The Impact of Political Volatility on Foreign Direct Investment: Evidences from the Western Balkan Countries

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Abstract

In this paper we estimate the effect of political volatility in Balkan transition economies on their FDI inflows. For transition economies unaffected by domestic and international instability, FDI inflows in the early 1990s were about 20 to 30% of those achieved by European market economies with similar economic characteristics. Progress with reforms and transition increased post-communist economies' ability to achieve their potential FDI inflows. The Balkan transition countries suffered additional shortage in FDI due to many barriers. However, we estimate than an important barrier is domestic and international volatility.

Key Words: foreign direct investment, Balkan transition economies, political volatility, political risk.

Introduction

Foreign direct investment (hereinafter named FDI) is a crucial component in the transition processes. FDI does not only provide scarce financial capital for the highly indebted transformation economies (Black/Moersch 1997; Manea/Pearce 2001b), but also leads to a cross border intra-organizational transfer of knowledge, managerial as well as marketing skills, technology, entrepreneurship, international market access (Manea/Pearce 2001b). In addition, FDI "promotes the diffusion of new technologies through direct linkages or spillovers to domestic firms" (Altomonte/Guagliano 2001:4). FDI has strong influence on domestic employment through types of jobs created, regional distribution of new employment; wage levels, income distribution, and skill transfer. Hence, FDI can be seen as an essential support for transforming the political and economic systems of these countries into democracy and market economy (Resmini 2000; Lankes/Venables 1996, Bevan et al. 2001). In the meantime, these processes of transition have reached an advanced stage in many CEECs (Central and East European Countries). Prices have been liberalized, the privatization of formerly state-owned enterprises has rapidly progressed, and the once closed economies have opened themselves to foreign trade and investment in many of these countries.

The relationship between FDI and economic growth is twofold: FDI stimulates economic growth, but also reacts to economic growth and progress of transformation. Growth is generated by FDI through imported means of investment, new technologies and capabilities transferred by foreign multinational and international networking. On the other hand, foreign investors react positively to the consolidation of market-economy rules and the resumption of economic growth (Gabor Hunya, 2000, p3).

As the European Union (EU) expands to the East and the South, promising new opportunities for FDI are arising and gaining broader recognition. The Western Balkan, a region comprising Albania, Bosnia and Herzegovina (BiH), Bulgaria, Croatia, Macedonia, Rumania, Serbia, Montenegro and Kosovo, is considered by many current and prospective investors to offer opportunities as Europe's next high-growth business location. The characteristics driving investment in this region include the access it offers to a growing market of over 150 million consumers, right at the doorstep of the EU; an expanding network of bilateral free trade agreements (FTA) under consideration for conversion to a multilateral agreement for the region; a cost-competitive overall operating environment, with labor costs 30-55% lower than of Czech and Hungary; the availability of skilled labor and a strong work ethic; availability of raw materials; and a rapidly improving investment climate.

The transition economies of Eastern Europe have seen a large increase in FDI during the past decade. These inflows have been dramatic because of the two factors:

a) their dynamism, as these countries began the 1990s with practically no stock of FDI, and;

b) because FDI had very important impact to the transition process and to these countries economic performance

However, the distribution of FDI in East European countries has been highly unequal. This because the timing of inflows has been influenced from the political events as well as the privatization, efforts for the macroeconomic stabilization and the building of market institutions process differs between countries. Referring to these factors we can find that there are two factors influencing FDI inflows to these countries. One is the process of transition itself. The progress in transition to a market economy should lead to FDI inflows that would be appropriate for a market economy (Josef C. Brada, p. 2). The second is political instability, armed conflicts, inter-state or inter-ethnic, political and civil conflicts including riots etc. Also, the embargos and trade restrictions and other forms of political conflict that characterized the region, have discouraged FDI inflows. In this paper we estimate the effect political instability on FDI inflows to Balkan transition economies. We find that political instability is a significant barrier to FDI inflow in these countries.

II. FDI inflow in Balkans

Rapidly changing economic environment of new markets in Central and Eastern European transition countries have got attention of many economists and several studies have attempted to study FDI determinants in these countries. Some of them have noted that previous studies have shown the predominance of market-seeking investors and factor-cost considerations have appeared to be less important for the majority of investments (Lankes and Venables 1996, Lankes and Stern 1998). The EBRD carried out a survey that concluded the same, predominance of market-seeing investments in these countries (Lankes et al. 1996). The authors of this survey pointed out that the type and the inflow of FDI depend significantly on the host country's progress in the economic transition.

Four groups of foreign investors have been distinguished in the literature considering their strategic objectives (Brewer 1993, p.4; Chudnovsky et al. 1997, p.2; Dunning 1994, p.36; Foreign Direct Investment 1998, p. 21; Oxelheim 1993, p. 180):

1) market-seeking foreign investors concentrate on servicing the host country's (and its neighboring country's) market;
2) efficiency-seeking investors are interested in low-cost host countries and the production is exported to the home country of foreign direct investment and/or other markets;

3) natural-resource-seeking investments are motivated by desire to reduce costs and provide access to raw materials;

4) strategic-asset-seeking investors are oriented toward acquiring resources and capabilities that the investing firms believes will sustain or advance its core competencies in regional or global markets[1].

Although some FDI projects include elements of more than one of these objectives, it is thought that most projects are focused on only one.

The main aim of market-seeking investment is to provide access to the host country's market, and some times also to its neighboring countries, market.

Efficiency-seeking foreign investors are interested in taking advantage of low production costs "for increasing the efficiency of regional or global MNC activities" (Dunning 1994, p.36). They can produce products to be exported to the home country or other countries. Unlike market-seeking investment, efficiency-seeking investment occurs only in the case of relatively free trade between the host country and export markets (Elteto 1999, p. 2).

The purpose of natural-resource-seeking investments is to use the raw materials available in the host country and lacking in the home country (Brouthers et al. 1996, p. 2).

Strategic-assets-seeking investment has the purpose to acquire resources and capabilities that an investing firm believes will sustain ore advance its core competencies in regional or global markets (Dunning 1994, p. 36).

Market-seeking and natural-resource-seeking motives are typical in the case of initial entry to the foreign market. Efficiency-seeking and strategic-assets-seeking investments are believed to represent the main modes of expansion by established foreign investors (Dunning 1994, p.35).

Table 1 presents a short overview of the most important host country determinants of FDI, taking into account differences in the foreign investor's strategic objectives.

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1 "Attractiveness of Central and Eastern European Countries for Foreign Direct Investment in the Context of European Integration: The Case of Estonia", Janno Reiljan, Ele Reiljan and Kairi Andersson p. 3.

Table1. Main Host country FDI determinants considering the foreign investor's strategic objective

Strategic Objective	Economic Determinants	Political Determinants	Other Determinants
Market-seeking FDI	・nominal GDP ・GDP per capita ・GDP growth rate ・previous FDI ・real wage ・production costs ・transport costs ・infrastructure tarifs and other import restriction	・ownership policies ・price controls ・convertibility of foreign exchang ・performance requirements ・market access constraints ・sector-specific control	・geographical locatior ・cultural differences ・different languages ・population ・local content requirements ・country specific customer preferences
Efficiency-seeking FDI	・inflation ・exchanging rate ・real wage ・savings rate domestic investments ・production costs ・infrastrucure transportation costs ・previous FDI	・market access constraints ・ownership constrains ・tax and subsidies ・price controls ・performance requirements ・FDI incentives ・trade agreements ・requirements of environmental protection	・geographical locatior ・availability of suitable workforce ・existence of supliers
Natural-resource seeking FDI	・prices of raw materials compared to world markets ・infrastructure ・transportation costs ・domestic investments	・FDI incentives ・FDI restrictions ・sector-specific controls	・exictence and quality ofraw materials
Strategig-assetss seeking FDI	・existence and quality of infrastructure ・intensity of R&D activities	・protection of intellectual property ・FDI incentives or restrictions in using the host country's resources ・risk level ・inovation policy	・exictence of patents, trade marks, etc

Source : Referred to “Attractiveness of Central and Eastern European Countries for Foreign Direct Investment in the Context of European Integration: The Case of Estonia”, Janno Reiljan, Ele Reiljan and Kairi Andersson p. 4.

FDI to developed countries have mostly market-seeking nature. On the other hand, efficiency- or natural-resource-seeking FDI flows are usually oriented towards developing countries (Brouthers et al. 1996, p.4; Narula 1994, p.3). Strategic-assets-seeking investments, as a rule, are secondary in explaining foreign capital movements (Hunya 1998, p.2). This kind of FDI seems to be large in transition countries due to the privatization process.

FDI inflows into the Balkan region are lower than those to the Central European Countries, and also are greater inter-country differences in the volume of FDI inflows. Romania, Bulgaria and Croatia are ranked on the top. Economic stabilization and political reform no doubt played a role in these trends. Also, there are big differences of FDI inflows even between the Balkan countries. At least, Bulgaria and Rumania FDI inflows are bigger than the other Balkan countries. With the exception of Bulgaria, Romania and Croatia, the levels of FDI in the Balkan region is very low compared to the Central Europe post-communist countries, such are Poland or Hungary.

Central European countries have experienced a rapid increase of FDI. Hungary was an early leader in FDI inflows, because of its consolidated relations with the West before the transition. This lead many foreign investors to see Hungary as a country with a good infrastructure and economic stability to welcome foreign investment. Poland's FDI inflows began to grow later than Hungary, due to the delays in privatization process. However, for the second half, Poland received the biggest FDI inflow within this group of countries.

Nevertheless, given Croatia's level of economic development, the strong influence of foreign trade with Western Europe and even of foreign investors in these countries in the 1980s, the relative sophistication of their institutions, and the experience of managers in these countries with market mechanism had very strong impact to the foreign investors. The performance of the other former Yugoslav Republics and Albania is much worse.

The reason of this Balkan shortage are manifold. Some of them can be attributed to the lower level of development of some of the former Yugoslav Republic, though even Slovenia and Croatia, which have high levels of per capita income, exhibit this shortage in FDI. Some of the Balkan countries are small by any standard, which may limit FDI inflow relative to countries that can offer a large domestic market, but even large economies such as Bulgaria and Romania suffer shortage in FDI (Josef C. Brada, p. 5). Many Balkan countries, by no means all, have been unable to implement or sustain coherent reform strategies. Some of the shortage may be caused by failures in stabilization, such as those experienced by Bulgaria and Romania, but Macedonia, Slovenia and Croatia have had low level of inflation and stable exchange rates. Yet, they have fared no better in attracting foreign investors.

Table2. FDI inflow in Balkan post-communist countries 1993-2006 (million USD)

Country/Year	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Bulgaria	40	105	98	138	507	537	802	998	803	876	2,070	1,232	1,991	2,106
Romania	87	341	417	415	1,267	2,079	1,025	1,051	1,154	1,080	2,156	5,020	5,230	4,480
Croatia	102	110	109	486	347	835	1,420	1,085	1,407	591	1,700	898	2,000	1,200
Macedonia	0	24	12	12	18	118	32	176	439	77	97	150	97	300
Albania	45	65	89	97	42	45	51	143	204	135	178	343	288	339
BiH	-	0	0	0	0	67	177	150	130	266	382	490	400	570
Serbia & Montenegro	-	-	-	0	740	113	112	25	165	562	1,405	1,028	2,020	2,000

Source : EBRD 2007

The rapid growth of FDI after 1995s should be interpreted with some caution because foreign investors are expected some trend in the future. Since the limited proves for this, it may be that estimates of expected investment based only on the level of contemporary values may understate investors sentiments based on their exceptions of future progress.

One common element affecting the Balkan region has been political instability, both among countries of the region and within many of the countries themselves. The breakup of the Republic of Yugoslavia and the continued separation of what remained as Yugoslavia, is the visible example of political instability in the Balkans. Also, Macedonia has suffered from the ethnic war and an embargo by Greece, as well as the enforcement of the embargo against Serbia. Albania experienced tensions with both, Greece and Macedonia, while Croatia continued conflicts with Serbia to its complicity in Bosnia. There have been many domestic instabilities also, some based on inter-ethnic tensions and assassinations of politicians, some others on the failures in regime change and yet others on weak or ineffective governments that were unable to deal with domestic unrest and violence (Albanian civil unrest 1997, caused from the collapse of pyramid schemes).

III. Political Volatility as a Barrier to FDI in Balkan Countries

FDI is a forward-looking activity based on investors expectations regarding future returns and the confidence that they can place on these returns (Josef C. Brada, p. 6). Thus, the FDI decision requires some assessment of the political future of the host country. There are two main risks deriving from the political volatility in the host countries that the investors face.

1) domestic instability, civil war and international conflicts will reduce the profitability of investing in the host country because domestic sales and exports-imports are inefficient, production splits and the facility is damage or destroyed. An easy example is the embargo of EU and USA toward Serbia and at the same time bombing from NATO in 1999, Serbia and Kosovo War.

2) the political volatility affects the value of the host country's currency, thus reducing the value of the assets invested in the host country as well as of the future profits generated by the investment. As most significant example is the case of Albanian pyramid schemes in 1997.

Note: The pyramid schemes in Albania and the embargo of EU and USA toward the Serbia events are not analyzed in details here. For more information, see World Bank, IMF, OECD, etc. homepages.

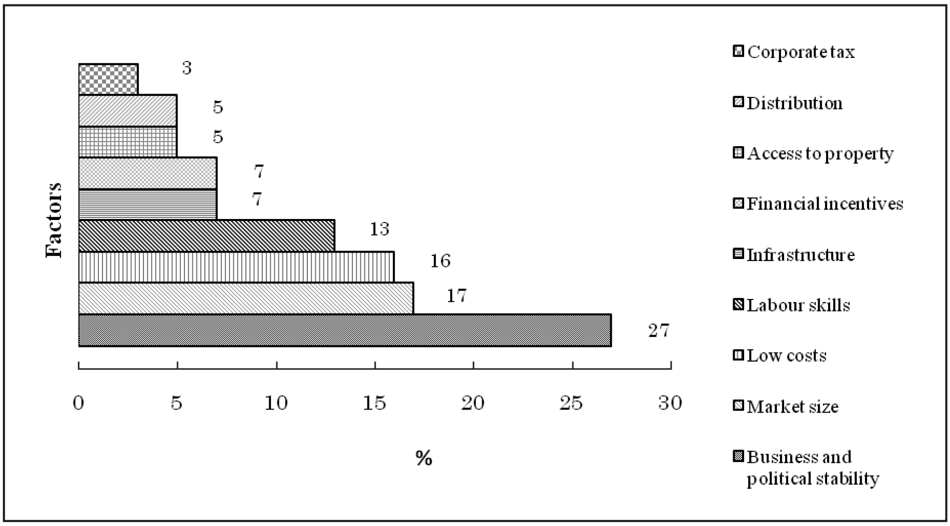

Figure1. Factors that influence FDI generation.

Composed by author, based on Investment Compact and OECD data

Source: www.investmentcompact.org.

Numerous studies and analyses have tried to answer the question why foreign investors invest in developing countries and transitional economies.

However, all the answers can be grouped into three simple strategies:

- Better serving of existing and new customers
- Increase of competition, market share and profitability
- Better access to resources

Major factors that influence the generation of FDI in a country are general policy frameworks, specific policies and policy encouraging business and finally many different economic factors. Policy framework is the first important factor. FDI requires a good macroeconomic and legal stability, convertibility of currency, fair privatization strategies and its visible progress, readiness of domestic companies to cooperate, appropriate opportunities for reconstruction of infrastructure and huge companies, as well as bilateral agreements for protection of investments from political risk and for avoiding double taxation.

The second set of factors refers to the factors that influence business performances, such as subjective vicinity, valid and timely obtaining of the true information about a country, general political environment, country image, administrative procedures in doing business, as well as financial and market privileges.

And finally, there is a range set of factors, mostly of economic nature, such as labor cost, labor skills, integration prospects, market size and market growth, access to neighboring and regional markets, natural resources, management skills, quality and cost of infrastructure, etc. Those factors can have a decisive impact on the investment decision, such as unpredicted expenditures referring corruption, efficiency of administration, good reputation and influence of foreign investors, as well as positive climate towards the foreign investors.

Many barriers on the state and regional level, or on the level of companies make the FDI even more difficult. The most critical are:

- Bureaucracy
- Corruption
- Legal and tax environment
- Inexperienced and incompetent government
- Political volatility and political risk
- Regional instability
- Democratic vacuum
- Macroeconomic and currency instability
- Lack of skilled management
- Poor infrastructure

There is a strong correlation between barriers and FDI inflows. Elimination of these barriers is an important factor for FDI growth. However, experience indicates that the barriers can be much easer created than removed.

The link between political volatility and investment has been studied from different point of view. One important part of the literature insists on the importance of political risk in transition economies. The political risk is a more determinant of assets returns in transition economies than in developed economies (Robin, Liew and Stevens 1996). Using a sample of 23 countries Bussiere and Mulder (1999), conclude that countries are more affected from the financial crises when election results are more unreal. Let us say, the general elections of 1996 in Albania that caused a massive riot of the opposition and 1 year latter, the collapse of the pyramid schemes. The result of the elections was one of the most shameless vote-stealing and manipulated elections ever (OECD homepage).

Another part of the literature points out the relevance between political volatility and the behavior of stock markets on the not unreasonable assumption that the later are a good mirror of investor reaction to political volatility (Ketkar and Ketkar 1989).

There is a growing literature on the effects of political stability on economic performance, both from a theoretical perspective and in terms of empirical work (Josef C. Brada, p. 7). A literature survey on the link between political volatility and economic performance is provided by Carmingnam (2003). This survey covers both theoretical model and empirical studies. He examines the significance of political risk for investment decisions. There are also other studies that examine the linkage of the impact of political volatility on economic growth and investment. The increase of political volatility decreases decrease investment and at the same time bring the slow down of the economic growth.

There are also some works on the effect of political volatility on foreign exchange markets. These works provide that political volatility causes the decline of country's currency and at the same time makes the exchange rate more instable (Kutan and Zhou 1993, 1995). Kutan and Zhou show that the political unrest in Poland during late 1980s and early 1990s affected foreign exchange returns.

But how the political volatility of Balkan countries affected their FDI inflows? We will try to explain by some of the following features.

All post-communist countries of Central and Eastern Europe suffered a shortage in FDI inflows due to the effect of the transition, but this shortage in the FDI of the Balkan countries is related to a very specific factor, the impact of political volatility in the region on the decision of foreign investors.

Recently, there is a well-developed literature that examines the relationship between host country political volatility and FDI inflows. Bennett and Green (1972), Singh and Jun (1995), Globerman and Shapiro (2002) and Cho (2003) all add measures that reflect domestic political volatility or risk as an important factor to economic characteristics of host countries. Also, they all find that such risk help to explain FDI inflows because the increase of political risk really reduces FDI. Some other indicators are the rule of law and investment climate, both of which to some extent reflect political stability and are significant factors in the determinants of FDI inflows into Balkans transition economies.

But, we can find that in these studies is a basic deficiency. It is that the political risk term used in these studies refers mainly to the domestic political volatility such as strikes, riots, civil unrest, etc. However, these studies do not treat the risk measures that reflect external political risk, such as war between countries, foreign trade embargos, economic sanctions, ethnic armed conflicts and neighboring wars that are so important for the Balkan region.

A problem is how to qualify the concept of external political stability. Many political scientists have developed both aggregate and bilateral measures of the goodness of relations between countries, but using these measures is difficult for situations where states are breaking up into constituent parts that have no record of external relations. So they may have relationships with their neighbors that are considerable different for those of the nation state from which they separated. We can bring as a sample the case of Macedonia, whose relation with Greece, even now, are much more influenced because of its name and status that they had been when it was a part of Yugoslavia.

As we can see the data of Table 2, the FDI inflows in Balkan countries increase over time, but, for most countries, the increase is sporadic, reflecting the fragility of economic stabilization. Many of the large changes in expected FDI can be attributed to the implementation of stabilization programs or to their collapse, both of which can have a quick impact on the political stability.

In the Balkan countries there are additional sources of instability, of which political volatility is most important one (Josef C. Brada, p. 8). For example, the sharp drop in Albanian FDI inflows in 1997-1999 as a reaction to the crisis caused by the collapse of the financial pyramid schemes in 1997 and 1998 and the Kosovo war of 1999. The same reduction in 1999 FDI can be seen for Macedonia and Romania. Another important factor is the major changes in privatization policy. In Balkans the privatization began in the mid-1990s, while in the Central Europe it began in the end of 1980s. Thus, the decision to push ahead with large privatization transactions in Albania in 2000 and the change of policy in favor of foreign investors in Croatia and in 1997 in Romania are much evident.

The difference between the FDI for each country of the region is due to the effect of political volatility in the region. The shortage due to political uncertainty is quite large, as the FDI inflows expected if these countries were merely in transition would be a multiple of the FDI inflows actually observed. Croatia displays a something different pattern. It observed FDI inflows fall short of what is expected, perhaps reflecting the effects of the breakup of Yugoslavia on FDI inflows. However, from the mid-1990s FDI inflows exceed expected FDI (Josef C. Brada, p. 21). This reflects both, policy changes in supporting

FDI as well as investors' perceptions that this country is not likely to be negative influenced by regional or domestic political uncertainty. At the same time, Albania appears to be an outlier as its actual FDI inflows exceeded the predicted levels, suggesting that Albania benefited from the regional instability in the early 1990s political volatility of the region. However, based on the different data, a more detailed explanation is related to the fact that, a part of this investment is done from the Albanian emigrants living abroad. In 2000 and 2001, the FDI inflows are driven by the privatization of state owned banks, telecommunications firms and the sale of mining concessions.

IV. Conclusion and some Policy Implications

Our research has demonstrated that the political volatility, whether domestic or international conflicts serves to reduce FDI inflows into the transition economy and especially in the Western Balkan. Moreover, we find that a large part of the shortage of FDI into the Balkan transition economies is attributed to the effects of regional political volatilities on the willingness of foreign investors to invest in these countries.

The economic cost of foregone FDI inflows in Balkan transition economies is beyond the scope of this paper. However, the literature on the effects of FDI in transition economies suggests that this cost must be quite high because of the important benefits that FDI brings. The most evident one is that FDI can serve as a plus to domestic saving and investment, and all transition economies much need additional investment to raise the productivity and living standards. It is true that much of the FDI inflow in transition economies has been used to purchase existing firms rather than to finance new green-field investments. Whatever, this kind of FDI has a positive impact on domestic capital formation because investors contribute the new capitalization to their acquisitions (Sohinger and Harrison). Moreover, as Hunya (1996) shows in the case of Hungary, foreign firms have higher profits and reinvest a much higher share of it than domestic firms, thus increasing capital formation in the future.

In the Balkan region, foreign companies are likely to be more productive and to use more advanced technologies. They serve as very important spillovers of these technologies and managerial skills from foreign companies to domestic economy.

As a result, we can conclude that the cost of lost FDI to the Balkan transition economies are of a magnitude that is much greater than the shortage that we have examine in this study. Consequently, the restoration of peace to the region and the elimination of tensions, both domestic and among the countries of the region, should bring important economic benefits.

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