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THE NEXUS BETWEEN FDI, EXTERNAL (IM)BALANCE AND ECONOMIC GROWTH ON SERBIAN REAL CONVERGENCE PATH

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Abstract:
The focus of this research is the nexus between foreign direct investments, FDIs, external imbalance and economic growth, in the case of Serbia in the period 2007-2024. From one side, convergence process towards more developed European economies implies fostering of economic growth i.e. real convergence, which is positively connected with FDIs inflows. From the other side, real convergence is usually accompanied with growing external imbalance i.e. current account deficit. The aim of this research is to shed more light onto these relations from the angle of national economy, under methodological framework of estimated VAR model. Empirical findings confirm that FDIs positively influence real convergence, while real convergence is connected with external imbalance deterioration. National economic authorities should continue efforts to maintain and attract FDIs as beneficial type of external capital inflows, having in mind their positive real repercussions and medium-term external balancing. Nevertheless, essential and long-run efforts should be oriented towards resolving of chronic CA deficit, thereby increasing country's resistance to global crisis shocks and sudden stop episodes.

Keywords:
FDIs, real convergence, external (im)balance, Republic of Serbia, VAR model.

JEL Classification:
E66, F43, O50

INTRODUCTION

External imbalance in the sense of current account deficit is a fundamental problem facing developing countries, including Republic of Serbia. However, current account (CA) deficit does not necessarily have to be a worrying indicator if there are adequate mechanisms for its financing. The most desirable scenario is to cover the given deficit with foreign direct investments (FDIs), which represent stable and long-term oriented external capital inflow. In the absence of capital in this form, the effort is to cover current account deficit with short-term capital in the form of a portfolio and/or other investments, which represent riskier scenario given the fact that short-term capital is less reliable, oscillatory, prone to "sudden stop" episodes.

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Foreign exchange reserves are used as a last solution in achieving external (balance of payments) balance. As foreign exchange reserves are limited, their frequent use could lead to their depletion, causing negative reflections on entire economy.

In the case of the Republic of Serbia, current account deficit has been successfully covered with FDIs for years, with accompanying accumulation of foreign exchange reserves. Alongside the role of FDIs in financing current account deficit, FDIs are important for developing countries as a stimulus for real economy *i.e*. real convergence, due to the transfer of knowledge and technology from abroad, the creation of new jobs, the increase of production, leading to economic growth (Gross Domestic Product - GDP growth). Having in mind the nexus between GDP growth and FDIs, the focus of this paper is to reconsider beneficial role of FDIs to GDP growth in the case of national economy. In addition, the paper analyzes the nexus between GDP and CA assuming negative relation in the context that real convergence negatively affects balance of payments position, thus deepening CA deficit. Empirical research is performed under descriptive and econometric framework. VAR model is used to shed more light into the dynamic relations between non-stationary variables (FDIs, GDP, CA) in the period 2007-2024 comprising three global economic crisis (Global Financial 2007 Crisis, Pandemic 2020 Crisis and Geopolitical 2022 Crisis).

After the introductory considerations, a review of the literature follows, indicating the importance of FDIs in financing CA deficit and promoting GDP growth in emerging economies, including Republic of Serbia. Within the framework of descriptive analysis, CA position, GDP growth, as well as FDIs are analyzed in more detail from the angle of national economy. Within the framework of econometric analysis, the empirical findings will be interpreted, followed by recommendations to policy makers and concluding considerations in the last Section 5.

LITERATURE REVIEW

FDIs are crucial for economic growth and sustainability in countries that are less economically developed, and it can be said that attracting FDIs has become a task of national importance (Wijeweera *et al.*, 2010; Ercegovac & Beker Pucar, 2021). Economies around the world are developing different policies with the aim of attracting foreign investments as a way to develop and improve their internal and external positions. Developed infrastructure and financial markets, openness to trade and the quality of institutions, largely determine FDI inflows (Elboiashi, 2015; Agrawal, 2015; Chien-Chiang and Chun-Ping, 2019). FDIs makes it easier to introduce new technology and access the global market, with positive repercussions for real convergence. This type of external capital inflow represents a way to increase production, employment, exports and living standards (Popescu, 2014; Ejupi Ibrahimi and Fetai, 2022). The more open an economy is, the greater the positive impact of FDI on employment, regardless of whether the country is developing or developed (Shengelia *et al*, 2020). In examining the impact of FDI on employment, some authors, however, indicate that there is no statistically significant impact of FDI on employment and average wages (Perić, 2019; Grahovac and Softić, 2017; Zdravković and Martinović, 2016). Countries that actively pursue an export-led growth strategy are able to reap great benefits from FDIs (Kurtishi-Kastrati, 2013; Xhelili Krasniqi and Topxhiu, 2017; Trpeski *et al*., 2021).

The previous review of the literature indicates the importance of FDI inflows both for economic growth (GDP growth), as well as for financing a chronic CA deficit in order to establish medium-term external balance. It is inherent for developing and transition countries that development and convergence process towards developed European countries negatively reflect on balance of payments, deepening

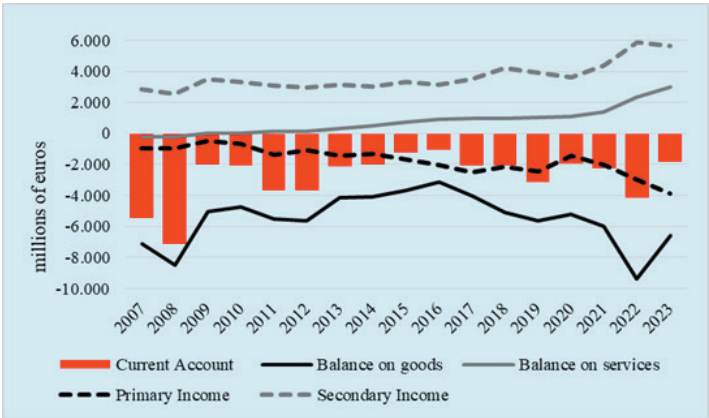
thus CA deficit, more precisely the trade balance (International Monetary Fund, 2020). Net capital inflows are the counterpart of CA deficits. The literature suggests that CA deficit can be maintained if the economy receives sufficient capital inflows, but the most favorably – net-inflow of FDIs (Hlivnjak, 2010; Devadas and Loayza, 2018). In order to eliminate the imbalance, the long-term interest of every export-oriented economy is to attract FDIs in new production capacities with the aim to boost export and economic growth, and at the same time to finance CA deficit with stable and less volatile flow of external capital (Stanišić, 2020; Ercegovac and Beker Pucar, 2022). However, excessive reliance to foreign capital exposes the country to the risk of disruptive "sudden stop" episodes with costly adjustment processes of real economy and external positions (Svrtinov *et al.*, 2015).

After political-economic changes in 2000, the economic priority of Republic of Serbia was to anchor inflationary expectations. This primary goal was achieved by pegging the national currency to the euro in the phase of exchange rate as a nominal anchor. After inflationary stabilization since 2003 the focus was moved towards the stimulation of economic growth *i.e.* real convergence. In accordance with the switched focus of economic authorities, exchange rate policy had been changed in the sense of more frequent dinar devaluation in order to enhance external competitiveness (Beker Pucar, 2024). Growth stimulation in the context of faster real convergence coincides with net-inflow of FDIs, bearing on mind that emerging economies in general, including our national economy, lack sufficient domestic accumulation. An improvement related with economic environment and functioning of public companies contributes to increased share of investments in GDP (Nikolić and Petrović, 2018; Aničić *et al.*, 2021). Republic of Serbia became one of the more attractive destinations for FDIs among transition economies, with a share of approximately 0.34% in global framework, which exceeds the percentage in other countries of the West Balkan (Vukmirović *et al.*, 2020). Consequently, the research results indicate that Serbia is progressing much faster than other countries of the Western Balkans (Marjanović *et al.*, 2021). Capital inflow through FDIs plays a significant role in financing the CA deficit in national economy. However, Čakajac *et al.* (2024) emphasize that despite the coverage of Serbian CA deficit with net-inflow of FDIs, these inflows will not be sufficient to ensure further external financing. Consequently, the efforts of economic policy makers should be made in order to intensify export and competitiveness improvement, as well as to motivate foreign investors to reinvest than repatriate profits.

DESCRIPTIVE ANALYSIS

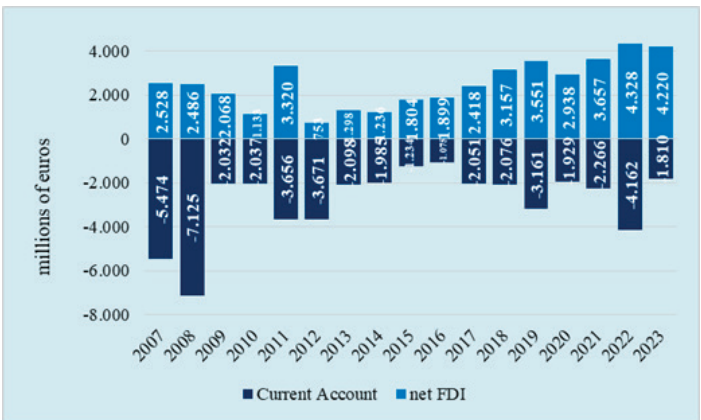
On its developing and convergence path towards more developed European countries, Republic of Serbia records CA deficit in the observed period 2007-2024. CA deficit is determined with chronic merchandise deficit due to insufficient export capacity and high dependence on imports. In this regard, encouraging export growth and differentiating the export structure is the only structural solution of chronic deficit in merchandise trade (Xhelili Krasniqi and Topxhiu, 2017). In addition, current account deficit is reinforced with negative balance of primary income, as a result of outflows due to previous FDI (profit repatriation vs profit reinvestment). Deficit positions in merchandise trade and primary income are mitigated with services surplus, primarily information, computer and telecommunication services (ICT). The importance of investments in the ICT sector is reflected in positive repercussions on economic growth and key macroeconomic indicators such as GDP, productivity and employment (Mićić, 2017; Domazet *et al.*, 2020). Also, the development of tourism can generate desirable economic, political and social effects (Čerović *et al.*, 2016). Positive balance of secondary income account alleviates previous deficit positions thanks to remittances from abroad. Figure 1 shows current account and its analyzed components in the case of Republic of Serbia in the period 2007-2024.

Figure 1. Current account and its components



Current account deficit does not have to be considered as a priori problem if there are adequate ways to cover or finance it. In this context, FDIs inflows used to neutralize the deficit position can be a source of long-term economic growth (Marjanović *et al.*, 2021). Figure 2 shows that FDIs net inflows successfully covered CA deficit from 2015 until the end of the observed period. Bearing in mind that FDIs represent a long-term oriented and stable capital inflow, this is exactly the desired scenario for financing CA deficit. Since external capital inflows surpass CA deficit, monetary authority is confronted with the excess of foreign exchange supply, thus intervening on foreign exchange market in order to keep the dinar's exchange rate relatively stable with the accumulation of foreign exchange reserves.

Figure 2. Current account deficit and net-FDI inflows



National economic authorities strive to attract more and more foreign investors through the creation of a safe and reliable market environment. Positive relationship between FDIs and economic growth provides an answer to the question of why economic policy makers use various incentive measures to create an attractive destination for foreign capital, stimulating economic growth, development, productivity and employment. Thanks to the stable and growing trend of FDIs net-inflow, not only the negative current account is covered, but it also has a beneficial effect on economic growth and development (Šapić and Filipović, 2016; Nikolić, 2021).

Figure 3. GDP of Serbia, 2007-2023

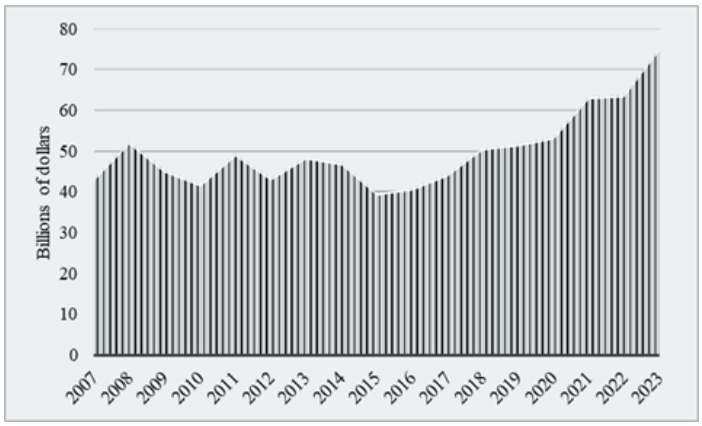


Figure 4. FDI in Serbia, 2007-2023

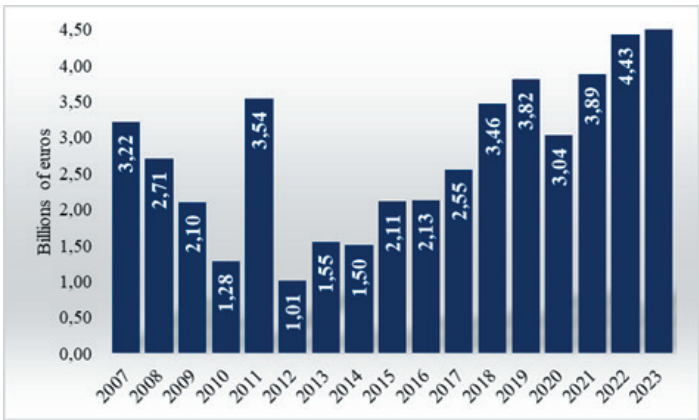
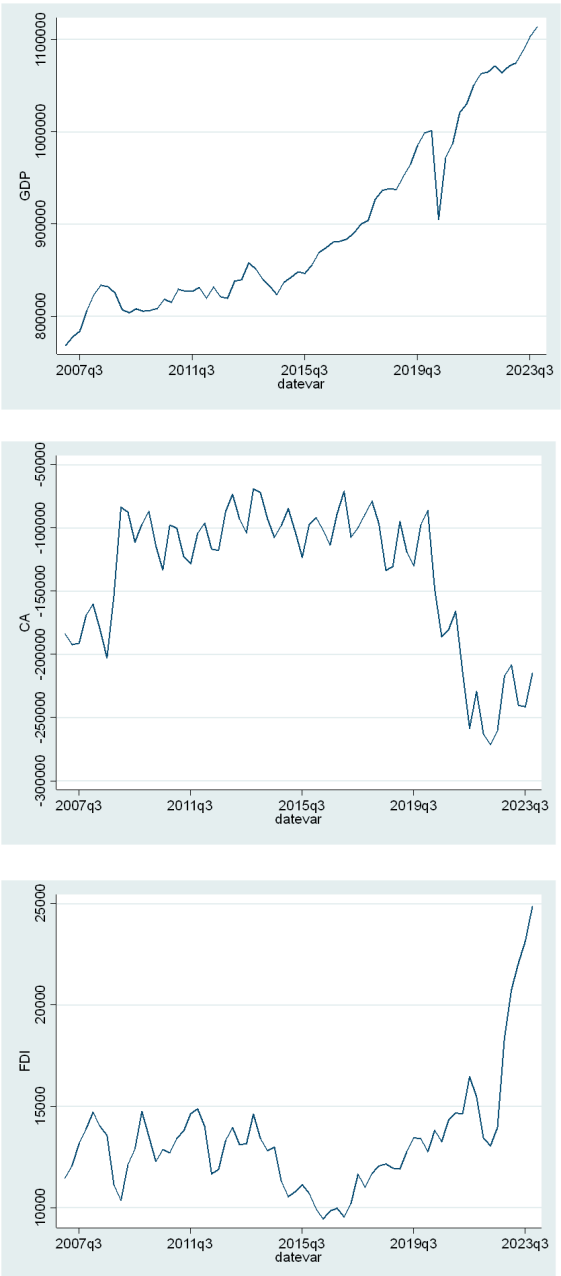


Figure 3 shows the movement of GDP in national economy, while Figure 4 illustrates FDI inflows during observed time period. The figures indicate that growing GDP of national economy has been accompanied with growing FDIs in the post-crisis period since 2012. Theoretically assumed positive relationship between FDIs and GDP is suggested by presented graphical representations. However, a deeper analysis of the nexus between FDIs, CA and GDP require a re-examination of these relationships based on econometric analysis in the following section.

ECONOMETRIC ANALYSIS

Empirical reconsideration of interdependence between GDP and CA, as well as FDIs and GDP growth, is performed using statistical discipline of Time Series Analysis (TSA). TSA refers to a set of random variables with the assumption that they are mutually dependent, allowing investigation of their dynamic relationship. The essence is to examine the degree of dynamic correlation of random variables over time with the application of a suitable estimation technique in dependence of pre- and post-estimation results. Econometric analysis comprises three observed variables FDI, GDP and CA, in quarterly frequency in the period 2007Q1-2023Q4, obtained from Federal Reserve Economic Data (FRED) database (Figure 5).

Figure 5. Serbian GDP, CA and FDI in the period 2007Q1-2023Q4



The nexus between GDP growth and external (im)balance in the case of Serbia is observed in the light of hypothesis that GDP growth initiates CA worsening (negative relation). Namely, GDP growth represents an expansive impulse in the economy, leading to the growth of employment and disposable income. With the growth of income, the opportunity to purchase both domestic and foreign products increases. Besides 'consumption' import, economic growth coincides with 'investment' import *i.e.* imported capital goods such as machines, equipment and technology from abroad. Growth of import in general, as a consequence of faster economic growth, increases trade deficit as a key component of CA balance. For this reason, a negative relationship between given variables is expected - GDP growth initiates a current account deficit and vice versa.

On the other hand, the nexus between FDIs and GDP growth is observed in the light of hypothesis that FDIs positively affects domestic production, employment, productivity, generally fostering real convergence of national economy. Therefore, positive relationship is expected between FDIs and GDP growth.

By applying various formal and informal tests of stationarity, starting from the graphic representation, correlogram on the first lag, as well as formal Dickey-Fuller and Phillips-Perron tests, it is concluded that all three time series are non-stationary *i.e.* there is no predictability in their movement during observed time period. Variables have the same order of integration I(1) with exactly one unit root, while their first differences are stationary I(0)[1]. Table 1 shows the results of stationarity tests for GDP, CA and FDI in the level and in the first differences. Since test statistics of Augmented Dickey-Fuller (ADF) and Philips-Perron (PP) tests for GDP, CA and FDI in the level are higher than critical values (in apsolute terms) H0 is accepted, thus these series are non-stationary, with the presence of unit roots. The results of ADF and PP tests for the first differences of GDP, CA and FDI suggest that H0 is rejected *i.e.* first differences are stationary. Therefore, analysed series are I(1) in the level, with exactly one unit root. The empirical procedure further continues with cointegration tests bearing in mind that all variables are I(1) with the possibility of long-run equilibrium relation between them.

Table 1. Stationarity tests of GDP, CA and FDI variables

Variable / Test	ADF in the Level	ADF at the First Differences	PP in the Level	PP at the First Differences
GDP	p-value			
	0.9915	0.0000	0.9876	0.0000
	Test Statistic			
			0.826	-77.919
	0.791	-9.599	0.599	-9.599
	Critical Value (5%)			
			-13.436	-13.428
	-2.917	-2.917	-2.916	-2.917
CA	p-value			
	0.6049	0.0264	0.523	0.0000
	Test Statistic			
			-5.143	-43.777
	-1.352	-3.102	-1.521	-7.685
	Critical Value (5%)			
			-13.436	-13.428
	-2.920	-2.920	-2.916	-2.917
FDI	p-value			
	0.987	0.0000	0.9824	0,0000
	Test Statistic			
			1.778	-47.546
	0.575	-5.442	0.425	-5.836
	Critical Value (5%)			
			-13.436	-13.428
	-2.918	-2.918	-2.916	-2.917

1 In this section are presented crucial results of empirical procedure, while less relevant results are omitted due to the space limitations. However, all results, specifically graph of first differences of FDI, GDP and CA, autocorrelation at the first lag, lag selection for VAR estimation, post-estimation VAR stability and serial correlation tests, are available upon request to the authors.

The results of Johansen cointegration test indicate that there is no long-term cointegration relationship between observed non-stationary time series FDI, GDP and CA, as shown in Table 2, where it can be seen that in both cases the trace statistic exceeds the critical value.

Table 2. Johansen's cointegration test

Johansen Test for Cointegration	GDP & CA	FDI &GDP
Trace statistic	10,7057	5,2201
Critical value	15,41	15,41

Therefore, short-term relationship between analysed non-stationary series is evaluated using VAR model, with previous differencing transformation in order to obtain their stationarity. Pre-estimation procedure concerning lag selection in VAR estimation suggests that dynamic relation between first differences of GDP and CA should include 2 lags, while dynamic relation between first differences of FDI and GDP should include 1 lag.

Post-estimation steps suggest that estimated VAR models are stable, without serial correlation. Derived impulse response functions allow to detect how GDP shock influence CA balance, as well as how FDI shock influence GDP variations during time, in this research during four quarters.

Figure 6 shows empirical findings related with the influence of GDP shock to CA balance. Impulse response functions confirm expected negative relationship between GDP and CA over a four-quarter time period. GDP growth leads to deterioration of CA position in the first quarter, after which the impact of the shock gradually weakens and disappears over a period of one year. Based on the obtained results, it could be concluded that real convergence process, inherent for emerging European economies, including Republic of Serbia, deepens CA deficit, worsening thus external imbalance.

Figure 6. Impulse response functions: GDP impulse (shock) & CA response

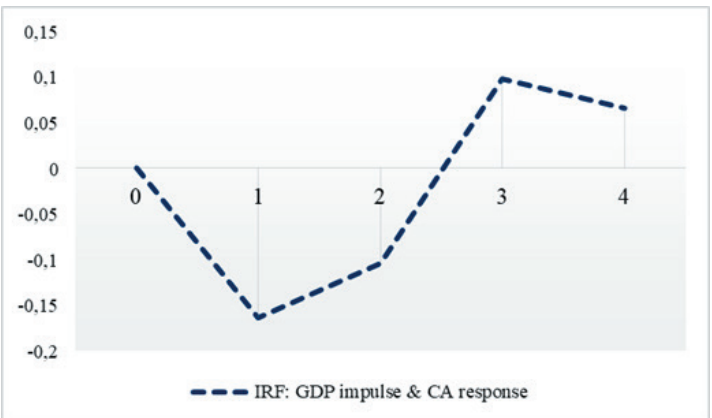
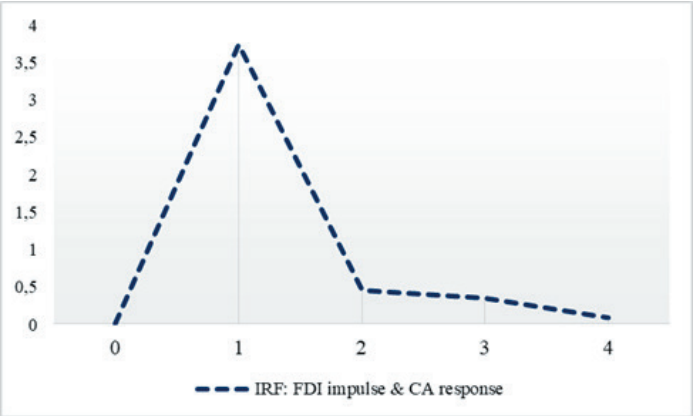


Figure 7 shows empirical findings related with the influence of FDIs to GDP growth. Impulse response functions confirm positive relationship between FDIs and GDP over four-quarter time period. A shock on the FDI side (growth) initiates a sharp GDP rise in the first quarter. Observed effect weakens in the second quarter, while in the third and fourth the influence of FDI shock gradually fades.

Figure 7. Impulse response functions: FDI impulse (shock) & GDP response



On the basis of descriptive and econometric analysis, the importance of FDIs in covering CA deficit, as well as the beneficial impact of FDIs to the real convergence, can be unequivocally recognized in the case of national economy. FDIs are relevant in both aspects – progress of real convergence from one side and stable and less volatile source of external financing from the other side. At the same time, real convergence is intertwined with CA deterioration. If the aim of low and stable inflation has been achieved as a primary background for other economic goals, further efforts of economic authorities continue with the balancing between real progress (convergence) towards more developed European economies and avoidance of chronic external imbalance. The balancing between internal balance (low inflation and high economic growth) and external balance (sustainable balance of payments position) is difficult and challenging task, especially in converging and vulnerable national economies.

CONCLUDING REMARKS

Emerging European countries on their path to the EU experienced rising GDP growth or real convergence. Nevertheless, common side effect of faster economic growth presents growing external imbalance *i.e.* CA deficit. FDIs play significant role in balancing between external imbalance and real economy. From one side, FDIs are one of key determinants of GDP growth in emerging countries, while from the other side FDIs serve to finance CA deficit providing external balance in the medium-term. Therefore, this research aims to shed more light onto the relations from the angle of national economy in the period 2007-2024.

Namely, after achieved macroeconomic stabilization, which was priority of Serbian economic authorities since political-economic changes in 2000, the focus was gradually shifted to fostering of economic growth *i.e.* convergence process towards more developed European countries in the research period 2007-2024. Rising economic growth in national economy was accompanied with external imbalance reflected in chronic CA deficit, which worsened during the Global Financial, Pandemic and ongoing Geopolitical Crisis. Chronic CA deficit is primarily based on merchandise trade deficit and negative primary income account. The surplus in services balance, as well as secondary income balance, weren't sufficient to cover previous deficit positions. In national economy, FDIs play a crucial role in financing chronic CA deficit, providing at the same time medium-term external balance, as well as the stimulus for economic growth.

The results of empirical research, based on estimated VAR model and derived impulse response functions, confirm positive nexus between FDIs and GDP in our country, in the sense that external capital inflow in the form of FDIs affects GDP rise *i.e.* fosters real convergence process towards more developed European economies. At the same time, the results confirm the expectation that real convergence process, reflected in GDP growth, is accompanied with CA deficit or external imbalance. It could be concluded that the external imbalance of national economy is, among other factors, generated with GDP growth or convergence towards developed European countries, as well as that FDIs positively affects domestic production growth. Thus, convergence path is inevitably followed with FDI inflows and external imbalance.

In the case when domestic accumulation is not sufficient to boost economic growth, national economy relies upon external capital as a stimulus for economic growth and financing channel of CA deficit. FDIs have played a significant role for years in financing CA deficit, with additional beneficial effect on GDP growth. The efforts of policy makers should continue concerning FDI maintenance as a favorable form of external financing. This notion especially holds having in mind positive real repercussions, medium-term external balancing and less national vulnerability to "sudden stop episodes" in the case of FDIs. Nevertheless, economic policy in the long run should be focused on finding ways to reduce the dependence from foreign capital via exports stimulation and import weakening.

In the context of further empirical research, here highlighted interdependence between FDI, real economy and external imbalance in convergence process of national economy, could be compared with West Balkan countries with similar development phase. However, an inclusion of other regional countries in the analysis implies different methodological framework *i.e.* macroeconomic panel techniques, as a combination of several countries with higher frequency data. It would be also interesting to compare the results with ex-transition countries at higher development stage, in order to draw lessons concerning balancing between internal and external economic goals on the road towards the EU.

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VEZA IZMEĐU SDI, EKSTERNE (NE)RAVNOTEŽE I EKONOMSKOG RASTA NA PUTU REALNE KONVERGENCIJE REPUBLIKE SRBIJE

Rezime:

Fokus ovog istraživanja predstavlja odnos između stranih direktnih investicija, SDI, eksterne neravnoteže i ekonomskog rasta u slučaju Srbije u periodu 2007-2024. S jedne strane, proces konvergencije prema razvijenijim evropskim ekonomijama podrazumeva ekonomski rast, odnosno realnu konvergenciju, što je u pozitivnoj vezi sa prilivima SDI. S druge strane, realna konvergencija obično je propraćena sa rastućom eksternom neravnotežom, preciznije deficitom tekućeg bilansa. Cilj istraživanja jeste da rasvetli pomenute relacije iz ugla nacionalne ekonomije, pod metodološkim okvirom ocenjenog VAR modela. Empirijski nalazi potvrđuju da SDI pozitivno utiču na realnu konvergenciju, dok je realna konvergencija u vezi sa pogoršanjem eksterne pozicije zemlje. Nacionalne ekonomske vlasti treba da nastave napore ka održavanju i privlačenju SDI kao povoljnije forme kapitalnih priliva, imajući u vidu njihove pozitivne realne posledice i srednjeročno eksterno balansiranje. Ipak, suštinski i dugoročni napori treba da budu orijentisani ka prevazilaženju strukturnog deficita tekućeg bilansa, povećavajući na taj način otpornost nacionalne ekonomije na globalne krizne šokove i epizode "iznenadnog zaustavljanja" priliva kapitala.

Ključne reči:

SDI,
realna konvergencija,
eksterna (ne)ravnoteža,
Republika Srbija,
VAR model.

JEL klasifikacija:
E66, F43, O50