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Determinants of Foreign Direct Investment in Western Balkans

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ABSTRACT

Purpose:

This study aims to establish the correlation between diverse economic and institutional factors and inward foreign direct investments (FDI) in Western Balkans countries. The analysis examines into the impact of market size, inflation rate, bank nonperforming loans, control of corruption, and rule of law on the relationship with inwards FDI.

Design/methodology/approach:

Ordinary least squares, fixed effects, random effects and Hausman Taylor IV models were applied to a balanced panel dataset comprising six western Balkans countries over the period 2008–2022. Our results provide evidence that past levels of FDI have a significant and positive impact on current FDI levels, even after accounting for endogeneity using instrumental variables.

Findings:

Our results provide evidence that past levels of FDI have a significant and positive impact on current FDI levels, even after accounting for endogeneity using instrumental variables. The coefficient for GDP per capita is negative, suggesting inverse correlation between GDP per capita and FDI. This relationship shows some marginal significance, indicating the possibility for further, more detailed studies to provide clearer insights in the future. Our findings suggest that inflation exhibits a positive and statistically significant relationship at the 0.01 level, implying that increased inflation rates correspond to higher levels of FDI. Over the course of our study period, the average inflation rate held at 3%. The results concerning the rule of law reveal a positive association with FDI. However, the coefficient for this variable is marginally significant (0.111), implying that stronger rule of law institutions may potentially attract higher levels of FDI. The results relating to control of corruption and bank nonperforming loans show no statistical significance.

Research limitations/implications:

While this study offers valuable insights into the factors influencing inward FDI in the Western Balkans, there are several limitations worth acknowledging. First, the analysis relies on a balanced panel dataset, which may not account for country-specific shocks or extreme events that could have affected FDI inflows during the study period. Another limitation is the reliance on certain macroeconomic and institutional indicators (GDP per capita, inflation, rule of law, corruption, and nonperforming loans), which may not encompass all the relevant factors influencing FDI. Future research could incorporate additional variables such as political stability, tax policies, or trade openness to provide a more comprehensive understanding of FDI drivers.

Originality/value:

This study offers a unique contribution to the literature on foreign direct investment (FDI) by specifically examining the relationship between FDI and a diverse set of economic and institutional factors within the context of the Western Balkans. While much of the existing research on FDI tends to focus on more developed economies or regions, this paper highlights the challenges and opportunities faced by transitional economies in Southeast Europe.

Keywords:

Foreign direct investment (FDI), GDP per capita, Inflation, Bank nonperforming loans, Control of corruption, Rule of law

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1. Introduction

Foreign direct investment has a significant impact on the host country's economy, affecting various aspects such as economic growth, employment, production process, competition, income, prices, salaries, and general economic conditions. Foreign direct investment is arguably one of the most influential factors shaping the development of the international economy. The substantial increase in FDI flows across countries is a key reason why the academic world is increasingly focusing on understanding the determinants of foreign direct investment. There are many studies that examine the relationship between foreign direct investment and economic development and most importantly the determinants of foreign direct investment.

Many scholars consider economic, political, and institutional factors as key determinants influencing the varying attractiveness of countries in comparison to each other. Most of the studies conclude that market size and economic growth are among the main determinant of foreign direct investment (Amal et al. (2009); de Castro et al.(2013); Jadhav (2012); Oneyiwu and Shrestha (2004); Biligli et al. (2012); Kok and Ersoy (2009); Alam and Sulfiqar Ali Shah (2013); Derado (2012)). On the other side there are researchers that found that economic factors are not important determinants when it comes to foreign direct investments (Bellumi (2014); Temiz and Gokmen(2014); Harzer and Klasen (2008)). Political and institutional factors have been found to play significant role in decisions of the companies to invest abroad (Ghazal and Zulkhibri (2015); Buchanan et al.(2012); Sabir et al. (2019); Wisniewski and Pathan(2014); Lucke and Eichler (2015); Sambharya and Rasheed(2015); Freckleton et al. (2012); Mina (2010); Peres et al (2018). According to Liu (2008) analysis, the spillovers linked to Foreign Direct Investment (FDI) may lead to a short-term decline in productivity levels but contribute to an enhanced long-term rate of productivity growth for domestic firms. The favorable impact of spillovers aligns with the core concept of endogenous growth literature, highlighting human capital or knowledge as the fundamental driver of economic growth. Acting as a knowledge source, FDI fosters sustainable productivity growth within domestic companies.

Following the 1980s, there was a substantial increase in the operations of Multinational Enterprises (MNEs), catalyzing the expansion of Foreign Direct Investment (FDI) in terms of worldwide production and the international movement of goods. The global economy has notably channeled investments into developing nations, encompassing Eastern European countries, the South Asian Association of Regional Cooperation (SAARC), the Association of Southeast Asian Nations, as well as African and Asian countries. Nevertheless, owing to conflicts and instability in recent decades, the Western Balkans did not establish itself as a primary hub for foreign direct investments.

Due to various challenges such as war, political instability, and hyperinflation, the countries of the Western Balkans struggled to attract investments. These nations now present a compelling case for study, especially in terms of their economic development and the need to enhance their appeal to investors. This is crucial, given that Foreign Direct Investment (FDI) is known to stimulate economic growth. The direction of this relationship, whether increased FDI fosters economic growth or vice versa, and the primary determinants involved are key aspects to explore.

The central objective of this study is to investigate determinants of Foreign Direct Investment (FDI) identifying the key determinants in six Western Balkans countries: Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, and Serbia.

This study brings a double contribution. Firstly, it distinguishes itself by investigating the causal relationship between Foreign Direct Investment (FDI) and economic indicators in the Western Balkans, incorporating political and institutional factors—a less-explored aspect in existing literature. Secondly the research employs a model utilizing a static panel approach with FDI as the dependent variable and a diverse set of independent variables. Various techniques, including pooled OLS, fixed and random effects models, and the Hausman–Taylor model, are employed. The study incorporates commonly used indicators in the literature such as GDP per capita, inflation, bank non-performing loans, control of corruption, rule of law. To address specific open-ended research questions, the primary objective of this study was to identify the key economic and political factors that influence Foreign Direct Investment (FDI).

The rest of this paper is structured as follows: Section 2 examines the literature; Section 3 elaborates on the research methodology and data; Section 4 presents the results; and Section 5 provides the conclusions.

2. Review of Literature

2.1 Theoretical Review

In this section, we underscore the empirical findings concerning the determinants of foreign direct investment. With respect to the interconnection of economic, political, and institutional factors that significantly influence the decisions of Multinational Enterprises (MNEs) to invest overseas, the available empirical evidence fails to yield a definitive conclusion.

Busse and Hefeker (2007) investigate the correlations among political risk, institutions, and the inflow of foreign direct investment. Employing two distinct econometric techniques—a country fixed-effects model and the Arellano-Bond generalized method of moments (GMM) estimator—and utilizing data spanning from 1984 to 2003 for a sample of 83 developing countries, the study focuses on the intricate relationship between political institutions and FDI. Across the cross-country analysis spanning two decades, they observe relatively few indicators related to political risk

and institutions that exhibit a strong association with FDI. Notable exceptions include government stability, law and order, and the quality of the bureaucracy.

Buchanan et al. (2012) conduct a panel data analysis encompassing 164 countries over the period 1996 to 2006, utilizing simple Ordinary Least Squares (OLS) regression to investigate the influence of institutional quality on both the levels and volatility of foreign direct investment (FDI). They provide evidence that institutional quality has a positive and significant effect on FDI.

Kumari and Sharma (2017) identified key determinants of foreign direct investment (FDI) inflows in developing countries using unbalanced panel data from 1990–2012, focusing on 20 developing countries in South, East, and South-East Asia. Employing fixed and random effect models, the Hausman test supported fixed effect estimation, highlighting market size, trade openness, interest rate, and human capital as significant factors influencing FDI inflow in the studied panel of developing countries. Notably, market size emerged as the most significant determinant of FDI inflow.

Ali et al. (2010), employing a random-effects model and analyzing a panel of 69 countries spanning from 1981 to 2005, they examined the influence of institutions on determining foreign direct investment (FDI). The study reveals that institutional quality exerts a significant role in determining FDI inflows, compared with other institutional attributes such as democracy, corruption, political instability, and social tension, property rights security appears to be the most relevant institutional aspect for FDI; once property rights security is controlled for, other institutional attributes lose their significance.

Gherghina et al. (2019) study examined the link between foreign direct investment (FDI) inflows and economic growth, also considering several institutional quality variables, as well as sustainable development goals. By estimating panel data regression models for a sample of 11 Central and Eastern European countries, from 2003 to 2016, the empirical outcomes provide support for a non-linear relationship between FDI and gross domestic product per capita. Regarding institutional quality, it is found that control of corruption, government effectiveness, regulatory quality, rule of law, and voice and accountability positively influence growth, while political stability and absence of violence/terrorism is not statistically significant.

Abbes et al. (2015) suggest that under favorable conditions, foreign capital can narrow the gap between capital needs and national savings, enhance skill levels, facilitate market access, and foster technology transfer and good governance. Examining data from 65 countries spanning 1980 to 2010, this study employs co-integration and panel Granger causality tests to explore the connection between foreign direct investment and economic growth. The findings reveal variations in the co-integration relationship within the panel study.

Sabir et al. (2019) conducted a study exploring the influence of institutional quality on Foreign Direct Investment (FDI) inflows. Panel data from low, lower-middle, upper-middle, and high-income countries during the period 1996–2016 were analyzed using the system Generalized Method of Moments (GMM). The empirical findings affirm a positive impact of institutional quality on FDI across all country groups. Notably, the coefficients for control of corruption, government effectiveness, political stability, regulatory quality, rule of law, and voice and accountability exhibit greater magnitude in developed countries compared to developing ones.

Freckleton et al. (2012) conducted an analysis employing panel dynamic ordinary least squares, utilizing data from 42 developing countries and 28 developed countries. They found that the fact that there is no significant impact of corruption in the long run may imply that investors are usually driven by prospects of profitability, government directed incentives, and local institutional and human capital effectiveness.

Sharma and Bandara (2010) presented empirical evidence of the determinants of Australian foreign direct investment using hypotheses drawn from an investment demand model, new trade theory and institutional economics, using data from 1992–2007. Findings suggest that countries which are open, have a large domestic market, and have a similar language and culture to Australia's attract most of its foreign investment.

Khachoo and Khan (2012) in their research paper, employed a panel econometric model to estimate the factors influencing foreign direct investment (FDI) inflows into developing countries over an extended period. Research focused on a sample of 32 developing nations. In their analysis, they modeled FDI inflows for host countries as a function of market size, total reserves, infrastructure, labor costs, and the degree of openness. Utilizing data from 1982 to 2008, the panel data estimator indicated that market size, total reserves, infrastructure, and labor costs emerged as the primary determinants of FDI inflows into developing countries.

Hayakawa et al., (2013) using the overall FDI inflows for 89 countries during the period from 1985 to 2007, empirically investigated the effects on inward FDI of various components of political and financial risk. They examine the effects of not only the level of these risks but also their changes over time. One of the major findings is that among the political and financial risks, only the political risk is adversely associated with FDI inflows. Specifically, not only the initially low level of political risk, but also a decrease in the level of political risk helps to bring a greater amount of FDI inflows. They found that internal conflict, corruption, military in politics, and bureaucracy quality are inversely related to inward FDI flows.

Arbatli (2011) investigates the determinants of FDI inflows to emerging market economies, concentrating on the effects of economic policies, using dynamic panel models. The data sample includes 46 countries and covers the period from 1990 to 2009 for most of them. The sample captures the global economic crisis and hence offers a preliminary assessment of the effects of the crisis on FDI inflows. Paper found that both global push factors and economic policies had a significant effect on FDI inflows for the set of emerging market economies in sample.

Campos and Kinoshita (2008) investigated the role of structural reforms –financial reforms, trade liberalization, and privatization– as determinants of FDI inflows based on dataset on structural reforms for 19 Latin American and

25 Eastern European countries between 1989 and 2004. Main finding is a strong empirical relationship from reforms to FDI, in particular, from financial liberalization and privatization. They also included variables like market size, the level of development, macroeconomic stability, infrastructure, and natural resource abundance. Over long term, the influence of market size evens out across sectors due to the extended adjustment period required for manufacturing FDI to reach its desired level. Therefore, an increase in GDP has a more pronounced effect on services FDI in the initial period, while it gradually affects manufacturing FDI.

Bevan and Estrin (2004) conducted an analysis using a dataset spanning from 1994 to 2000 to examine the factors influencing Foreign Direct Investment (FDI) from Western countries, with a primary focus on the European Union (EU), into Central and Eastern European nations. Their findings highlight unit labor costs, gravity factors, market size, and proximity as the most substantial determinants. Notably, host country risk does not emerge as a significant factor. Consistent with their observations, their empirical investigation reveals that announcements regarding EU Accession proposals exert an influence on FDI in countries slated for future membership.

In their study spanning the years 2003 to 2009, Zhang and Daly (2011) utilized panel data analysis to assess the primary determinants of China's outward Foreign Direct Investment (FDI). Their findings reveal a positive correlation between China's foreign investments and factors such as international trade, market size, economic growth, degree of openness, and the presence of natural resources.

Rogmans and Ebbers (2013) studied determinants of foreign direct investment (FDI) into countries of the Middle East North Africa (MENA) region, in their research found that energy endowments have a negative impact on FDI flows into a country. GDP per capita, openness to trade and oil prices has a positive impact on FDI inflows, while aggregate measures of environmental risk are not a differentiating factor among countries in the region. Their findings are based on panel data, analyzing the flows of FDI into 16 MENA countries during the 1987-2008 period. In order to test the hypotheses, they built a multiple ordinary least squared regression model that includes the main parameters that are expected to be associated with FDI inflows.

Limited empirical research has explored the correlation between economic and political indicators and Foreign Direct Investment (FDI), particularly within the Western Balkans region. Previous research has not provided conclusive findings regarding the influence of economic and political indicators on Foreign Direct Investment (FDI). Addressing this gap is the primary objective of our research paper. The results of our research contribute to the existing body of knowledge on this subject and hold relevance for policymakers when making decisions.

3. Methodology

In this section, we construct an empirical econometric model aimed at evaluating the interplay and causality between foreign direct investment (FDI), GDP per capita, inflation, bank non-performing loans, control of corruption, and the rule of law across Western Balkans countries, encompassing Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, and Serbia. To achieve this objective, we employ pooled Ordinary Least Squares (OLS), fixed effects, and random effects methodologies, as well as the Hausman–Taylor IV approach. Additionally, we employ the Hausman test to select the most appropriate model among fixed effects, random effects, and the Hausman–Taylor model. The Hausman test results indicate that the fixed effects model is deemed more consistent and efficient for our analysis.

The specification of the empirical model is as follows:

$$y_{it} = c + \beta_1(y_{it-1}) + \beta_2(GDP_{it}) + \beta_3(Inf_{it}) + \beta_4(Loan_{it}) + \beta_5(Law_{it}) + \beta_6(Cor_{it}) + u_{it}$$

Where y_{it} is dependent variable which represents Foreign direct investment, net inflows (% of GDP); c is term of constant; the explanatory variables include y_{it-1} is the first lagged of dependent variable, GDP_{it} - GDP per capita is gross domestic product divided by midyear population, Inf_{it} - Inflation reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services, $Loan_{it}$ - Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio, Law_{it} - Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society, Cor_{it} - Control of Corruption captures perceptions of the extent to which public power is exercised for private gain, u_{it} are the exogenous disturbance.

The research employs panel data encompassing six Western Balkans countries—Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, and Serbia—spanning from 2008 to 2022. The selection of this time frame is dictated by the availability of consistent time series data for all variables included in the model. Data utilized in this study were obtained from reputable sources such as the World Bank (WB) and the National Central Banks of the respective countries. A critical aspect of the dataset revolves around selecting appropriate indicators as variables to ensure reliable outcomes. Drawing on insights from prior research (e.g., Ali et al., 2010; Arbatli, 2011), we have used Foreign Direct Investment, net inflows (% of GDP), as the dependent variable. We use GDP per capita as independent variable which was also used in other studies (Head, Ries 2008; Chakrabarti 2001). Following Singhania and Gupta (2011), Ibrahim and Hassan (2013), Igošina (2015), and Cevic and Camurdan (2007) we include in empirical model also inflation.

Wei (2000), Chakrabarti (2001), Dumludag (2009), and Badea et al. (2018), as well as Su et al. (2018), examined corruption and additional institutional variables, which they deemed significant in explaining Foreign Direct Investment (FDI) dynamics.

We provide summary statistics for the study in Table I. Tables AI contain information on the data and on the data source.

Table 1

| Variable | Observation | Mean | Std. Dev. | Min | Max |
|----------------|-------------|-------------|-----------|------------|-------------|
| FDI | 90 | 6.873555 | 5.096312 | 0.0622294 | 37.27248 |
| GDP per capita | 90 | 3.739694 | 0.1195547 | 3.454472 | 3.995351 |
| Inflation | 90 | 3.054937 | 3.688807 | (2.410264) | 14.20472 |
| Loan | 90 | 9.880489 | 5.887009 | 1.93257 | 22.24386 |
| Corruption | 90 | (0.3850691) | 0.1958072 | 0.7787294 | (0.0145488) |
| Law | 90 | (0.2758902) | 0.1650175 | 0.6273103 | 142629 |
| FDI lag 1 | 84 | 6.806976 | 5.187901 | 0.0622294 | 37.27248 |

Source: Author's calculation

3.1 Measurement of Study Variables

In this part, we present the outcomes derived from pooled Ordinary Least Squares (OLS), fixed effects, random effects, and the Hausman–Taylor IV estimations. The coefficient obtained from the pooled Ordinary Least Squares (OLS) estimator tends to be biased due to the presence of unobservable individual-specific effects heterogeneity. Consequently, we proceed to compute both fixed and random effects models, the results of which are presented in Table II. Further statistical analysis reveals that the random effects estimator exhibits inconsistency and lower efficiency compared to the fixed-effect estimator, which demonstrates greater consistency and efficiency. Unlike the random effects estimator, the fixed-effect estimator mitigates the correlation between unobservable individual-specific effects and explanatory variables.

To address potential endogeneity issues, which may introduce biases to the regression coefficients, we employ the Hausman–Taylor estimator (as shown in Table II). The Hausman–Taylor (IV) method with instrumental variables (IVs) is utilized to eliminate correlations between the variables included in the model and individual components of the error terms, thereby tackling the problem of endogeneity. In the application of the Hausman–Taylor IV estimator, GDP per capita is identified as an endogenous variable. To resolve this issue, the variable is employed as an exogenous variable in the estimation process.

The first lag of FDI (% of GDP) is initial level of FDI (% of GDP) which is instrumented by the deviations of the individual means. This means that the variations or deviations from the individual means of the FDI (% of GDP) across different units are utilized as instrumental variables to account for potential endogeneity or omitted variable bias in the analysis. By using the deviations from individual means as instrumental variables, we aim to address any potential biases that may arise from the relationship between the initial level of FDI and the outcome of interest. This approach helps ensure the robustness and reliability of the analysis results.

The positive coefficient (0.3366562) of the first lag of Foreign Direct Investment (FDI) as a percentage of Gross Domestic Product (GDP), denoted as $yit-1$, with a standard error of 0.10237, and its statistical significance at the 0.001 level suggest a meaningful relationship. These results suggest that the first lag of FDI as a percentage of GDP has a significant and positive impact on the current level of FDI, as indicated by the statistically significant coefficient of 0.3366562 with a low standard error. Our results provide evidence that past levels of FDI have a significant impact on current FDI levels, even after accounting for endogeneity using instrumental variables.

GDP per capita coefficient estimated using the Hausman–Taylor IV method is -15.28784. While this coefficient is negative, indicating a potential inverse relationship between GDP per capita and FDI, it is marginally significant at the 0.1 level ($p = 0.072^*$). This suggests that higher levels of GDP per capita may be associated with lower levels of FDI, but the relationship is not as robust as other variables in the model. Our results contradict the findings of studies conducted by Casi and Resmini (2010), Khamphengvong et al. (2018), Cuyvers et al. (2011), Kalyoncu et al. (2015), and Boateng et al. (2015). Our results align with those of Belloumi (2014), whose research indicates the absence of significant Granger causality from Foreign Direct Investment (FDI) to economic growth or from economic growth to FDI. Belloumi measured economic growth by the increase in real GDP per capita. Similarly, our findings are consistent with those of Hisarciklilar et al. (2006), whose Granger causality test results for the relationship between Foreign Direct Investment (FDI) and Gross Domestic Product (GDP) mirror our own. Their findings suggest the absence of significant Granger causality from FDI to GDP or from GDP to FDI.

Coefficient obtained for inflation is 0.33386. It is positive and statistically significant at the 0.01 level, indicating that higher inflation rates are associated with higher levels of FDI. This suggests that investors may view inflation as a signal of economic growth and potential investment opportunities. An increase in inflation tends to stimulate or enhance the inflow of Foreign Direct Investment into the country. According to this, inflation stimulates Foreign

Direct Investment, countries should aim to maintain a moderate level of inflation that is neither too high nor too low. This can signal economic stability and attractiveness to foreign investors. Many central bank's target a specific inflation rate as part of their monetary policy. A moderate and predictable inflation rate (typically between 2% and 3% annually) is considered by some policymakers to provide a stable environment for economic growth. Researches conducted by Singhania and Gupta (2011), Ibrahim and Hassan (2013), Igošina (2015), and Ceviz and Camurdan (2007) have identified inflation as a significant factor influencing foreign direct investment. Over the course of our study period, the average inflation rate held at 3%. However, in the final year of the period, 2022, overall inflation experienced a substantial increase attributable to post-pandemic pressures and the conflict in Ukraine, thereby inflating the overall average for the entire period.

Table 2. Regression result

| Variables | OLS | Fixed effects | Random effects | Hausman–Taylor IV |
|---|--|--|---|---|
| Foreign direct investment (% of GDP) L1 | 0.66075 s.e. 0.07997 p 0.000*** (1.92790) | 0.26861 s.e. 0.10740 p 0.015** (22.02044) | 0.066075 s.e. 0.07997 p 0.000*** (1.92790) | 0.33665 s.e. 0.10237 p 0.001*** (15.28784) |
| GDP per capita | s.e. 6.25694 p 0.759 | s.e. 9.3029 p 0.021** | s.e. 6.25694 p 0.758 | s.e. 8.490625 p 0.072* |
| Inflation (annual %) | 0.22912 s.e. 0.13179 p 0.086* | 0.37729 s.e. 0.12687 p 0.004*** | 0.22912 s.e. 0.13179 p 0.082* | 0.33386 s.e. 0.12479 p 0.007*** |
| Bank nonperforming loans | 0.00294 s.e. 0.06903 p 0.966 | (0.12813) s.e. 0.98362 p 0.197 | 0.00294 s.e. 0.06903 p 0.966 | (0.07518) s.e. 0.09194 p 0.414 |
| Rule of Law | 4.24133 s.e. 5.05395 p 0.404 | 7.96374 s.e. 4.68778 p 0.094* | 4.24133 s.e. 5.05395 p 0.401 | 7.4614 s.e. 4.6833 p 0.111 |
| Control of Corruption | 0.23524 s.e. 2.60547 p 0.928 | (5.35507) s.e. 3.2916 p 0.108 | 0.23524 s.e. 2.60547 p 0.928 | (3.78718) s.e. 3.18087 p 0.234 |

Notes: ***, **, and * indicate significance at the 1, 5 and 10 % levels, respectively.

Source: Author's calculation

The coefficient estimated for bank nonperforming loans is -0.07518, although it is not statistically significant ($p = 0.414$). This suggests that the ratio of nonperforming loans to total loans does not have a significant impact on FDI levels in the Western Balkans countries, according to the Hausman–Taylor IV estimation. Tang (2017) and Nkoa (2018) noted a beneficial influence of increased bank credit flows on foreign direct investment (FDI). Consequently, we anticipated a potential correlation between nonperforming loans and FDI. However, our hypothesis appears to be unsupported according to the findings.

The coefficient obtained for the rule of law variable is 7.4614, indicating a positive relationship between the rule of law and FDI. However, this coefficient is marginally significant at the 0.1 level ($p = 0.111^*$), suggesting that stronger rule of law institutions may attract higher levels of FDI, but the relationship is not as robust as other variables. Our findings align with those of other studies, such as Naudé and Krugell (2007) and Zhang and Liu (2021), who similarly discovered that the Rule of Law has a positive impact on inward Foreign Direct Investment (FDI).

The coefficient estimated for control of corruption is -3.78718, but it is not statistically significant ($p = 0.234$). This suggests that the level of corruption control does not have a significant impact on FDI levels in the Western Balkans countries, according to the Hausman–Taylor IV estimation. Our findings are consistent with those of other studies, such as Egger and Winner (2005), as well as Su et al. (2018). Contrary Asongu et al. (2018), Badea et al. (2018) found that institutional quality play insignificant role in attracting FDI.

5. Conclusion and Recommendations

Using an empirical model and econometric methods, we analyzed the impact of economic and political factors on foreign direct investment (FDI) in six Western Balkan countries—Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, and Serbia—from 2008 to 2022. Our study integrated four economic indicators and two institutional variables for examination. Our findings underscore that past FDI levels significantly influence current FDI levels, even after addressing endogeneity. Interestingly, we found a marginally significant negative relationship between GDP per capita and FDI, although the strength of this relationship is uncertain and may not hold across different contexts. Further investigation is needed to better understand the nature of this potential link.

Moreover, our results highlight a significant and positive relationship between inflation and FDI, indicative of increased FDI levels with higher inflation rates, which averaged 3% during our study—a potentially healthy level. While stronger rule of law institutions positively correlates with FDI levels, the marginal significance of the rule of law variable deserves further investigation into its impact. On the contrary, our analysis found no statistical significance regarding control of corruption and bank nonperforming loans, emphasizing the need for additional research into their dynamics with FDI. Overall, our study offers valuable insights into FDI determinants, explaining the complex interplay of economic, institutional, and regulatory factors in attracting foreign investment. For future research, expanding the temporal scope and incorporating additional political control variables could deepen understanding. Additionally, exploring industry profitability, particularly in light of substantial international bank investments in the region, may provide further insights into FDI determinants.

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Appendix

| | Variable | Type of variable | Definition/Explanation | Source |
|---|---|---|---|---|
| 1 | Foreign direct investment, net inflows (% of GDP) | Nominal | Foreign direct investment refers to direct investment equity flows in the reporting economy divided by the total GDP | World Development Indicators |
| 2 | GDP per capita (current US\$) | Real | GDP per capita is gross domestic product divided by midyear population. | World Development Indicators |
| 3 | Inflation, consumer prices (annual %) | Nominal | Inflation reflects the annual percentage change in the cost to the average consumer of acquiring a basket of goods and services | World Development Indicators |
| 4 | Bank nonperforming loans to total gross loans (%) | Nominal | Bank nonperforming loans to total gross loans are the value of nonperforming loans divided by the total value of the loan portfolio | World Development Indicators and National Central Banks |
| 5 | Rule of Law: Estimate | Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. | Rule of Law captures perceptions of the extent to which agents have confidence in and abide by the rules of society | World Development Indicators |
| 6 | Control of Corruption: Estimate | Estimate gives the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5. | Control of Corruption captures perceptions of the extent to which public power is exercised for private gain | World Development Indicators |

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