</sup> SAA is similar but not identical to the Europe Agreements for the CEEC.

<sup>37</sup> See Gligorov et al. (2003), p. 31.

<sup>38</sup> Source: Central Bureau of Statistics for Croatia, National Central Banks for Macedonia and Serbia & Montenegro, EUROSTAT for Albania and Bosnia & Herzegovina.

EU of about 6,138 million USD in 2002<sup>39</sup>, the volume of EU trade of the Western Balkans appears to be rather small. In addition to this, the CEECs have experienced a tremendous growth regarding the EU exports during the first decade of transition, which cannot be stated about the Western Balkan countries where exports to the EU countries have quite stagnated. Only recently, EU exports have begun to grow moderately in SEE-5.

An important factor reflecting the competitiveness of the Western Balkans on the EU markets is their structure of the manufacturing exports. While the CEECs display an increase in technology-driven exports to the EU (close to 30%), most of the SEECs-5 do not share this trend since technology-driven exports account for only 5% without any tendency of expanding in the future. The export of market-driven industries including food processing offers a totally different perspective. The reverse seems to be true here: the share of the CEECs in this sector reaches just 10% whereas the share of the SEECs is much higher: the share of Albania's exports of marketing-driven industries is about 40%, the shares of the other Western Balkan countries vary between 15% and 20%. Very important for the SEE-5 are exports in labour-intensive industries (including textile industry). Four countries (excluding Serbia and Montenegro with a share of 20%) export about 40% of total manufacturing exports in the EU labour-intensive products. In the mainstream industries that include various types of machinery goods, only Croatia provides a share similar to the CEECs (about 20%), the share of Albania, Bosnia and Herzegovina and Macedonia is hardly above 5%, Serbia and Montenegro reach 15%. The export structure with respect to the industries demanding low, medium and high skilled labour shows that the Western Balkans tend to have lower shares of high-skill industries but significantly higher shares<sup>40</sup> in low-skill industries in total manufacturing exports in the EU. The analysis of the export structure in the Western Balkans shows the dominance of products exported to the EU which rely mostly on unskilled labour and low technology inputs, while CEE economies have made a significant progress towards the increase of the share of medium-/high-skill and medium-/high-technology industries in their exports to the EU markets.<sup>41</sup>

An important component of the EU integration process in the Western Balkans is the intensification of intra-regional cooperation. For the moment there does not exist a possibility for the EU accession without a progress in the intra-regional integration issues: To upgrade their relationship with the EU, the Western Balkans have to make a progress in regional cooperation.

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<sup>39</sup> Source: CANSTAT (2003).

<sup>40</sup> With the exception of Croatia, the shares of SEE-5 countries in low-skill industry exports of total exports in the EU are well above 60%.

<sup>41</sup> This paragraph of the paper draws from the results of the study of the Vienna Institute for International Economic Studies that examines patterns of trade specialization in SEE countries from 1997 to 2001. See Gligorov et al. (2003), pp. 11-19.

The actual intra-regional trade in the Western Balkans is mainly characterised by the revitalisation of traditional trade links. After the long disintegration phase following the decay of the Socialist Federative Republic of Yugoslavia (SFRJ) and the subsequent ethnic conflicts and wars, regional export and import shares were continuously increasing in the second half of the 90s. The recent level of intra-regional integration can be illustrated by the level of intra-regional trade. Intra-Balkan trade is important for Serbia and Montenegro, Bosnia and Herzegovina and Macedonia with a significant share in total trade of these countries (shares in exports are between 20% and 35% and in imports between 15% and 20%) and much less important for Croatia (13% and 2% respectively), while the intra-regional trade for Albania is practically negligible.<sup>42</sup> In the Western Balkans, a lot of both non-economic and economic factors representing serious barriers to the development of the regional trade still exist. The following aspects mark some of the non-economic obstacles of regional integration: ethnic nationalism, political instability, lack of laws, a “fragmented” region with numerous state borders on the small area, visas, bureaucracy, etc. Economic barriers result among others from a low level of economic development, individual markets with low buying power, underdeveloped infrastructure, numerous trade restrictions, and a large share of shadow economy. Some progress in trade liberalisation has been made under the Stability Pact, mainly in the last three years. By signing the Memorandum of Understanding on Trade Liberalisation and Facilitation in June 2001, eight countries (SEE-7 and Moldova) took the commitment to create a Free Trade Area (FTA) in South-Eastern Europe, a market with the size of 55 million people.<sup>43</sup>

One of the most probable results of the creation of a FTA in the Balkan region (SEEFTA) will be an increase of intra-regional trade and a decrease of intra-regional FDI because trade and capital flows are often substitutable modes of serving foreign markets. However, this negative effect is of minor importance: intra-regional FDI flows – apart from Croatian investments in Bosnia and Herzegovina – are not substantial in the Western Balkan at the moment. This effect can be anticipated while outside FDI will be increased: a large common market will make the region more attractive for foreign investors from the non-member countries. The countries that have the best location advantages will attract the most FDI inflows. In the Western Balkan these countries will be, above all, Croatia and, depending of the progress of political and economic reforms, Serbia and Montenegro. Bosnia and Herzegovina, Albania, and Macedonia are not likely to benefit notably from an increase of FDI inflow to the Balkans as result of the establishment of the SEEFTA. Recent empirical studies suggest that in a case of South-South integration,

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<sup>42</sup> See Uvalic (2003), pp. 472-473.

<sup>43</sup> See Brkic (2003), pp. 3-6.

macroeconomic stability is a more important factor than integration itself.<sup>44</sup> A stable macroeconomic development will also have a positive impact on FDI inflows into the region. It is possible that the establishment of a FTA in the region also generates various dynamic effects that affect FDI flows. An integration process can lead to significant efficiency benefits that may raise the growth rates of participating countries over the medium or long term. These dynamic benefits might increase the attractiveness of the integrated region as a location for domestic and foreign investment. The effects on FDI discussed above take into account the establishment of the SEEFTA as a single factor. All the countries of the Western Balkan region have engaged in the trade liberalisation with the EU. FTAs between countries of different levels of development (North-South integration) generally lead to positive implications for the economy of the Southern partner, including a significant increase of FDI inflows. In this way, the negative implications of FDI performance for Albania, Bosnia and Herzegovina, and Macedonia concerning the establishment of the SEEFTA may be partially or fully compensated.

## **Conclusions**

Positive effects of FDI for the host country were pointed out in numerous theoretical and empirical studies and are widely known: transfer of technological know-how, implementation of advanced management structures and modernisation of the manufacturing sector raise the competitiveness of the economy, facilitate access to western markets and stimulate growth. An increase of FDI inflows is crucial for the catching-up process and international competitiveness of the Western Balkans and consequently for the acceleration of the EU integration process. The experience of CEE underlines the importance of SAA for the SEE economies: the positive effects on growth and welfare are being obtained from trade through the liberalisation of markets for goods and capital, in fact, before the proper joining. In the Western Balkans, similar effects can be achieved. After the Kosovo crisis, SEE-5 countries succeeded in bringing about market economic reforms and this in turn proves how economic and political stabilization lead to an improvement of investment conditions. Combined with the reforms of the legal systems and the efforts in combating corruption, this in fact promotes the urgently needed increase of FDI inflows in the region. The implementation of a common market in the Western Balkans could decisively increase the attractiveness of this region to foreign investors. It is the higher FDI inflow achieved thereby which will enable the Western Balkans to access the EU.

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<sup>44</sup> See Ranchev (2001), p. 25.

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