FOREIGN DIRECT INVESTMENT LOCATION AND INSTITUTIONAL DEVELOPMENT IN IN THE MANUFACTURING SECTOR IN SOUTH EAST EUROPEAN COUNTRIES

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ABSTRACT

This paper investigates the importance of factor endowment vis-à-vis institutions development in explaining the locational choice of foreign investors in manufacturing sector in SEE countries. Using panel dataset for the period 1999 to 2006 we constructed an econometric model that was used to estimate the determinants of FDI on sectoral level. The determinants were grouped into control variables and institutionally related variables. The selection of control variables was motivated by existing research on FDI, and our results are consistent with the empirical evidence on the key determinants of FDI reported in the literature. Our analysis indicates that the overall quality of the institutions attracts FDI in manufacturing sector in SEE region. Besides, we identified individual determinants by disaggregating to subsets of institutional development. In this context, the results indicate that a few institutional changes enhanced FDI receipts to manufacturing sector: development of privatisation process, liberalization of foreign exchange and trade, development of competition policy and development of infrastructure reform. On the other hand, enterprise restructuring, domestic price liberalization and development of the banking sector do not seem to be a significant motive for FDI in our study, probably because the described institutional changes do not present a significant obstacle to foreign investors.

JEL classification: O16, R58

Key words: foreign direct investment, location determinants, South East European countries, manufacturing sector, panel data
1. INTRODUCTION

Foreign direct investment inflow in transition countries triggered numerous debates and studies on FDI determinants in these states. The use of different explanatory variables in FDI determinant studies is due to the fact that FDI is a complex economic category dependent on numerous factors, the comparative significance of which can change in accordance with the economic environment development over time; a change in a recipient country’s economy may also bring about a change in FDI determinants (UNCTAD; 1998). Although traditional determinants do not disappear due to globalization, their significance diminishes, while determinants such as institutional development and structural reforms gain in significance. In this context, the paper is aimed at analyzing the influence of various dimensions of the institutional framework on FDI.

The extensive research into the nature and determinants of FDI in transition economies has paid little attention to the study of FDI determinants in SEE countries, primarily due to a lack of comparable data. In over 45 empirical studies we reviewed, only four cover some of the South East Europe (SEE) countries, while only two include all countries of the region (Demekas et al; 2005, Kersan-Škabić & Orlić; 2007). Besides, there is an observable lack of research into FDI determinants on the sectoral level, which is interesting since FDI is related to industry rather than to countries (Buigues-u and Jacquemin, 1994), and since FDI concentration in individual sectors in the transition countries can affect the direction and speed of the economy restructuring process as foreign investors can bring in a set of tangible and intangible benefits essential for the development of market economy in these countries (Resmini, 2000).

For these reasons, the paper attempts to fill the gap in the current debate on the relationship between the institutional infrastructure development and FDI in SEE countries on the sectoral level, in the period 1999-2006. Our central hypothesis is that countries with more developed institutions for market economy also have a greater FDI stock in the manufacturing industry. The paper is organized as follows. Section 2 discusses the theoretical context of FDI determinants from the host economies’ perspective. Section 3 provides empirical issues, while Section 4 discusses variables and methodology used in the paper. Section 5 offers the panel regression results while Section 6 discusses conclusions.

1 Countries of South East Europe: Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Serbia and Montenegro
2. THEORETICAL FRAMEWORK

In his attempt to answer the question as to why, how and when FDI will occur, Dunning merged different FDI theories into the so-called OLI theory. The eclectic theory postulates that three conditions are essential for a FDI. The first condition is that the firm must have a net ownership advantage over the other firms serving the foreign market. This ownership advantage may be a product or process differentiation ability, a monopoly power, a better resource capacity or usage, or an exclusive, favored access to product markets etc. The second condition requires that the firm prefer internalizing its ownership advantages rather than externalizing them. This means that the firm possessing ownership advantages must deem producing abroad more profitable than selling or leasing its activities to foreign firms. A firm might prefer internalizing its ownership advantages in order to protect the quality of its products, to control supplies and conditions of sales of inputs, to control market outlets. Finally, the firm enjoying an ownership advantage and an internalization incentive will produce abroad only if there are abroad location advantages such as cheaper labor, higher labor productivity, market access etc. (see Dunning and Buckley, 1977; Dunning 1988). The ownership, location, and internalization (OLI) advantages are not static. They may change over time. Location determinants are the only group of determinants that the host country governments can directly affect.

Dunning identified four types of investment activities by multinationals: market seeking, resource seeking, efficiency seeking and/or strategic asset seeking ones. In accordance with Dunning’s approach, FDI determinants will depend on the type of undertaken activities, and each of the listed types corresponds with a specific set of OLI benefits.

Dunning (2005) also included factors related to institutions and institutional infrastructure in the existing eclectic paradigm, consequent to the impact of globalization and aims of the New Paradigm Development (NPD). He identified three generic groups of factors that can influence FDI inflow: frameworks of policies and strategies for FDI, economic determinants and business exemptions. As classified, the institutionally related determinants are spread over each of the three groups. The group of FDI-related policies and strategies includes policies for market functioning and structure, bilateral agreements on FDI, privatization, industrial policies, etc. The economic determinants group was expanded with the availability, quality and cost of skilled labour, membership in regional integration agreements, market institutions’ quality, quality of managerial and other creative resources, physical
infrastructure, etc., while the business exemption group includes investment incentives and promotion, legislation quality and intellectual property protection, good institutional infrastructure and support (banking, accounting jobs, and other services), social capital, regional clusters and networking.

The above framework of FDI gives guidance in identifying the set of economic and institutional variables to be tested as determinants of investment locations, which is discussed in detail in the next section.

3. EMPIRICAL ISSUES

There is a number of empirical studies on FDI determinants that are mostly distinguished by the choice of explanatory variables, applied methodology and the sample of countries included in the research. Our review of empirical literature focuses on the most significant papers researching the link between FDI and selection of explanatory, including institutionally related variables in transition countries.

In the transition economy context, legal framework was radically changing in order to create a new set of formal institutions in the 1990s. Most studies indicate that institutional development is a significant location advantage in international business. According to the World Bank (1996), the change of ownership in transition countries is probably the most significant institutional change. Lansbury, Pain and Smidkova (1996) found that the share of private sector has a positive effect on FDI inflow in the sample of Central European countries. Besides, Holland and Pain (1998) and Bevan and Estrin (2000) found that the level of privatisation is closely tied with the increase in FDI inflows in CEECs.

Transition from planned to market economy also required the establishment of institutions for unimpeded exchange of goods and services. In this context, research shows that liberalization of home markets, openness and competition policy development have a favourable impact on FDI inflow (Blattner, 2002, Cieslik and Ryan, 2004). Connection between host country political instability and FDI inflows was also discussed in literature on FDI determinants. Smarzynska (2002) and Bevan et al. (2000) found that poor protection of property rights has a negative impact on FDI inflows. Pournarakis and Varsakelis (2002) also studied the connection between institutional factors and FDI using panel-data set for 19 CEEC countries in the period 1997-2000 and found that civil and political rights and corruption are crucial in explaining FDI inflows in the observed transition economies. Kinoshita and Campos (2003) used a sample of 25 transition economies in the period
1990-1998 to study location determinants classified into three categories: country specific advantages, institutions and agglomeration economies. Their main conclusion is that institutions and agglomeration economies have a higher impact on FDI inflows than other economic variables. Bevan et al. (2004) found that several specific formal institutions influence FDI: private ownership of business, banking sector reform, foreign exchange and trade liberalization, and legal development. Conversely, domestic price liberalization, non-bank financial sector development and competition policy do not enhance FDI.

4. MODELLING AND DATA

The empirical framework employed in the analysis involves the use of a single equation model for testing the relationship between FDI and institutional infrastructure. The model regresses the FDI data on a measure of institutional development, and a set of control variables. The dependent variable in the paper is FDI stock per capita, NACE 1-digit in the manufacturing sector for each observed SEE country in the period 1999-2006. Due to the lack of data for SEE countries, we took a particular effort to attempt to create a relevant database of FDI in the manufacturing sector of the observed countries, which can serve the goals of this analysis. Most FDI data were taken from the Vienna Institute for International Economic Studies (WIIW) database. Data that were missing for certain years were added based on the author’s calculations and estimates founded on the data collected from various sources.

4.1. Independent variables

4.1.1. Institutional infrastructure

The concept of locational advantages captures properties of host locations that make them attractive to potential foreign direct investors (Dunning; 1958, 1998).

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2 There are several advantages in working on FDI stocks rather than flows. First, foreign investors decide on the worldwide allocation of output, hence on capital stocks. Second, stocks account for foreign direct investment being financed through local capital markets, hence it is a better measure of capital ownership (Devereux and Griffith, 2002). Finally, stocks are much less volatile than flows which are sometimes dependent on one or two large takeovers, especially in relatively small countries (Quere et al, 2005).

3 National Bank of Romania, National Bank of Serbia, Foreign Investment Promotion Agency Bosnia and Herzegovina
Initial studies related to FDI determinants mostly focused on factor endowments, particularly on labour cost and productivity as local advantages. In recent years, multinational enterprises increasingly focus on “created assets” (Narula & Dunning, 2000) including knowledge-based assets, infrastructure and institutions of the host economy. Legal, political and administrative systems tend to be the internationally immobile framework whose costs determine in international attractiveness of a location. Institutions affect the capacity of firms to interact and therefore affect the relative transaction and coordination costs of production and innovation’ (Mudambi & Navarra; 2002: p. 636). Thus, institutional environment can be a significant location determinant in attracting FDI. In this paper, institutional development was measured based on a series of indicators of the transition process progress constructed by EBRD. Indices can take values from 1 to 4+, whereby a higher index denotes getting closer to norms of developed market economies.

The construct measurements of the independent variable first used the confirmatory analysis with the following indicators: Large scale privatisation, Small scale privatisation, Enterprise restructuring, Price liberalisation, Trade & forex system, Competition policy, Banking reform & interest rate liberalisation, Securities markets & non-bank financial institutions, Overall infrastructure reform and Telecommunications, in order to verify their relevance for the analysis and to obtain meaningful factors measuring the levels of institutional transformation. All variables loaded on the one factor, hereafter referred to as FACINST, with an eigenvalue of 7.013 and which explained 70.133% of variance. Besides the FACINST variable, which is a proxy variable for institutional development, the selected EBRD indicators were used in order to find out which particular institutions influence FDI (Table 1).

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4 Index of small scale privatisation (SSP) was not used because it has small within standard deviations, which suggests that coefficient for SSP may not be as well identified as the others (Baum; 2006, 223).
Table 1: Construct and variables definition

<table>
<thead>
<tr>
<th>Construct</th>
<th>Variable definition</th>
<th>Predicted effect</th>
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<tbody>
<tr>
<td>Privatization and enterprise reform</td>
<td>Large scale privatisation index (LSP)</td>
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<tr>
<td></td>
<td>Enterprise restructuring index (ER)</td>
<td>+</td>
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<tr>
<td>Liberalization</td>
<td>Index of price liberalisation (PL)</td>
<td>+</td>
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<td></td>
<td>Index of trade &amp; forex system liberalization (TFS)</td>
<td>+</td>
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<tr>
<td>Regulation</td>
<td>Index of competition policy (CP)</td>
<td>+</td>
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<tr>
<td>Financial infrastructure</td>
<td>Index of banking reform &amp; interest rate liberalisation (BR)</td>
<td>+</td>
</tr>
<tr>
<td>Infrastructure</td>
<td>Index of overall infrastructure reform (OIR)</td>
<td>+</td>
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</tbody>
</table>

In some cases, there is some collinearity\(^5\) between the indicators of institutional development, largely because progress in various elements of the transition process often occur simultaneously, if unevenly, in particular countries. For this reason, we test hypothesis by estimating a series of equations, one for each institutional development index.

In order to ensure that we are able to obtain unbiased econometric estimates, our analysis controls for a number of factors that the existing literature has identified as important determinants of FDI. The influence of institutional development on FDI stocks, our analysis controls for a number of factors that the existing literature has identified as important determinants of FDI. A set of control variables are intended to capture those structural characteristics of the host economy that may attract FDI.

4.1.2. Market size

Most empirical studies on FDI in transition countries suggest that most enterprises in these countries invest in order to find new markets for their products, regardless of the industry the investment is made in (Lankes and Venables; 1996). A larger market offers a few potential benefits for the investing firm. First, a larger market represents a greater number of potential customers, which may lead to profit growth. Higher profits may also be due to the fact that a larger market facilitates potential economies of large-scale production and fixed cost reduction. Besides, a larger market allows more ways of new product placement, although it depends both on the overall market size and on the dynamics of the market (Resmini; 2000). Our model includes GDP per capita which is a proxy for the purchasing power of

\(^5\) Correlations matrix is not presented due to space limitations
local consumers (local demand) and market size. We expect a positive sign for this variable: countries with higher purchasing power of their consumers are expected to attract more foreign investors.

4.1.3. Input cost

Besides the size and dynamics of the market and access to the host market, the prevailing factors for attracting FDI certainly include the cost and quality of input factors (Neuhaus, 2005). According to the neoclassical theory of determinants, an FDI enterprise can undertake a foreign investment because of the advantage, i.e. lower manufacturing cost in the host economy including the cost of labour, energy and raw materials. The analysis considers wages, as an independent variable, as a proxy variable for input cost. We calculate unit labor costs as the ratio of the annual average wage in each economy to GDP per capita in each economy. In this way, our measure of unit labor cost is effectively a unitless ratio (Bevan et al; 2004).

4.1.4. Macroeconomic stability

Successful implementation of economic reforms in transition countries is a good sign to potential investors, since stable macroeconomic performance implies a lower risk for investment. In this context, price stability is a good indicator for host governments’ macroeconomic management. The sustainability of moderate or low inflation tells investors how successful the host government is and thus the prospect of further growth. Thus, the lower the average inflation rate is in the host country, the more foreign investment will be attracted to the country (Kinoshita and Campos; 2002). The paper therefore approximates macroeconomic stability with the inflation rate. We expect the higher inflation to have a negative effect on FDI inflows in the manufacturing sector, i.e. the coefficient to be negative.

4.1.5. Openness

Liberalization of trade could be closely related to FDI, because it could make the country more attractive for foreign investors. Trade and FDI can be either substitutes or complements, and consequently barriers to trade can have two conflicting influences on FDI. In the context of vertical FDI, trade openness facilitates imports of intermediate goods for production and allows exports of final products after the production, which is a common case in the manufacturing industry of the observed transition countries. Conversely, if FDI is horizontal, which means that they are a direct substitute for trade, FDI inflows are likely to decrease with the liberalization
of host economy’s trade regimen. The paper used the shares of imports and exports in the observed countries’ GDO as the degree of openness. The expected sign of the coefficient with this variable is positive (depends on FDI form).

Data used for independent variables are mainly those from the United Nations Economic Commission for Europe Statistical Division Database, compiled from national and international (CIS, EUROSTAT, IMF, OECD) official sources, World Development Indicators (WDI) database and Vienna Institute for International Economic Studies (WIIW). Despite the fact that there are different sources for independent variables, the goal was to use data only from a couple of sources in order to avoid problems due to different ways of defining variables and the way of data collection, at least in terms of independent variables. Data for independent variables that were missing in the listed database were complemented by data published by National Statistical Offices of the sample countries.

The model we estimated to depict the determinants FDI is as follows:

$$ FDI_{it} = \beta \alpha + i + \beta_1 GDP_{pc_{it(t-1)}} + \beta_2 WAGE_{i(t-1)} + \beta_3 OPENESS_{i(t-1)} + \beta_4 INFLATION_{i(t-1)} + \beta_5 INSTITUTIONAL_{i(t-1)} + e_{it} $$

where INSTITUTIONAL refers to the institutional related variables FACINST, LSP, ER, PL, TFS, CP, BR and OIR.

We used a panel data set covering seven South East transition economies between 1999 and 2006. Data were not available for all the seven countries for all the years, and the dataset is therefore “unbalanced”. Since a change in any independent variable may take some time to affect FDI, we lag all independent variables by one year except for variables CP and BR. Since the all variables are expressed in logs, the estimated coefficients should be interpreted as elasticities.

Given the longitudinal nature of the dataset, we begin by estimating equation (1) with country fixed effects model (FEM). Use of pooled data in econometric

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6 Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FYR Macedonia, Romania, Serbia and Montenegro

7 Variable CP was not used in (current) period t because it has small within standard deviations, which suggests that coefficient for CP. There is some collinearity between GDPpc and variable BR in (current) period t. Besides, the independent variables were lagged to account for possible endogeneity issues - measuring the impact of institutions on FDI encounters the classical problem of reverse causality.

8 Results for FEM model is not presented due to space limitations
analyses frequently leads to certain complications (Hicks; 1994, 171-72). First, errors tend to be not independent from a period to the next. In other terms, they might be serially correlated, such that errors in country i at time t are correlated with errors in country i at time t+1. Second, the errors tend to be correlated across nations. They might be contemporaneously correlated, such that errors in country i at time t are correlated with errors in country j at time t. Third, errors tend to be heteroskedastic, such that they may have differing variances across ranges or sub sets of nations. And fourth, errors may contain both temporal and cross-sectional components reflecting cross-sectional effects and temporal effects. In other words, even if we start with data that were homoschedastic and not auto-correlated, we risk producing a regression with observed heteroschedastic and auto-correlated errors. This is because heteroschedasticity and auto-correlation we observe is a function also of model misspecification. It is for this reason that we applied tests for checking the presence of heteroschedasticity and auto-correlation. First, a modified Wald test for groupwise heteroskedasticity in fixed effect regression model reveals the presence of heteroscedasticity which, while leaving coefficient estimates unbiased, can significantly influence standard errors and therefore affect hypothesis testing. There are a number of statistical techniques that can address this problem (e.g. weighted least squares), but their applicability and implementation are less clear in a panel context (Podesta; 2000).

In addition to heteroscedasticity, the estimates using FEM model are also affected by serial correlation. In particular, a Wooldridge test for autocorrelation in panel data rejects the null hypothesis of no first order serial correlation. The consequences of autocorrelation are similar to heteroscedasticity, but the problems caused by the latter are usually more severe. OLS coefficient estimates remain consistent and unbiased in the presence of autocorrelation, but they are no longer best linear unbiased estimators (BLUE) or asymptotically efficient. Furthermore, autocorrelation causes standard errors to be biased.

Consequent to the previously described problems, both Parks-Kmenta method and Beck and Katz’s (1995) proposal are alternatives. They represent two different approaches to tackle the complications of serial correlation, contemporaneous correlation and heteroscedasticity. Beck and Katz show that the overconfidence in the standard errors makes the Parks-Kmenta method unusable unless where there are more time points than there are cross-section units. In other words, they recommend using Parks only when T is very large relative to N, which is not the case in this paper (T is almost identical to N). Nevertheless, Beck and Katz (Beck and
Katz; 1995) showed that these approaches significantly underestimate the variability of the estimated coefficients, especially if the sample size is small. In this study, we followed the suggestions of Beck and Katz and estimated OLS with panel-corrected standard errors (PCSEs) using Prais-Winsten to take into account the AR(1) process.

5. PANEL REGRESSION RESULTS

In Table 2 we report the results separately for each of the observed measures of institutional related variables combined with the same set of control variables.

Table 2: Panel regression results

<table>
<thead>
<tr>
<th>Model</th>
<th>GDP (t-1)</th>
<th>Wage (t-1)</th>
<th>Openness (t-1)</th>
<th>Inflation (t-1)</th>
<th>TACT (t-1)</th>
<th>LSP (t-1)</th>
<th>ER (t-1)</th>
<th>PL (t-1)</th>
<th>TFS (t-1)</th>
<th>CP (t)</th>
<th>BR (t)</th>
<th>OIR (t-1)</th>
<th>R-sq</th>
<th>Prob&gt;chi2</th>
<th>N</th>
</tr>
</thead>
<tbody>
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<td>Model 1</td>
<td>1.179***</td>
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<td>0.912**</td>
<td>-0.009</td>
<td>0.769**</td>
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<td>0.94</td>
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<td>(0.282)</td>
<td>(0.477)</td>
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<tr>
<td>Model 2</td>
<td>1.454***</td>
<td>-0.566</td>
<td>1.072**</td>
<td>-0.037</td>
<td>1.554*</td>
<td>1.111</td>
<td>0.111</td>
<td>-0.377</td>
<td>2.360***</td>
<td>0.612*</td>
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<td>0.343</td>
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<td>0.000</td>
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<td>(0.520)</td>
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<td>(0.835)</td>
<td>(0.902)</td>
<td>(1.639)</td>
<td>(1.639)</td>
<td>(0.950)</td>
<td>(0.367)</td>
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<td>(1.464)</td>
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<td>Model 3</td>
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<td>Model 4</td>
<td>1.700***</td>
<td>-0.358</td>
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<td>-0.017</td>
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<td>Model 5</td>
<td>1.534***</td>
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<td>1.209**</td>
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<td>Model 6</td>
<td>1.551***</td>
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<td>1.446***</td>
<td>-0.038</td>
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<td>0.94</td>
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<td>Model 7</td>
<td>1.619***</td>
<td>-0.376</td>
<td>1.566***</td>
<td>-0.028</td>
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<tr>
<td>Model 8</td>
<td>1.507***</td>
<td>-0.240</td>
<td>1.272***</td>
<td>-0.015</td>
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<td>0.95</td>
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</table>

Source: Authors’ calculations
Turning first to the results for the control variables, we note that, in all models, the variables display the correct sign and that coefficients cannot change significantly. This shows us the stability of the model. FDI is positively related to GDPpc and is always statistically significant at the 1% level. Therefore, larger markets, which recorded faster economic growth, offered better opportunities for manufacturing industries to make use of their ownership advantages, which in turn led to a greater FDI inflow into this sector. Surprisingly, wages are insignificant although they have the expected sign in all the models. A possible explanation for the obtained results can be found in the use of average wages in the analysis, rather than the wages in the manufacturing industry, since such data are not available for all the observed countries. Inflation as an approximation variable of macroeconomic reforms success has also the expected negative relationship with FDI flows, although it is not statistically significant. This should not undermine the importance of price stabilization in the transition period. It is perceived that stabilization programmes were successful so that inflation is no longer seen as a possible impediment to FDI inflow. Rather, as the price stabilization is typically introduced in the initial stage of transition and external liberalization in the latter stage, investors may distinguish the winner of economic reform by looking at the outcome of external liberalization. Openness is a variable always being highly significant and exerting a positive influence on the FDI in the manufacturing sector in SEE countries. The positive effect of openness is in contrast to the arguments that FDI inflows are a substitute for trade. A positive estimated coefficient for this variable can be interpreted as evidence that FDI is used to serve other markets and not only the market of the host country. Consequently, it can be concluded that FDI in the manufacturing sector in the SEE countries is vertically oriented.

We can now consider the results for the institution-related variables. The most important result in model 1 is that the establishment of institutions for market economy significantly increases FDI inflows in manufacturing sector in SEE region. The result is highly statistically significant having in mind the relatively short period of observation. In the context of obtained results, the relationship between institutional development and FDI can be viewed as a channel through which in-
stitutions promote the growth of productivity. Developed institutions and progress in transition can have a positive influence on development through promotion of investment.

Models 2 and 3 present results of the influence of privatization and enterprise reform. Large-scale privatization has a positive sign and the coefficient is statistically significant. Enterprise restructuring, however, does not have significant implications for FDI since the observed region mostly witnessed weak enforcement of bankruptcy legislation and little action taken to strengthen competition and corporate governance.

In models 4 and 5 we find partial evidence that liberalization has a significant effect on FDI. Progress in domestic price liberalization does not have a significant effect on FDI stock, but foreign exchange and trade liberalization do; indeed, the coefficient is statistically significant. Thus, a liberal trade regime can stimulate investment because it allows for specialisation and larger-scale production, which are of the greatest importance in small countries. Today FDI is often motivated more by productivity enhancing opportunities than by the need to access local markets, which explains why multinationals delocalise the labour-intensive part of their production chain to transition economies. Local businesses in transition economies may benefit from this development, in that some functions of the value chain may be contracted out to domestic suppliers. Trade can interact with FDI to increase the competitiveness of domestic enterprises’ exports through knowledge and technology transfer.

The development of competition policy has a significant impact on FDI receipts but only at the 10% level. Although the competition policy in the region is still in the early stage of development, the obtained result may indicate the tendency by certain foreign investors to invest in protected or regulated markets to gain market power (see Bevan et al.; 2004).

Banking reform and interest rate liberalization do not have a significant effect on FDI in the manufacturing sector of the observed region (model 7). Such a result is expected, due to the significant lending to private enterprises and significant presence of private banks, particularly in the period after 2000. Therefore, foreign investors do not seem to consider the effectiveness of the banking sector as an obstacle to investment.
Although endowments of physical infrastructure are still relatively weak, results in Model 8 indicate that investors pay attention to this category as well, since the OIR variable is significant at 10% level. The infrastructure sector is undergoing a process of restructuring through the establishment of sector regulators, privatisation of state enterprises and opening of domestic markets to competition. Physical infrastructure is therefore becoming less of a constraint for foreign direct investors.

6. CONCLUSION

Our analysis presented in this paper indicates that general measure of institutional development, proxied by the FACINST variable, is statistically significant and confirms that the overall quality of the institutions attracts FDI in manufacturing sector in SEE region. The impact of institutional progress on FDI confirms that traditional variables cannot fully explain FDI in SEE region, and that institutionally related variables should be attached a particular significance in future research. Besides, we identified individual determinants by disaggregating to subsets of institutional development. In this context, results indicate that a few institutional changes enhanced FDI receipts to manufacturing sector: privatisation process, liberalization of foreign exchange and trade, development of competition policy and development of infrastructure reform. On the other hand, enterprise restructuring, domestic price liberalization and development of the banking sector do not seem to be a significant motive for FDI in our research, probably since the described institutional changes are not a significant obstacle to foreign investors’ investing activities. The weak influence of domestic price liberalization and the insignificant effect of the development of competition policy on FDI may point to the conclusion that certain foreign investors invest in this region in order to achieve extra profit, and that policy makers should consider the possibility of conflicting interests of foreign business and institutional development.

LITERATURE:


