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Assessing the Impact of Foreign Direct Investment on Economic Growth: Evidence from the Western Balkans

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Abstract

This study aims to empirically explore the relationship between FDI and growth in six of the Western Balkan countries. The hypothesized relationship between FDI and economic growth was examined for the period between 1996 and 2021. Descriptive statistics and simple linear regression were used in data processing. The findings of this study reveal that a hypothesis about a positive impact FDI inflows on the GDP selected countries has been rejected in case of Albania and Bosnia and Herzegovina. It means that FDI has no statistically significant influence on growth in these two countries. However, when it comes to Croatia, North Macedonia, Montenegro and Serbia, a hypothesis was not rejected providing explanation that FDI contributes to growth of these four countries. FDI functions as a growth accelerator yet its success ratings differ in each situation. Government policies need to be customized for each country based on the successful Montenegro's model.

Keywords:
Economic Growth,
FDI,
Western Balkans,
ANOVA,
Parameter Estimates.

JEL Classification:
C23, F21, F43

Doğrudan Yabancı Yatırımların Ekonomik Büyüme Üzerindeki Etkisinin Değerlendirilmesi: Batı Balkanlar'dan Kanıtlar

Öz

Bu çalışma, altı Batı Balkan ülkesinde DYY ve büyüme arasındaki ilişkiyi ampirik olarak araştırmayı amaçlamaktadır. DYY ve ekonomik büyüme arasındaki varsayılan ilişki 1996 ve 2021 yılları arasındaki dönem için incelenmiştir. Veri işlemede tanımlayıcı istatistikler ve basit doğrusal regresyon kullanılmıştır. Bu çalışmanın bulguları, Arnavutluk ve Bosna Hersek için DYY'nin seçilmiş ülke Milli Gelirleri üzerine olumlu etkisi olup olmadığı hakkında hipotezin reddedildiğini ortaya koymaktadır. Bu, DYY'nin bu iki ülkede büyüme üzerinde istatistiksel olarak anlamlı bir etkisi olmadığı anlamına gelmektedir. Ancak, Hırvatistan, Kuzey Makedonya, Karadağ ve Sırbistan söz konusu olduğunda, DYY'nin bu dört ülkenin büyümesine katkıda bulunduğunu gösteren hipotez kabul edilmiştir. DYY büyümeyi hızlandırıcı işlev görmekte ancak, başarı her durumda farklılık göstermektedir. Hükümet politikalarının başarılı Karadağ modelinde olduğu gibi her ülke için özelleştirilmesi gerekir.

Anahtar Kelimeler:
Ekonomik Büyüme,
DDY,
Batı Balkan Ülkeleri,
ANOVA,
Parametre Tahmini.

Jel Sınıflandırması:
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1. Introduction

Economic recovery following the war remains slow across the Western Balkans except for places seeking EU membership which require additional investments for future economic development. The transition of the former Yugoslav states from closed economies to liberalized, free-market systems is evident. Yet, these nations have faced challenges in attracting capital and fostering a business-friendly environment. For instance, Ganić (2020) highlights that the liberalization of capital accounts, coupled with the transition process in the Western Balkans, has significantly influenced the growth of foreign direct investment, international trade, and foreign exchange reserves. Collaboration with the EU is regarded as a critical factor in this context. Steady economic growth has been achieved largely due to foreign investments originating from various regions around the globe.

With the dissolution of Yugoslavia, these newly formed countries have shifted their focus towards international markets and attracting Foreign Direct Investment (FDI) inflows to catch up with developed nations. These circumstances underscore the importance of addressing this issue through a scientific approach and generating empirical findings that can have practical applications.

This study seeks to examine the relationship between FDI and economic growth, specifically investigating whether FDI inflows contribute to growth in selected Western Balkan countries. More precisely, the research aims to provide empirical evidence on this connection, not only for the Western Balkans as a region but also for individual countries: Albania, Bosnia and Herzegovina (B&H), Croatia, Montenegro, North Macedonia, and Serbia. If FDI is found to contribute to economic growth, it indicates a positive relationship between FDI inflows and growth; otherwise, the effect is deemed negative or negligible.

Numerous studies have explored the relationship between economic growth and foreign direct investment (FDI), with particular emphasis on this connection in developed economies. Significant research has also been conducted on the impact of FDI on the economic development of recipient nations; however, the findings often differ depending on the data, sample, and methodologies applied (Sarker and Khan, 2020; Bilas, 2019; Dritsaki and Stiakakis, 2014; Vurur et al, 2023; Güryel and Kula, 2023). Consequently, in recent decades, a growing number of countries have liberalized their capital and current accounts and introduced policies aimed at attracting foreign investments. The paper begins with his introduction of the research problem as well as its objectives and potential contributions. First, the paper conducts a literature review to explore the relationship between FDI and Gross Domestic Product (GDP) growth. The methodology segment of this research describes the research methodology. The study provides findings followed by conclusions and suggests future research directions in subsequent parts of this work.

2. Literature Review

The literature on FDI identities is numerous but most contemporary studies follow motives proposed by Dunning (1993) including resource-seeking, market-seeking, and efficiency-seeking. Similarly, Jakubiak and Kudina (2008) in their research point out

importance of natural resources, cheap unskilled or semi-skilled labor, creative assets etc. One of the main reasons is the desire of foreign investors to join new markets. Investors will try to enter the market through an investment strategy if the state macroeconomic policy or the competitive activity in this market makes it difficult for a company to enter.

A theoretical model developed by Asteriou vd. (2005) suggests a positive correlation between economic growth and foreign direct investment (FDI). Similarly, Alfaro et al. (2006) proposed a theoretical framework that highlights the role of FDI in accelerating economic growth within the domestic economy. Their theory posits that well-developed financial markets enable entrepreneurs, who might otherwise lack access to credit, to establish their own businesses, ultimately benefiting the production of final goods. Conversely, underdeveloped financial markets may limit an economy's ability to fully capitalize on FDI inflows.

Olofsdotter (1998) also found that an increase in FDI positively impacts economic growth, especially in countries with efficient bureaucracies and robust property rights protection systems. Such institutions facilitate the absorption of foreign innovations and aid in making informed investment decisions. Moreover, political stability and administrative efficiency are critical for attracting investment and fostering sustained economic growth. Carkovic and Levine (2002) found that FDI has a significant positive impact on economic growth when adjusting for variables such as inflation and country size. However, when trade openness, the black-market premium, or financial development were used as control variables, the statistical significance of FDI decreased. Similarly, Alfaro et al. (2004) concluded that while FDI does not directly influence economic growth, its impact becomes substantial when financial development factors are considered. Bevan and Estrin (2000) argued that a country's ability to attract FDI depends on its risk profile, categorized into three main areas: institutional stability, macroeconomic stability (including low inflation, economic growth, and exchange rate stability), and overall low inflation. Garibaldi et al. (2001) conducted a panel study on 26 transition economies from 1990 to 1999, identifying significant macroeconomic variables—such as inflation, budget deficits, and lagged economic growth—that influence capital inflows into these nations. Mencinger (2003) found a negative correlation between FDI and economic growth in transition economies, suggesting that the causal relationship between these two factors has evolved over time. He posits that increased FDI inflows could contribute to a rise in external debt if they exacerbate current account deficits. Supporting this notion, data on public debt indicates that FDI may not always yield growth benefits. In their study of 11 transitional countries from 1994 to 2002, Bačić et. al. (2004) discovered that FDI positively influences economic growth in smaller nations like Slovenia, Slovakia, and Lithuania. In these countries, FDI has a significant impact on international trade, but the productivity gains associated with FDI are more pronounced in developed economies.

There are many studies dealing with FDI of entire Western Balkan region. Estrin and Uvalic (2013), Estrin and Uvalic (2015) Sanfey et. al. (2016) are some of many studies that dealing with the issues of FDI in Western Balkans. Contrasting perspectives exist regarding the impact of FDI on economic growth in Bosnia and Herzegovina. For instance, Mamuti and Ganić (2019) and Smolo (2021) found no significant or even negative effects of FDI on

growth. Similarly, other empirical studies have included Bosnia and Herzegovina as part of broader investigations on the Balkans and Eastern Europe (Smolo, 2021; Ganić, 2022; Ganić and Novalić, 2023). For example, studies by Görgülü (2015), Ganić and Hrnjić (2019) and Perciun et al. (2014) examined the effects of FDI on transition economies, while Lyroudi et. al. (2004) conducted a similar investigation. Additionally, a notable study by Ganić (2020) highlighted that much of the foreign capital in the region has been driven by accelerated transition processes, deeper EU integration, and the removal of FDI barriers. He observed that countries such as Bulgaria, Croatia, Romania, and Serbia attracted more FDI compared to Albania, Bosnia and Herzegovina, Montenegro, and North Macedonia.

While some of the mentioned researchers identified a positive relationship between FDI and economic growth, Kersan-Škrabić and Zubin (2009) concluded that FDI had no significant impact on growth or exports. Croatia, in particular, has seen substantial research into the relationship between FDI and economic growth. Studies by Kersan-Škrabić and Zubin (2009), Dritsaki and Stiakakis (2014), and Ivanović et. al. (2014) are notable contributions that have explored the effects of FDI on growth within the country.

In examining the relationship between FDI and economic growth in North Macedonia, some researchers have conducted country-specific studies (Krstevska and Petrovska, 2012), while others have included North Macedonia as part of broader regional analyzes (Palinescu and Radulescu, 2009). These studies largely confirm the existence of a relationship between FDI and GDP in North Macedonia.

In the case of Montenegro, Fabris et al. (2008) observed a favorable investment climate, with foreign investors from 107 countries contributing to the country's economic development. Similarly, Karadžić (2015) employed a regression model to measure the impact of FDI on GDP, providing empirical evidence of a direct relationship between FDI inflows and economic growth. For Serbia, researchers have adopted diverse approaches to studying FDI. Milenković and Milenković (2012) analyzed the motives behind FDI inflows and identified the privatization of public companies as a key driver. In contrast, Vasa and Angeloska (2020) found no significant evidence that FDI inflows contribute to economic growth in Serbia.

The study set the next hypothesis to analyze the effects of changes in FDI on GDP in the Western Balkans:

H_1: FDI inflows have a statistically positive impact on the GDP of Albania.

H_2: FDI inflows have a statistically positive impact on the GDP of B&H.

H_3: FDI inflows have a statistically positive impact on the GDP of Croatia.

H_4: FDI inflows have a statistically positive impact on the GDP of Montenegro.

H_5: FDI inflows have a statistically positive impact on the GDP of North Macedonia.

H_6: FDI inflows have a statistically positive impact on the GDP of Serbia.

3. Data Set and Methodology

This study focuses on analyzing the relationship between two key variables: FDI flows (as a proxy for capital flows) and GDP growth rate (representing economic growth). Specifically, it investigates how FDI inflows influence GDP across different contexts to assess the impact of capital flows on economic growth. The hypothesized FDI-Growth relationship is investigated using data of Value of announced greenfield FDI projects, by destination, and GDP growth rate (% annual) as a proxy for economic growth from World bank databases for period between 1996 and 2021 because of limited data on the World bank. Besides these countries are still very young states. It covers six the Western Balkan countries as follows: Albania, B&H, Croatia, Montenegro, North Macedonia, and Serbia. Considering previously defined hypotheses about a positive impact FDI inflows on the GDP selected Western Balkan countries, it examines correlation and conduct regression analysis.

For some selected countries, data was available for longer periods while for some of them, shorter periods. Descriptive (univariate) and bivariate (i.e. t-test, ANOVA, correlation analysis) and simple linear regression were used as a part pf methodology. In addition, test of residual autocorrelation is performed by employing the Durbin-Watson (DW) test.

Linear regression explains the relationship between two variables where each unit increase in the value of one variable corresponds to approximately equal linear change of the other variable.

The study follows a model of simple liner regression:

$$Y = a + bX + e \tag{1}$$

X = FDI as percent of GDP (independent variable); Y = GDP growth rate (dependent variable); e = the error term; a, b = parameters.

Pearson's linear correlation coefficient is an indicator of the strength and direction of the statistical relationship between the two variables. The basis for its calculation is pairs of observed values of the two variables in the scatter plot. The starting value for measuring the strength and direction is the covariance of the variables X and Y.

$$\mathrm{Cov}(X,Y) = \mu_{11} = \frac{1}{n}\sum_{i=1}^{n}(x_{i-}\ \bar{x})\,(y_i - \bar{y}) = \frac{1}{n}\sum_{i=1}^{n} x_i\ y_i - \bar{x}\,\bar{y}_t \tag{2}$$

Covariance depends on the size and units of variables X and Y, and in order to obtain a strength indicator independent of units, both variables need to be standardized. The covariance of the standardized values is the Pearson linear correlation coefficient:

$$r = \mu\_11/(\sigma\_x\ \sigma\_y)\,, -1 \le r \le 1 \tag{3}$$

A value of the coefficient equal to zero indicates that there is no linear correlation between the phenomena, a value of 1 means a positive direction, and a value of -1 means a negative direction.

4. Analysis and Results

Table 1 reports the descriptive statistics for key country level variable in this study. A closer look at the variability of the GDP between six the Western Balkan countries reveals that North Macedonia has the lowest variability while Albania, B&H, and Montenegro have the highest.

Table 1. Country Level- Descriptive Statistics

		Mean	Std. Deviation	Min	Max	Skewness	Kurtosis
Albania	GDP	4.866394	-10.91998	4.567389	13.32233	-1.179084	6.96731
	FDI	5.859284	.2826401	2.99196	111.17064	.0604675	1.562471
B&H	GDP	6.714083	7.910553	-3.004456	28.95767	1.539643	4.504859
	FDI	3.698715	2.570192	.7863762	11.67374	1.735273	5.636813
CRO	GDP	2.294717	3.178918	-7.2817	6.132025	-1.194062	4.449067
	FDI	3.45597	2.157826	.1042124	7.673608	.3561276	2.162917
NMK	GDP	2.506303	2.374617	-3.067257	6.473487	-.6231976	2.720617
	FDI	3.845991	2.782938	.2016131	12.65813	1.194065	5.163252
MNG	GDP	6.137228	4.161278	- 1.268599	17.29078	-.4309332	3.291718
	FDI	8.441769	14.08599	- 37.17265	43.91211	.6188393	6.844652
SER	GDP	3.319091	3.981356	-9.424162	9.028197	-1.45536	5.496927
	FDI	5.893248	2.34499	2.9	10.24575	.4445106	2.108709

Source: Authors' calculation.

As shown in Table 1, Albania, Montenegro and Serbia have the highest average FDI inflows ranged from 5.86 percent of GDP to 8.44 percent of GDP while Croatia, B&H and North Macedonia have below 4 percent of GDP. The kurtosis value for GDP in Albania, BIH, Croatia, Montenegro and Serbia is higher than the kurtosis of normal distribution (±3) showing that distribution has a sharper and higher peak with the values concentrated around the mean. The kurtosis of N. Macedonia's GDP is 2.72 and is very close to the normal distribution (±3). Related to FDI inflows, the study finds that the kurtosis value for B&H, North Macedonia, and Montenegro is higher than the kurtosis of normal distribution (±3) while Albania and Serbia have the values below of normal distribution.

Table 2 shows the values of the Pearson correlation coefficients. The values of correlation coefficients are the highest in Montenegro (0.64), North Macedonia (0.52), Serbia (0.42) and Croatia (0.39). It indicates that, there is a moderately strong positive link between GDP and FDI inflows in Montenegro and North Macedonia, while a slightly weaker relationship was found in the case of Serbia and Croatia. It implies that FDI in these four countries had a positive impact on GDP, or FDI contributed to its growth.

Table 2. Correlation Between FDI and GDP by Individual Countries

		Name	FDI	GDP
ALB	FDI	Pearson correlation	1	0.215327
		Sig. (2 tailed)		0.290778
		N	26	26
	GDP	Pearson correlation	0.215327	1
		Sig. (2 tailed)	0.290778	
		N	26	26
B&H	FDI	Pearson correlation	1	0.02261
		Sig. (2 tailed)		0.912666
		N	26	26
	GDP	Pearson correlation	0.02261	1
		Sig. (2 tailed)	0.912666	
		N	26	26
CRO	FDI	Pearson correlation	1	0.395183
		Sig. (2 tailed)		0.045704
		N	26	26
	GDP	Pearson correlation	0.395183	1
		Sig. (2 tailed)	0.045704	
		N	26	26
NMK	FDI	Pearson correlation	1	0.528023
		Sig. (2 tailed)		0.005651
		N	26	26
	GDP	Pearson correlation	0.528023	1
		Sig. (2 tailed)	0.005651	
		N	26	26
MNG	FDI	Pearson correlation	1	0.641935
		Sig. (2 tailed)		0.000408
		N	26	26
	GDP	Pearson correlation	0.641935	1
		Sig. (2 tailed)	0.000408	
		N	26	26
SER	FDI	Pearson correlation	1	0.432834
		Sig. (2 tailed)		0.027
		N	26	26
	GDP	Pearson correlation	0.432834	1
		Sig. (2 tailed)	0.027	
		N	26	26

Source: Authors' calculation.

Table 3 shows the values of the estimated parameters, their standard errors, empirical t-ratios, basic indicators of the estimated regression mode, with a 95% confidence level after a simple regression analysis of the impact of FDI on GDP in the Western Balkan countries.

Table 3. ANOVA and Parameter Estimates

	ANOVA					Parameter Estimates				
	N	R^2	Adj. R^2	F-test	p-value	Intercept	Slope	SE	t	DW
ALB	26	0.10	0.067	2.809	0.106	7.76	-0.494	4.410	1.08	2.01
B&H	26	0.0005	-0.041	0.012	0.91	5.87	0.056	6.13	0.11	0.46
CRO	26	0.156	0.12	4.441	0.045	1.524	0.419	2.226	2.10	1.71
NMK	26	0.278	0.248	9.27	0.005	1.220	0.395	1.807	3.04	1.29
MNG	26	0.412	0.387	16.82	0.000	4.536	0.189	3.256	4.10	1.58
SER	26	0.18	0.153	5.532	0.027	0.273	0.552	3.451	1.50	1.69

Source: Authors' calculation

In the case of Montenegro, the regression model confirmed a strong link between GDP and FDI, indicating a high coefficient of determination of 41.2%. The coefficient of determination for the regression function of economic growth is 0.412 in Montenegro. It indicates that the model of simple linear regression interpreted 41.2% of all deviations, which means that according to this indicator, this model is relatively representative.

The reliability of the regression model was examined by the ANOVA test. The level of significance of 0.000 is less than 0.05, and it indicates that the regression model is reliable for analysis and can be used in predictions (Table 3). Therefore, based on the F-test and the level of significance of 5%, the null hypothesis that all estimators are equal to zero is statistically nonsignificant and it can be rejected. In addition, test of residual autocorrelation was performed by employing the Durbin-Watson (DW) test. In accordance with the obtained values of the DW test in Table 3, it can be concluded that there is a positive autocorrelation of residues in all analysed countries except Albania. The reliability of regression coefficients was also examined in the regression model, where their significance was determined. Also, the connection between GDP and FDI in Croatia, North Macedonia, and Serbia was confirmed, but with a slightly lower coefficient of determination of 15.62%, 27.82%, and 18.72% respectfully.

Additionally, preliminary results of simple linear regressions of the two variables by countries are shown in Figure 1. Figure 1 shows that there is a slight positive correlation between the variables GDP and FDI, in the case of Croatia and Serbia and a little bit stronger in the case of Montenegro and North Montenegro. From the scattering diagram, it is noticeable that with the increase of FDI, there is a tendency to increase economic growth in the previously mentioned countries. The scatter diagram indicates that there is the relationship between FDI and economic growth and it can be analytically expressed by a simple linear regression model.

The model of simple linear regression with estimated parameters for Montenegro can be expressed as follows:

$$\hat{y} = 4.536 + 0.1896x \quad (4)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 4.536%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.19%. The model of simple linear regression with estimated parameters for Croatia can be expressed as follows:

$$\hat{y} = 1.525 + 0.4199x \quad (5)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 1.525%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.42%. The model of simple linear regression with estimated parameters for North Macedonia can be expressed as follows:

$$\hat{y} = 1.22 + 0.3958x \quad (6)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 1.22%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.39%. The model of simple linear regression with estimated parameters for Serbia can be expressed as follows:

$$\hat{y} = 0.2377 + 0.5529x \quad (7)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 0.27%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.55%. The model of simple linear regression with estimated parameters for Bosnia and Herzegovina can be expressed as follows:

$$\hat{y} = 5.87 + 0.0569x \quad (8)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 5.87%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.057%. The model of simple linear regression with estimated parameters for Albania can be expressed as follows:

$$\hat{y} = 7.762 - 0.494x \quad (9)$$

Interpretation: Regression value of economic growth if FDI is equal to 0 amounts 7.762%. In the case that FDI increases by 1%, the value of economic growth will increase by an average of 0.49%. Figure 1 provides scattering diagram by individual countries.

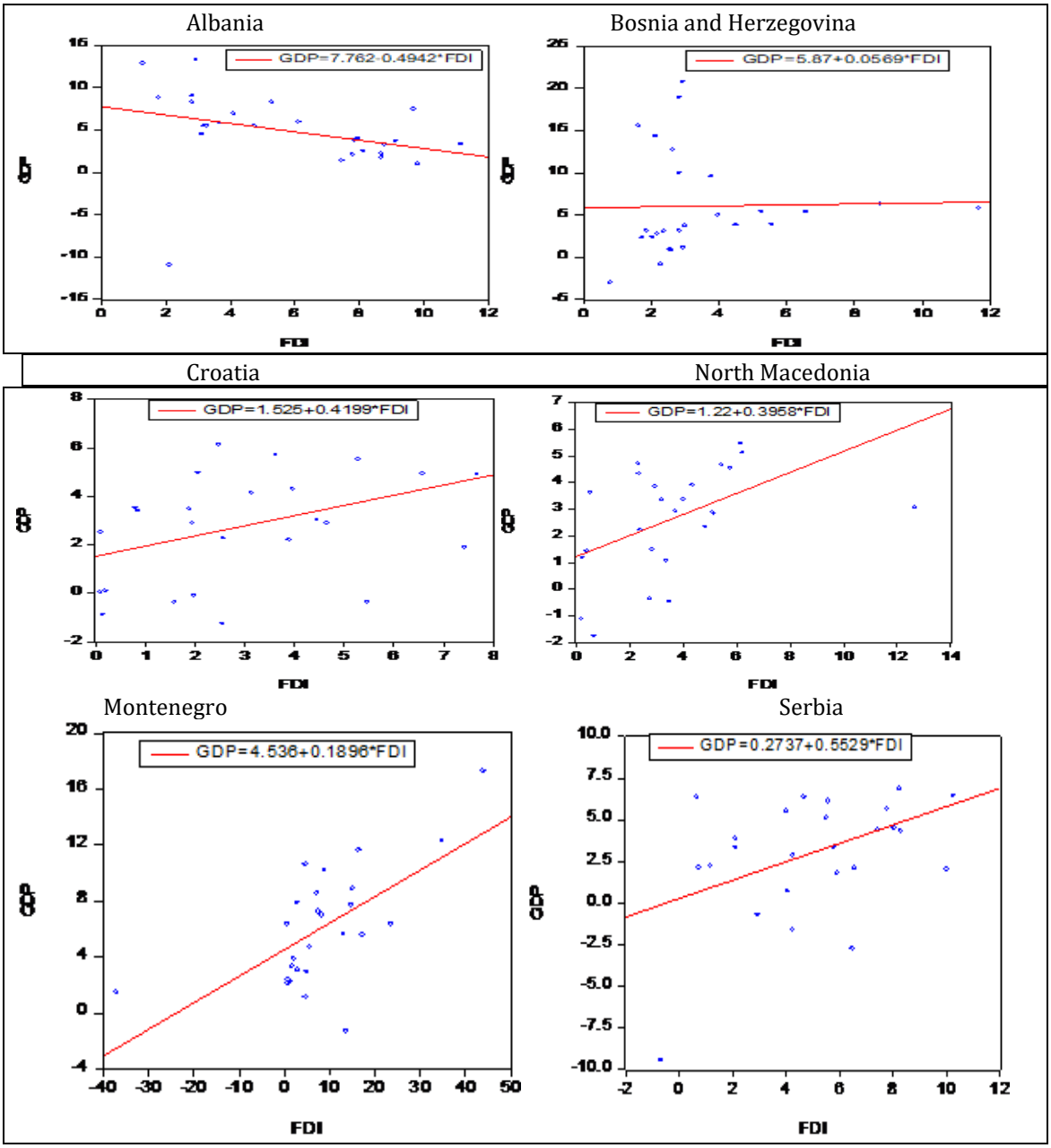

Figure 1. Link between FDI and GDP by individual countries
Source: Authors' calculation

5. Conclusion

The objective of this paper is to examine the potential impact of FDI inflows on economic growth in six Western Balkan countries. The hypothesis was established to

determine whether FDI affects economic growth in the region. Based on the correlation coefficient values between FDI and GDP for the period 1996–2021, the analysis concludes that there is a weak but positive relationship between FDI inflows and economic growth. Specifically, an increase in FDI inflows is associated with higher GDP values, indicating a positive correlation between these two economic indicators.

The study's findings reveal that FDI significantly and positively influences GDP in Croatia, Montenegro, North Macedonia, and Serbia during the analysed period. However, no statistically significant relationship between FDI inflows and GDP was found for Albania and Bosnia and Herzegovina, aligning with previous research by Smolo (2021) and Mamuti and Ganić (2019). Consequently, four out of six hypotheses of this study are supported, while two are rejected.

FDI contributes to GDP growth in most Western Balkan countries and Montenegro receives the maximum benefits through FDI which accounts for 41% of GDP growth. Bosnia and Herzegovina exhibits low positive effects in comparison with Croatia, Serbia and North Macedonia which display intermediate positive effects. The negative relationship between FDI and Albania suggests that the country may allocate its foreign investments inefficiently.

Accordingly, the countries should prioritize investment in technology alongside tourism ventures which generate substantial economic value within high-performing economies. Both Albania and Bosnia and Herzegovina need to eliminate their government management deficiencies and widespread corruption.

Domestic reforms especially EU integration and financial sector modernization should be integrated with foreign direct investment initiatives. These results show that transition countries should still welcome FDI inflows. Additionally, advances in the financial sector could further strengthen the positive impact of FDI on economic growth. Utilizing FDI as a complementary driver alongside domestic investment may yield substantial benefits.

To attract foreign direct investment and foster domestic investment, governments should consider implementing incentives such as tax reductions or subsidies. These measures can create a more favourable environment for FDI inflows, potentially boosting economic growth in the region.

Statement of Research and Publication Ethics

Research and publication ethics were complied with in this study, which did not require ethics committee approval and/or legal/special permission.

Researcher's Contribution Rate Statement

The authors declare that they have contributed 70% (A.Mamuti) and 30% (E.Özen).

Researcher's Conflict of Interest Statement

There is no potential conflicts of interest in this study.

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