

Determinants of FDI location in South East Europe (SEE)

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This paper focuses on whether previous findings on the relationship between trade and institutional integration on FDI location in Central and Eastern European economies are consistent with observed patterns in South East Europe.

* The views expressed in this paper are those of the authors only, and do not reflect the official position of the OECD, the European Commission, the CEFTA institutions or CEFTA Parties themselves.

Introduction

In the previous paper we investigated the relationship between foreign direct investment (FDI), progressive regional integration and institution building in Central and Eastern Europe (CEE). In this final section we extend the analysis to produce a series of auxiliary regressions that attempt to establish how institution building and regional integration have influenced the location of FDI in South East Europe (SEE).

As in CEE, SEE countries have concluded numerous free trade agreements (FTAs) with their neighbours. In 2007, the over 30 bilateral FTAs in place were consolidated into a regional free trade agreement covering Albania, Bosnia and Herzegovina, Croatia, Kosovo under UNSCR 1244/99, the Former Yugoslav Republic of Macedonia, the Republic of Moldova, Montenegro and Serbia. This new Central European Free Trade Agreement (CEFTA 2006) provided for the immediate liberalisation of trade in industrial products and the gradual liberalisation of trade in agricultural products. It also incorporated advanced provisions on trade in services, national treatment, intellectual property rights and government procurement. Bulgaria, Croatia and Romania were members of the original CEFTA agreement, although Bulgaria and Romania left the agreement in 2007 once they became EU member states (see “Determinants of FDI location in Central and Eastern Europe” for more information).

Simultaneously, SEE countries have been implementing institutional reforms. Led by the Stabilisation and Association Agreements, SEE economies have been upgrading their institutions and policies to bring them in line with EU standards.¹

The aim of our empirical work in this final paper is to illustrate how trade integration and institution building are conducive to higher FDI in South East Europe. It is to be viewed as a complement to the work in the previous paper by extending the analysis to SEE countries.² In the next section we describe the variables used in our empirical research. Following this is a description of our empirical methodology. We conclude by presenting the results of our main regressions and ancillary regressions which investigate in more detail the impact of trade and investment climate variables on FDI.

Variables

Our methodology for choosing which variables to include in the analysis follows the same logic as that presented in the previous paper. We include a variable for market potential. In the analysis on CEE countries, a measure of market potential was constructed to reflect both economic performance and geographical market size. However, this indicator was only available for a select group of SEE countries and over a limited time series. Instead, we rely on gross domestic product (GDP) per capita (GDPcap) from the World Bank’s World Development Indicators (WDI) database. We expect the sign on GDPcap to be positive: all things equal, market-seeking FDI will be attracted to larger domestic economies.

We also include a variable of trade openness (OPEN) measured as the ratio of a country’s imports and exports to GDP. As illustrated in the previous paper, OPEN is used as a proxy for trade costs and barriers. All else equal, foreign investors will chose to locate where trade costs and barriers are the lowest. Therefore, we expect a positive relationship between FDI and OPEN. Our data on OPEN is sourced from the WDI database.

Furthermore we explicitly test for the effect of membership in the original CEFTA and the new CEFTA 2006. We construct a dummy variable CEFTA which equals one if a country was a member of CEFTA or CEFTA 2006 in time t .³ For the same reason we expect a positive relationship between FDI and OPEN, we also expect a positive relationship between CEFTA and FDI. CEFTA and CEFTA 2006 serve to reduce trade related costs and barriers, providing an incentive for foreign investors to chose to locate in the signatory countries.

In the previous paper, real effective exchange rates were used in the analysis to account for the effects of macro-economic policies on the location of investments. Due to data unavailability, we were unable to construct a similar indicator for SEE. However, we do include a measure of inflation to proxy for the effects of macro-economic policies on FDI. Typically, an inverse relationship has been found between inflation and FDI (see *e.g.* Sayek, 1999) and Greene and Villanueva, 1991).

Finally, we also include indicators on the reform process of SEE countries. A healthy investment climate can significantly reduce enterprise transaction costs; conversely, a weak investment climate can increase the cost of doing business to the extent that foreign investors are reluctant to enter a market, irrespective of other benefits it provides. To account for this, we use various European Bank for Reconstruction and Development (EBRD) Transition Indicators.⁴ For the same reasons outlined in the previous paper, we use the Transition Indicators on better quality infrastructure (INFRAREF), privatisation reform (PRIVREF), enterprise restructuring (ENTREST) and competition policy reform (COMPREF). All else equal, reforms in these areas should reduce the transaction costs faced by foreign investors. Therefore, we expect a positive relationship between them and FDI. Due to relatively high correlation between each of these indicators, we sum these indicators into a composite indicator of the investment climate – IC. In subsequent sections we also analyse the impact that each indicator has individually on FDI.

Table 1 summarises the above discussion.

Because data were either not available or not available for a long enough time period, we were unable to construct variables on labour cost and productivity, implicit tax rates or natural resources. In the case of the latter two, we do not expect the omission to seriously affect our analysis. Both variables were found to be insignificant in the analysis of FDI determinants in CEE countries. Additionally, SEE countries have very few natural resource endowments. For example, energy production is only about 0.1 kilotons of oil equivalent per capita, compared to almost 0.2 in the rest of the world.⁵ When compared to other countries, SEE ranks about 120th among energy producers. Additionally, de Melo, *et al.* (1997) find that SEE countries have few natural resources.

Table 1. Description of key variables

Variable	Definition	Relevance	Expected sign	Source
FDI	Inward FDI stock in millions of USD	Dependent		World Bank WDI
GDPcap	GDP per capita in USD	Traditional	+	World Bank WDI
OPEN	Ratio of trade in GDP	Traditional	+	World Bank WDI
INFLATION	Inflation, GDP deflator (annual %)	Traditional	-	World Bank WDI
CEFTA	Dummy variable for duration of membership in CEFTA or CEFTA 2006	Traditional	+	European Commission
INFRAREF	EBRD index of infrastructural reform	Transition	+	EBRD
PRIVREF	EBRD index of privatisation reform	Transition	+	EBRD
COMPREF	EBRD index of competition reform	Transition	+	EBRD
ENTREST	EBRD index of enterprise restructuring	Transition	+	EBRD
IC	Sum of INFRAREF, PRIVREF, COMPREF, ENTREST	Transition	+	EBRD

The fact that we were unable to construct variables on labour cost and productivity is a serious drawback on our analysis. To the extent that wage and productivity differs across countries but are time invariant, their absence from our analysis will be caught by the entity fixed effects. However, if countries are more likely to change wage and productivity levels across time periods and at faster or slower rates, the omission of labour productivity and labour cost could result in significant omitted variable bias.

Empirical methodology

The methodology specified in this annex is identical to the methodology described in Seric (2011). It is based on the standard gravity model approach. The dependant variable is countries' annual net FDI stock from their balance of payment statistics (in current USD). As in the previous paper, we relate our dependent variable to the independent variables described in the previous section. All variables are logged and enter the equation in the following form:

Equation 3

$$FDI_{ct} = \beta_0 + \beta_1 GDPcap_{ct} + \beta_2 OPEN_{ct} + \beta_3 CEFTA_{ct} + \beta_4 IC_{ct} + \beta_5 INFLATION_{ct} + \gamma_c + \varepsilon_{ct}$$

where c and t indicate country and year, respectively; ε is the error term. Similar to the model in the previous paper, we assume that foreign investors will chose to locate where profits are the highest. Table 2 provides a summary of all variables while Table 3 produces correlation coefficients from the matrix featuring all explanatory variables.

Table2. Summary statistics

Variable		Mean	Std. Dev.	Min	Max	Observations
GDPcap	overall	7.32	0.67	5.71	8.82	N = 160
	between		0.63	6.05	8.50	n = 9
	within		0.25	6.09	7.99	T = 17.8
OPEN	overall	4.45	0.33	3.55	5.10	N = 149
	between		0.26	4.07	4.72	n = 9
	within		0.22	3.66	5.02	T = 16.6
INFLATION	overall	2.73	1.60	-1.36	7.29	N = 142
	between		0.67	1.67	3.69	n = 9
	within		1.48	-0.84	7.67	T = 15.8
CEFTA	overall	0.27	0.45	0.00	1.00	N = 193
	between		0.20	0.15	0.70	n = 10
	within		0.40	-0.43	1.12	T = 19.3
INFRAREF	overall	0.57	0.38	0.00	1.20	N = 180
	between		0.14	0.39	0.78	n = 9
	within		0.35	-0.16	1.07	T = 20
PRIVREF	overall	0.98	0.36	0.00	1.39	N = 180
	between		0.15	0.76	1.21	n = 9
	within		0.33	-0.05	1.39	T = 20
COMPREF	overall	0.42	0.39	0.00	1.10	N = 180
	between		0.26	0.09	0.80	n = 9
	within		0.31	-0.39	1.02	T = 20
ENTREST	overall	0.54	0.38	0.00	1.10	N = 180
	between		0.19	0.26	0.79	n = 9
	within		0.34	-0.25	1.07	T = 20
IC	overall	2.05	0.33	1.39	2.55	N = 180
	between		0.16	1.83	2.27	n = 9
	within		0.30	1.22	2.49	T = 20
TREND	overall	10.67	5.70	1.00	20.00	N = 193
	between		0.79	10.50	13.00	n = 10
	within		5.67	1.17	20.17	T = 19.3

Note: between variation is constructed by calculating the means over time for every industry; within variation represents the deviation of individual observations from an industry's average and can naturally be negative.

Table 3. Correlation matrix

	FDI	GDP-cap	OPEN	INFLATION	CEFTA	INFRA-REF	PRIV-REF	COMP-REF	ENT-REST	IC
FDI	1.00									
GDPcap	0.54	1.00								
OPEN	0.18	-0.19	1.00							
INFLATION	-0.27	-0.24	-0.20	1.00						
CEFTA	0.75	0.34	0.15	-0.13	1.00					
INFRAREF	0.77	0.35	0.39	-0.54	0.62	1.00				
PRIVREF	0.56	0.23	0.24	-0.58	0.40	0.75	1.00			
COMPREF	0.60	0.15	0.32	-0.20	0.54	0.66	0.52	1.00		
ENTREST	0.62	0.38	0.18	-0.56	0.43	0.67	0.81	0.56	1.00	
IC	0.74	0.33	0.33	-0.55	0.58	0.90	0.90	0.78	0.87	1.00

Results

The results of our econometric analysis are presented in Table 4. Columns 2 and 3 contain the fixed effects and random effects estimates, respectively. We perform a robust Hausman test using the method proposed by Wooldridge (2002). The test leads us to strongly reject the null hypothesis that the random effects model is appropriate.⁶

Examining the fixed effects results in the first column, we see that GDPcap, OPEN and IC all enter the equation significantly with the expected sign. FDI in SEE is attracted to markets with higher income, greater trade openness and a higher degree of investment climate reforms. The coefficient on CEFTA is positive, as expected; however it is not significant. Contrary to expectations, inflation is positive, although it is not significant. The positive coefficients on our two regional integration variables – OPEN and CEFTA – suggest that deeper regional integration has a tangible effect on attracting FDI. This is in line with the findings for Central and Eastern Europe outlined in Seric (2011).

We next exclude INFLATION from the regression and re-estimate our model.⁷ The results are presented in the fourth column. GDPcap, OPEN and IC remain significant while CEFTA is still insignificant. The magnitude of the coefficients on the independent variables does not change much by omitting INFLATION. In the fifth column we re-estimate our fixed effects model from column four to allow for auto-correlated errors up to four lags. In particular, we re-estimate the fixed effects model by applying the method of Driscoll and Kraay (1998). The results mirror those in our previous fixed effects model, although GDPcap becomes significant at the 0.01 level. These results are our preferred model (PREF_FE).

The results in columns 4 and 5 suggest that IC has high explanatory power with respect to attracting FDI in SEE. In other words, a one percent increase in reforms to the investment climate, all else equal, leads to an almost 3.5 percent increase in additional FDI stocks. Likewise, market size as represented by GDPcap is important in attracting FDI to SEE. Similar to the situation in CEE, “Review of bilateral investment treaties signed by Parties to the Central European Free Trade Agreement (CEFTA) 2006”, the cumulative effect of greater trade openness and membership in CEFTA is important. Increasing trade openness by one percent while being a member of CEFTA, all else equal, results in a cumulative 2 percent increase in FDI stocks.⁸

We also introduce one period lags to each of our explanatory variables. This allows us to account for both potential endogeneity of our explanatory variables and the time it often takes foreign investors to adjust to changes in the policy and general economic environment (Wooldridge 2002). The results of this analysis are presented in the sixth column of Table 4. All variables retain their significance levels. The coefficients’ explanatory power is roughly equivalent to what is found in our preferred fixed effects model with Driscoll and Kraay (1998) standard errors.

As mentioned earlier, the omission of productivity and cost measures from our analysis potentially biases our estimates. We showed in Seric (2011) that labour productivity and cost had significant impacts on foreign investment in Central and Eastern Europe. It is natural to conclude that the same situation prevails in SEE. To the extent that such measures vary across country but not across time, they will have been picked up by our country fixed effects. However, it is more probable that wages and productivity levels change across time periods and at faster or slower rates. Thus, the omission of labour productivity and labour cost likely results in omitted variable bias.

Table 4. Estimation results

Variables	(1)	(2)	(3)	(4)	(5)	(6)
	Fixed effects	Random effects	Fixed effects	Fixed effects (PREF_FE)	Driscoll and Kraay (1998) standard errors Fixed effects with lags	
GDPcap	1.569*	1.200***	1.526*	1.526***	1.526***	1.853***
	(0.774)	(0.425)	(0.779)	(0.402)	(0.402)	(0.508)
OPEN	1.918***	1.575***	1.869***	1.869***	1.869***	1.541***
	(0.439)	(0.398)	(0.451)	(0.282)	(0.282)	(0.255)
CEFTA	0.219	0.461***	0.229	0.229	0.229	0.322
	(0.248)	(0.170)	(0.258)	(0.139)	(0.139)	(0.254)
IC	3.550***	3.578***	3.469***	3.469***	3.469***	2.649***
	(0.363)	(0.393)	(0.360)	(0.260)	(0.260)	(0.175)
INFLATION	0.0397	0.0464				
	(0.0371)	(0.0461)				
Constant	-22.28***	-18.09***	-21.48***	-21.48***	-21.48***	-20.37***
	(5.207)	(3.326)	(5.323)	(2.276)	(2.276)	(4.448)
Observations	109	109	110	110	110	109
Number of groups	8	8	8	8	8	8

Note: standard errors in parentheses. All standard errors have been corrected for heteroskedasticity. *** p<0.01, ** p<0.05, * p<0.1.

Another issue concerns the particular endogeneity of GDPcap. It is likely that higher levels of GDP per capita increase FDI and conversely higher levels of FDI increase GDP per capita. However, due to a lack of a suitable instrument, we are unable to control for this fact. The same argument could be made for our variable OPEN. Combined with our omission of labour cost and productivity estimates, care should be taken when interpreting our coefficient estimates, as they are likely biased.

Effects of investment climate variables

Until this point, we have used IC, the sum of the EBRD Transition Indicators on the quality of infrastructure, privatisation, enterprise restructuring and competition policy reform. Because of high multicollinearity between these variables (see Table 3), we estimated the previous equations by creating one variable as the log of the sum of the individual indicators. Here, we introduce the investment climate variables all together and one at a time to examine in more depth the effect of location on investment.

Column 2 shows the regression with all four investment climate variables. The coefficients on GDPcap and OPEN remain significant and roughly the same size as in PREF_FE. The CEFTA variable remains positive with roughly the same coefficient value, but is insignificant. Infrastructure reforms are positive, but insignificant.⁹ Privatisation, competition and enterprise restructuring reforms are positive and significant, the latter two at the 0.01 level. The magnitude of the coefficient on enterprise reform outperforms that of all other variables. The enterprise restructuring indicator (ENTREST) measures the degree to which a country's government promotes and enforces corporate governance principles, including bankruptcy legislation. Our findings suggest that when controlling for other investment climate reforms, a 1% increase in enterprise restructuring reforms leads to a 1.3% increase in FDI.

In columns 3 through 6 we introduce each investment climate variable separately. Both GDPcap and OPEN are highly significant. Additionally, the magnitude of their coefficients increases compared to PREF_FE and the model presented in column 2. The magnitude of the coefficients on the CEFTA dummy variable increases and in fact turns significant. Each investment climate variable is positive and significant at the 1% level. The magnitude of the coefficient on ENTREST again surpasses the coefficients on the other investment climate variables.

Our analysis offers additional support to the claim that investment climate reforms are important for foreign investors. We offer evidence that reforms in infrastructure, competition policy, privatisation and enterprise restructuring can lead to noteworthy increases in FDI. In particular, reforms in corporate governance appear to be particularly valued by foreign investors. Policy makers can therefore appreciably impact the location decisions of investors by implementing reforms in their investment climate.

Table 5. Estimation results from PREF_FE model with IC variables

(1) Variables	(2) ALL	(3) INFRAREF	(4) PRIVREF	(5) COMPREF	(6) ENTREST
GDPcap	1.517*** (0.407)	1.937*** (0.445)	2.273*** (0.272)	2.097*** (0.421)	2.007*** (0.268)
OPEN	2.007*** (0.319)	1.617*** (0.354)	1.792*** (0.233)	2.277*** (0.510)	2.707*** (0.462)
CEFTA	0.244 (0.133)	0.405** (0.148)	0.476** (0.188)	0.575** (0.239)	0.481* (0.211)
INFRAREF	0.542 (0.306)	1.954*** (0.334)			
PRIVREF	0.838 (0.374)		2.498*** (0.280)		
COMPREF	0.761*** (0.198)			1.756*** (0.352)	
ENTREST	1.267*** (0.280)				2.533*** (0.428)
Constant	-17.09*** (2.339)	-17.17*** (2.520)	-21.89*** (1.632)	-21.04*** (3.413)	-23.09*** (2.041)
Observations	110	110	110	110	110
Number of groups	8	8	8	8	8

Note: Driscoll-Kraay standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1.

Interactions with investment climate variables

In our final section, we introduce interaction variables. First we investigate whether CEFTA membership yields a greater impact on FDI when implemented in conjunction with investment climate reforms. To do so, we interact the dummy variable CEFTA with the EBRD Transition Indicators. The new equation for these regressions is:

Equation 4

$$FDI_{ct} = \beta_0 + \beta_1 GDPcap_{ct} + \beta_2 OPEN_{ct} + \beta_3 CEFTA_{ct} + \beta_4 EBRD_{ct} + \beta_5 CEFTA_{ct} \times EBRD_{ct} + \gamma_c + \varepsilon_{ct}$$

where EBRD represents an EBRD Transition Indicator. If a country is not a member of CEFTA in time t then $CEFTA_{ct} = 0$ and the impact of EBRD on FDI will be represented by β_4 . However, if a country is a member of CEFTA in time t then $CEFTA_{ct} = 1$ and the impact of EBRD on FDI will be represented by $\beta_4 + \beta_5$.¹⁰

The second column shows the regression run with the interaction between CEFTA and COMPREF, the EBRD Transition Indicator of Competition Policy. Here we see that if $CEFTA_{ct} = 0$ then an increase in the Competition Policy Indicator by 1% will increase FDI by about 1.6%. But if a country is a member of CEFTA, then an increase in the Competition Policy score by 1% will increase FDI by 3.3%. The second column shows the regression run with the interaction between CEFTA and TELEREF, the EBRD Transition Indicator of Telecommunications.¹¹ In this case, if a country is not a member of CEFTA in time t then an increase in the EBRD Telecommunications score by 1% will increase FDI by 1%. If a country is a member of CEFTA, an increase in the EBRD Telecommunications score by 1% will increase FDI by 1.74%. Finally, the fourth column shows the regression with the interaction between CEFTA and TRADEREF, the EBRD Transition Indicator of Trade and Foreign Exchange.¹² If a country is not a member of CEFTA, then increasing the EBRD Trade and Foreign Exchange score by 1% will increase FDI by about 2.6%. On the other hand, CEFTA member countries that increase their Trade and Foreign Exchange score by 1% can expect to see FDI increase by roughly 4.8%.

In the preceding section, CEFTA proved to have a positive impact on FDI in South East Europe. Here we have shown that when implemented in conjunction with general reforms on the investment climate, countries can expect an even greater impact on FDI. Being a member of CEFTA and simultaneously implementing broad investment climate reforms brings FDI above and beyond what one might expect without CEFTA. Reforms in competition policy, telecommunications and trade and foreign exchange liberalisation in particular interact with CEFTA membership to bring higher levels of FDI. The analysis suggests that implementing CEFTA and other investment climate reforms at the same time brings additional benefits in excess of what one would expect if either were implemented in isolation. Conversely, CEFTA membership by itself cannot be expected to generate significant increases in FDI. Instead, it is most effective in increasing FDI when surrounded by a healthy investment environment.

Table 6. Estimation results from PREF_FE model with CEFTA interactions

(1) Variables	(2) COMPREF	(3) TELEREF	(4) TRADEREF
GDPcap	2.008*** (0.365)	1.909*** (0.472)	2.961*** (0.241)
OPEN	2.180*** (0.445)	2.026*** (0.468)	1.297*** (0.318)
CEFTA	-0.709 (0.757)	-0.0275 (0.414)	-2.500* (1.208)
COMPREF	1.585*** (0.395)		
CEFTA×COMPREF	1.687* (0.849)		
TELEREF		1.033** (0.328)	
CEFTA×TELEREF		0.702* (0.348)	
TRADEREF			2.591*** (0.486)
CEFTA×TRADEREF			2.244* (1.032)
Constant	-19.90*** (2.193)	-18.40*** (3.319)	-25.57*** (2.593)
Observations	110	110	110
Number of groups	8	8	8

Note: Driscoll-Kraay standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. The coefficient on the CEFTA variable in this regression should be interpreted as the amount the constant term would change in the event that a country is a member of CEFTA in time t . In this equation, it should not be interpreted as the impact of CEFTA membership on FDI. See Wooldridge (2009).

Next we interact the variable OPEN with the EBRD Transition Indicators. The new equation for these regressions is:

Equation 5

$$FDI_{ct} = \beta_0 + \beta_1 GDPcap_{ct} + \beta_2 OPEN_{ct} + \beta_3 CEFTA_{ct} + \beta_4 EBRD_{ct} + \beta_5 OPEN_{ct} \times EBRD_{ct} + \gamma_c + \varepsilon_{ct}$$

The interaction term allows us to determine if investment climate reforms have a different effect on FDI depending on the level of trade openness in a country. If $\beta_5 > 0$, then an additional 1% increase in the EBRD Transition Score yields a higher increase in FDI for countries with more trade openness. On the other hand, if $\beta_5 < 0$ then an additional 1% increase in the EBRD Transition Score yields a lower increase in FDI for countries with more trade openness.

We present our results in Table 7. In the second column, we show the regression run with the interaction between OPEN and IC, the natural logarithm of the sum of the EBRD Transition Scores on enterprise restructuring, competition policy, privatisation reform and infrastructure reform. The coefficient on the interaction term is positive and significant at the 0.05 level. This implies that an additional 1% increase in IC will yield a greater increase in FDI for countries with higher levels of trade openness. Similar results were found for other investment climate variables, including the EBRD Banking Reform and Interest Rate Liberalisation Indicator (BANKREF),¹³ the indicator on Large-Scale Privatisation (PRIVREF), the Infrastructure Reform Indicator (INFRAREF), the Telecommunications Indicator (TELEREF) and the indicator on Trade and Foreign Exchange Systems (TRADEREF). The findings suggest that countries who marry these investment climate reforms with greater trade openness can expect increasing returns. Put another way, additional reforms yield a higher increase in FDI to countries with a higher level of trade openness than to countries with a lower level.

Interestingly, the coefficient on the interaction term of PRICEREF, the indicator on price liberalisation, is negative. This implies that an improvement in the investment climate yields a lower increase in FDI for countries with more trade openness. In other words, countries that benefit the most (in the form of FDI) from price liberalisation will be those that are not open to trade at all. One possible explanation is that price liberalisation, more than other investment reforms, is a minimum condition for foreign investors to be willing to enter a country; its marginal impact on investment thereafter is decreasing.

Our analysis suggests that simultaneously opening trade and improving the investment climate reaps the highest levels of FDI. With the exception of price liberalisation, the marginal effect of investment climate reforms increases when a country has a higher degree of trade openness. This reinforces the idea that broad reforms in trade liberalisation and the investment climate should be implemented together to attract the highest levels of FDI.

Table 7. Estimation results from PEF_FE model with OPEN interactions

(1) Variables	(2) IC	(3) BANKREF	(4) PRIVREF	(5) INFRAREF	(6) PRICEREF	(7) TELEREF	(8) TRADEREF
GDPcap	1.279** (0.445)	1.648*** (0.295)	1.772*** (0.448)	1.798*** (0.460)	3.018*** (0.209)	1.525** (0.505)	2.693*** (0.299)
OPEN	-1.817 (1.394)	1.068* (0.474)	0.446 (1.054)	1.099** (0.405)	4.704*** (1.156)	1.301** (0.448)	-2.614 (1.555)
CEFTA	0.170 (0.123)	0.384** (0.144)	0.535** (0.203)	0.356** (0.145)	0.814** (0.269)	0.536** (0.175)	0.657* (0.308)
IC	3.716*** (0.254)						
OPEN×IC	1.806** (0.643)						
BANKREF		2.547*** (0.247)					
OPEN×BANKREF		1.292* (0.647)					
PRIVREF			2.094*** (0.283)				
OPEN×PRIVREF			2.034* (0.996)				
INFRAREF				2.064*** (0.332)			
OPEN×INFRAREF				1.121** (0.390)			
PRICEREF					2.066*** (0.381)		
OPEN×PRICEREF					-2.118* (0.993)		
TELEREF						1.432*** (0.245)	
OPEN×TELEREF						1.761** (0.523)	
TRADEREF							3.978*** (0.907)
OPEN×TRADEREF							2.851** (1.136)
Constant	-3.832 (7.366)	-13.65*** (2.521)	-11.63** (4.629)	-13.95*** (2.591)	-40.49*** (5.634)	-12.71** (3.910)	-8.080 (7.461)
Observations	110	110	110	110	110	110	110
Number of groups	8	8	8	8	8	8	8

Note: Driscoll-Kraay standard errors in parentheses. *** p<0.01, ** p<0.05, * p<0.1. The coefficients on each EBRD Transition Indicator represent the partial effect of the Transition Indicator on FDI, *i.e.* $\Delta FDI/\Delta EBRD = \beta_4 + \beta_5 \mu_{OPEN}$, where μ_{OPEN} is the mean value for OPEN. The standard errors have been adjusted accordingly.

Notes

1. Stabilisation and Association Agreements have been signed with Albania, Bosnia and Herzegovina, Croatia, the Former Yugoslav Republic of Macedonia, Montenegro and Serbia. Kosovo under UNSCR 1244/99 has not yet begun negotiations. The Republic of Moldova has a partnership and co-operation agreement giving it autonomous trade preferences and eventually a comprehensive trade agreement with the EC. Although not governed by an EU membership agreement, the Republic of Moldova has engaged in many comprehensive reform programmes to improve its investment climate.
2. The countries included in the analysis are Albania, Bosnia and Herzegovina, Bulgaria, Croatia, the Former Yugoslav Republic of Macedonia, the Republic of Moldova, Serbia and Romania. Kosovo under UNSCR 1244/99 and Montenegro were excluded from the analysis due to data availability.
3. We have allocated Romania and Bulgaria a 1 for the CEFTA variable even post 2007 to signify their deeper EU integration and continued intra-regional trade. We also performed our main regression on a restricted dataset of only current CEFTA 2006 members. The results still hold with similar magnitudes and levels of significance.
4. For more information on the methodology used to construct the EBRD's Transition Indicators, please see: www.ebrd.com/country/sector/econo/stats/timeth.htm.
5. Energy production in kilo tons of oil equivalent divided by total population. Data sourced from the World Bank WDI database.
6. Tested on the random-effects model with GDPcap, OPEN and CEFTA. Sargan-Hansen statistic: 46.037, p-value = 0.0000.
7. Our decision to exclude INFLATION follows the same methodology employed in the two previous papers. We proceed first by estimating a 'general model' containing all explanatory variables. We then exclude explanatory variables whose coefficients were insignificant and re-estimate the corresponding restricted specification. The exclusion level is fixed at the 10 per cent significance level. Despite its insignificance, we include CEFTA due to our particular interest in the impact that agreement has had on FDI flows in SEE.
8. However, according to our fixed effects regression results in the fifth column, CEFTA has a p-value of 0.14, just above the 0.1 significance cut-off.
9. This may be explained by relatively high correlation between the investment climate variables.
10. Interaction regressions were performed on all EBRD Transition Indicators. Only the significant terms are presented here.
11. The EBRD Transition Indicator on Telecommunications rates transition countries on the extent they have liberalised and effectively regulate their telecommunications sector.
12. The EBRD Transition Indicator on Trade and Foreign Exchange systems evaluates transition countries on the extent to which they have liberalised their foreign exchange regime and eliminated restrictions on trade (*e.g.* tariffs).

13. The EBRD's indicator on Banking Reform and Interest Rate Liberalisation rates transition countries on their implementation of banking reform and supervision and their degree of interest rate liberalisation.

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