

Impact of Foreign Direct Investment on Economic Growth — Case Study of the SEE Countries



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ABSTRACT

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The main focus of this study is on foreign direct investment (FDI), which (through its direct and indirect contributions) can serve as the main driver of economic development for countries in general. The study examines countries in Southeastern Europe (SEE) - Kosovo, Albania, Montenegro, Serbia, Northern Macedonia and Bosnia and Herzegovina for the period 2005-2020 for the dependent variable, i.e., GDP, and for the independent variables: Goods and Services, Wages, Social Transfers, Subsidies, Investment Expenditures, and FDI. The techniques used to analyse the data include the descriptive method, the regression model, the DW test and (for multicollinearity between variables) the VIF test. In general, the study finds a positive and significant relationship between economic growth and FDI flows in some countries, but not in Kosovo and Bosnia and Herzegovina. Based on the results studied, more appropriate FDI policies are suggested. It is suggested that policy makers in these countries not only respond to protect the deterioration of GDP, but also support the infrastructure for doing business.

1. INTRODUCTION

Two important indicators of economic development are investment and trade. Investment helps local businesses that need labour to open, which reduces unemployment and raises the standard of living of the population. Investments in technology, infrastructure and employee training also contribute to higher productivity of workers in companies. This promotes economic progress by enabling developing countries to produce more goods and services.

Trade remains essential for the economic development of a nation, as it ensures the flow of products and services as well as the participation of production actors across national borders. Most economists and policy makers have long argued that free trade is better because it reduces poverty and inflation and promotes employment, health and education. This is because trade is a pro-growth policy variable. FDI refers to foreign capital invested in a country. This income contributes to the increase in gross domestic product (GDP) and overall economic output. Various reforms aimed at attracting foreign direct investment are believed to generate this revenue. These include procedural facilitation for foreign capital investment, improving the efficiency of the courts in handling economic matters, and deepening international trade relations [1].

GDP is the main economic indicator in the national accounts, representing a country's economic performance over a given period of time [2-4]. Moreover, GDP is an aggregate measure of the value of all final goods and services produced in an economy. Therefore, it is important that GDP is

measured when assessing the state of an economy and its dynamics [5], using the impact of FDI.

According to the EU Statistical Office [6], FDI is a category of international investment that reflects the objective of achieving a sustained interest by an investor from one economy in a resident enterprise in another economy.

FDI, therefore, is the use of capital by an individual or legal entity with the objective of obtaining a lasting interest in, or control over, a company or enterprise abroad. According to this definition, FDI can take three main forms: the acquisition of at least 10% of the shares of an enterprise operating abroad, the establishment of an enterprise outside the national territory, and the reinvestment of profits earned by an enterprise established abroad [7].

Countries or companies that want to make direct investments in a less developed country have different motives that determine their decisions. The motives for foreign investment are essentially the search for the most cost-effective human resources, the search for strategic assets, and the search for markets where a company can grow more profitably, which is not possible in the country of origin [8].

FDI is the key to global economic integration, productivity growth, financial stability, promoting economic growth, and improving social welfare [9-14].

FDI is believed to be an important factor in economic development, but its impact varies from country to country. This means that FDI may or may not have a positive impact on a country's economic development [15, 16]. The presence of various factors can increase or decrease the potential impact

of foreign investment on economic growth. To determine how FDI affects the economic development of countries at SEE, we conduct this study.

By researching various reports on statistical data, this study takes a holistic approach to examining and analysing the impact dynamics of these investments as well as government spending.

Therefore, the objective of the study is to determine the degree of impact of these variables on GDP and to show the correlation or relationship between FDI and economic growth of a country SEE. The study covers the period 2005-2020 and is organised as follows. Section 1 discusses the background of FDI. Section 2 provides the theoretical literature on FDI and economic growth. Section 3 discusses the model, the econometric technique, and the data used. Section 4 discusses the results and Section 5 presents the conclusions.

2. LITERATURE REVIEW

Depending on the stage and level of economic development, different countries attract FDI in different sectors. However, in many countries, FDI is limited to the primary sector. Based on the experience of various countries, this study examined whether the composition of FDI in SEE countries plays a role in the development of economic growth.

In the last decade, numerous studies have been conducted on the role of FDI in promoting growth and economic development [17-22]. In the studies conducted by various authors, there are both proponents and opponents of FDI. Some argue that FDI contributes to economic growth and increased productivity in an economy, and thus to economic growth and development in various countries, but others emphasise the danger that FDI can destroy local capacity and deplete natural resources without adequately compensating poor countries.

Silajdzic and Mehic [22] found that FDI has a direct impact on economic growth by contributing to gross fixed capital formation and an indirect impact by contributing to the stock of knowledge.

The positive effects of FDI inflows occur in many ways. FDI helps to increase investment by leading to the creation of new jobs and the generation of tax revenues, among other things, as Nixha [23] found in his study.

Nixha [23] concludes that FDI causes the host economy to increase exports, improves the balance of payments, and in many cases reduces international financial constraints on economic growth. Oyegoke and Aras [24] examined the extent to which FDI in Nigeria affected economic growth during the period 1981-2007 and concluded that investment stimulated growth and thus there was a positive relationship between FDI and economic growth.

Sukar et al. [25] found that FDI contributes directly to employment in a local economy by creating new jobs, and indirectly when local spending increases through the purchase of goods and services due to the increase in new employees. All of these are expected to have positive multiplier effects in an economy.

Kamara [26], in his study of 47 countries over the period 1981-1999, found that the impact of FDI on economic growth depended on the sector; for example, there were positive effects in the manufacturing sector, while the results for the service sector were unclear.

Alfaro et al. [27] found that foreign direct investment is one of the most important determinants of economic growth in 20 countries of the Organization for Economic Cooperation and Development (OECD). Moreover, their empirical results showed that in these countries the level of development of the financial market was important for the relationship between FDI and economic growth.

Positive associations between FDI and economic development were also found in studies [28-32] conducted in China, Pakistan, and the eurozone.

The relationship between macroeconomic policies, investment, financial development, trade/financial openness, external debt, economic freedom, institutional quality, and even corruption could also be relevant random factors affecting the relationship between FDI and growth [33-39].

Other studies find opposite results, showing that FDI tends to have nonsignificant (or even negative) effects on economic growth in host countries [40-45], implying that FDI has negative effects on economic development or that the relationship between FDI and economic growth is positive but the effects are weak.

However, some studies have found a positive relationship between FDI and economic growth only in high-income countries. In their study, Alvarado et al. [46] examined how FDI has a positive and significant impact on products in high-income countries. The same opinion is expressed by Kulu et al. [47] in his study of 57 developing countries for the period 1980-1999, which shows that countries with high economic growth noticed the direct effect of investment, but this was not the case in countries with low economic growth. In addition, Ozekhome [48] studied the relationship between FDI, foreign aid, and economic growth in the ECOWAS trade bloc for the period 2000-2015. Using the generalised method of moments (GMM), the author found that FDI is one of the most important drivers of growth.

In a study by Rustamugli and Baxodirovna [49], it was shown that an increase in investment in financially developed countries can lead to higher growth rates than in financially poor countries. Local conditions, such as the development of a country's financial markets and the level of education, affect the impact of FDI on economic growth. Similarly, a study by Lakhbiz and Mekki [50] concluded that FDI has a lower impact on economic growth in the case of developing countries. In other words, these countries need to have a certain level of development in education, technology, infrastructure, and health to benefit from FDI.

Most studies [51-53] have found the relationship between FDI and economic growth, financial development and trade openness based on cross-sectional and pooled or panel data, which shows the inconsistency of empirical results with respect to specific countries.

Our study contributes to the literature by analysing the relationship between FDI and economic growth in SEE countries.

3. METHODOLOGY

The study on the impact of FDI on economic growth in SEE was conducted using quantitative analysis. The quantitative method was analysed to obtain empirical results; therefore, it was necessary to test the hypothesised predictors related to FDI and economic growth. The empirical results were used to provide some important recommendations for FDI and the

countries studied to determine the relationship between FDI and growth. Secondary data sources were used to assess the impact of FDI on economic growth in SEE countries (Kosovo, Albania, Montenegro, Serbia, North Macedonia, and Bosnia and Herzegovina). The study analysed time series data for the period 2005-2020 for the dependent variable, i.e. GDP, and for the independent variables goods and services, wages, social transfers, subsidies, investment expenditures, and FDI. The data come from the World Development Indicators (WDI) database published by the World Bank, statistical offices and central banks of the countries under study.

The methods used in the study were: the descriptive-descriptive method [54], the regression model, the DW test, and (for multicollinearity between variables) the VIF test [55].

Model layout:

$$Y = \beta_0 + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \beta_4 X_4 + \beta_5 X_5 + \beta_6 X_6 + e_i;$$

- Y: Economic growth (GDP)
- X₁: Foreign direct investment
- X₂: Wages and salaries
- X₃: Goods and services
- X₄: Subsidies
- X₅: Social transfers
- X₆: Capital expenditures.

From the equation used throughout the study, we can see which of the factors included in the model affect economic growth and how they relate to each other.

4. RESULTS AND DISCUSSION

For this study, a panel data set was used for six countries (Kosovo, Albania, Montenegro, Serbia, Northern Macedonia, and Bosnia and Herzegovina) from 2005 to 2020. In order to investigate the relationship between FDI and economic growth, we first perform a descriptive statistical test for the variables that compose our sample, which in our case are analyses. The descriptive analysis was conducted to examine the mean, standard deviation, minimum and maximum of the variables in each country of the study. Table 1 provides a summary of the descriptive statistics.

Table 1 describes the basic characteristics of FDI in the study that allow comparison. The average FDI in Kosovo was 287.4 with a standard deviation of 85.6, where the minimum value of investment was 107.6 and the maximum 440.7 million euros. In Albania, the minimum value of FDI was 213.0 and the maximum value was 1079.0; in North Macedonia, the minimum value of investment was 77.2 and the maximum value was 614.1.

In Montenegro, FDI had the lowest value of 1,224,000 and the highest value of 85,810,000; in Bosnia and Herzegovina, FDI had a minimum value of 180,040,000 and a maximum value of 1,330,140,000; and in Serbia, FDI reached a higher value than in the other countries (3,815,000,000).

The relevance of the determinants of FDI can be better captured by a correlation analysis. As mentioned earlier, multiple regression analysis would clearly be superior to simple correlations, but is not feasible given the relatively small number of sample countries. Table 2 shows a correlation analysis.

Table 1. Descriptive statistics of variables

Descriptive Statistics					
	N	Mean	St. dev.	Min.	Max.
K	16	287.4	85.6	107.6	440.7
A	16	750.5	255.8	213.0	1079.0
N.M	16	283.5	147.5	77.2	614.1
M	16	57408125	23896168	1224000	85810000
B. H	16	424123125	268635304	180040000	1330140000
S	16	2218250000	934100459	1009000000	3815000000

Source: Calculated by the author. (K - Kosovo; A - Albania; N.M - North Macedonia; M - Montenegro; B.H - Bosnia and Hercegovina; S - Serbia)

Table 2. Pearson's correlation matrix of dependent and independent variables

Correlation						
	EGW	Wages and salaries	Goods and services	Subsidies	Social transfers	Capital expenditures
K	-.117	-0.021	-0.042	-0.096	0.040	0.007
A	0.935	0.533	0.863	-0.832	0.908	0.502
N.M.	0.257	0.301	0.128	0.065	0.200	0.047
M.	0.513	0.503	0.226	-0.076	0.459	0.577
S.	0.447	0.441	0.273	0.306	0.300	0.626
B.H.	-0.174	-0.595	-0.006	-0.105	0.014	-0.255

Cell contents: Pearson correlation

Source: Calculated by the author.

Table 2 presents the analysis of the correlation between FDI and economic growth and government spending for all countries included in the study.

In the case of Kosovo, FDI had a negative correlation with economic growth, as the coefficient was -0.117, and also in relation to other categories of government spending, investment had a weak negative correlation.

In Albania, FDI had a strong positive relationship with economic growth (0.935), whose coefficient value was high and also higher than that of the other countries. With expenditure on subsidies, these investments had a skewed relationship, while the relationship with the other four categories of expenditure was positive.

In Northern Macedonia, the relationship between FDI and economic growth was weakly positive (0.257), and the same

relationship was observed with the categories of government spending.

In Montenegro, FDI had a significant positive correlation with economic growth or its impact on economic growth, with a coefficient of 0.513. There was a negative correlation only with the category of subsidy expenditures (-0.076) and a positive relationship with the other categories of expenditures.

In the case of Serbia, a positive correlation was found, as the coefficient was 0.447, and the same correlation was found with the other categories of government spending. In contrast to Serbia, the value of the correlation coefficient in Bosnia and Herzegovina was negative (-0.174), and this relationship was also negative in the case of expenditures on wages/salaries, goods/services, subsidies and investment expenditures, which means that the increase in these expenditures was accompanied by a decrease in investments. The only positive relationship was with respect to social transfers.

The most important factor that will show whether they influenced the entry of FDI in the countries studied is the regression analysis used. Table 3 shows a regression analysis.

Using the above analysis, we can understand the impact of FDI on economic growth. Starting with Kosovo, we can see that the value of the regression coefficient is -1.82, which shows that these investments have no effect on economic growth because the relationship is skewed, as in the case of Kosovo and Bosnia and Herzegovina, where the same situation applies, that is, the investments are negatively associated with economic growth, and if we observe an

increase in these investments for a given unit in this case, we will observe a decrease in GDP by 3.34.

In the other four countries, namely Albania, Montenegro, North Macedonia and Serbia, FDI was positively related to economic growth. This means that when these investments increased for a given unit, economic growth was 97.56 in Albania, 20.9 in North Macedonia, 18.22 in Montenegro and 53.5 in Serbia.

Table 4 contains the values for the significance of the econometric model for all countries studied and the percentage contributions for each independent variable.

Table 3. Regression analysis

Regression Analysis						
Term	Coef.	SE coef.	95% CI	T value	P value	VIF
K	-1.82	4.11	(-10.63, 7.00)	-0.44	0.665	1.00
A	97.56	98.5	(764.4, 1186.8)	9.91	0.000	1.00
N.M	20.9	210	(-241, 659)	1.00	0.337	1.00
M	18.22	8.15	(0.74, 35.69)	2.24	0.042	1.00
S	53.5	286	(-78, 1148)	1.87	0.082	1.00
B.H	-3.34	5.04	(-14.15, 7.48)	-0.66	0.519	1.00

Source: Calculated by the author.

Table 4. Model summary and contribution

	R sq.	Contribution						
		Wages & Salaries	Goods & Services	Subsidies	Social Transfers	Capital Expenditure	FDI	Error
K	98.53%	95.97%	1.14%	0.01%	0.01%	0.72%	0.67%	1.47%
A	99.13%	36.77%	52.06%	3.46%	6.10%	0.34%	0.41%	0.87%
N.M	97.75%	68.82%	1.95%	14.06%	12.38%	0.02%	0.52%	2.25%
M	92.83%	82.93%	0.26%	0.68%	3.15%	5.57%	0.23%	7.17%
S	98.51%	86.09%	8.70%	0.59%	2.13%	0.89%	0.11%	1.49%
B.H	77.85%	11.15%	15.47%	3.51%	0.08%	47.55%	0.09%	22.15%

Source: Calculated by the author.

5. CONCLUSION

The econometric analysis conducted using FDI data collected for the six countries at SEE shows that the impact varies across countries. Our results show that in North Macedonia, Montenegro, Serbia and Albania there is a positive impact of FDI on economic development, while the results in Kosovo and Bosnia and Herzegovina show the opposite relationship with economic growth.

Therefore, the governments of Kosovo and Bosnia and Herzegovina should not only take appropriate policy measures and improve the business climate, but also create business opportunities to attract FDI.

The results obtained lead us to make the following recommendations to promote economic growth in Kosovo and Bosnia: The economies of these two countries need to reduce the risks and uncertainties associated with foreign direct investment. They also need greater integration, especially with their neighbours. They should improve the country's image by creating and promoting appropriate policies and infrastructure for economic development.

Governments must be very careful when developing policies and strategies to attract FDI, because unfavourable policies not only do not attract foreign investors, but also lead to a slowdown in economic growth, as in the case of Kosovo, where previous governments had a wrong policy to withdraw FDI by abolishing the dividend tax, which resulted not only in no FDI being withdrawn, but also in a loss of budget revenues, as companies in Kosovo are making huge profits.

To increase investment and economic growth, SEE countries need to attract more FDI and retain it by improving the investment environment, investing more in human capital (skilled labour), building key infrastructures, strengthening regional integration, enhancing internal coordination and external relations, pursuing export-oriented investments, and conducting careful impact assessment, which is very important. But no circumvention of environmental policy and regulations.

Policy governance infrastructures need to be repaired so that the voice of experts and researchers can be heard and complaints responded to. In addition, the culture of accountability and transparency should be promoted, while every effort should be made to improve the stability of the

policy environment to enhance investor confidence in SEE economy countries.

Host governments offer many incentives to attract foreign investors-including tax breaks and subsidies.

This study did not address the challenges and spillover channels of foreign direct investment. Therefore, this study suggests that future studies should be conducted to identify the challenges and positive spillover channels of foreign direct investment in host countries.

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