



# Regional Economic Cooperation in the Western Balkans:

## The Role of Stabilisation and Association Agreements, Bilateral Investment Treaties and Free Trade Agreements in Regional Investment and Trade Flows

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The following background study was written in the context of a joint project conducted by wiiw and the Bertelsmann Stiftung. The project examined whether, and if so how successful, the EU strategy has been in promoting rapprochement and reconciliation through regional cooperation in the Western Balkans. The overall results of the project were published under the title '[Pushing on a string? An evaluation of regional economic cooperation in the Western Balkans](#)'.



# Abstract

In this report we present the results of our econometric investigation of the role of (1) stabilisation and association agreements (SAAs), (2) bilateral investment treaties (BITs) and (3) free trade agreements (FTAs) in the Western Balkans and their impact on the region's inward foreign direct investment (FDI) and exports, with primary interest in the effects on intra-regional FDI and trade. We find that BITs were generally not related to intra-regional FDI (nor to the FDI from other countries). However, in a separate discussion of Serbian FDI into Montenegro we argue that the corresponding BIT between the two countries may have been an exception. The Central European Free Trade Agreement (CEFTA) contributed to increased intra-regional trade. This effect is stronger if Serbia is left out of the analysis, which may be due to the diversion of Serbian exports to the EU over the same period, possibly also facilitated by Serbia's SAA with the EU. If all regional FTAs are 'merged' with CEFTA and assessed as a single variable, its impact on exports is not significant, unless Serbia is left out of the analysis. This indicates that the early intra-regional FTAs, which were replaced by CEFTA, were weakly implemented and did not contribute significantly to stronger trade integration in the region. Finally, we find that SAAs turn out to be highly significant for FDI from the EU to signee countries, as well as for exports from these countries to the EU.

**Keywords:** Free Trade Agreements, Bilateral Investment Treaties, Economic Cooperation, Western Balkans

**JEL classification:** F13, F14, F21, F53



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# 1. Introduction

In this study we present the findings of our econometric investigation of how (1) stabilisation and association agreements (SAAs), (2) bilateral investment treaties (BITs) and (3) free trade agreements (FTAs) impact inward foreign direct investment (FDI) and exports of the Western Balkan countries. We are primarily interested in whether such agreements are related to intra-regional FDI and trade flows and, in the case of SAAs, whether they are related to FDI from the EU into the region and to an increase in exports from the region to the EU.<sup>1</sup>

Since the beginning of 1990s the economic ties between the Western Balkan countries have largely been disrupted by the conflicts and political tensions in the region, especially across the countries of former Yugoslavia. Rebuilding these ties and strengthening regional economic integration has been placed high on the list of policy priorities, not least because this has been seen as a means to increase the economic competitiveness of Western Balkan countries and to better prepare them for further economic integration with the EU, as restated, for example, in the EU strategy for Western Balkans (EC 2018). The importance of regional economic integration in the context of preparing for future EU membership has been recognised in the preamble of what is possibly the most important regional economic cooperation initiative, the Central European Free Trade Agreement ('new' CEFTA), which refers explicitly to '...the contribution of the Central European Free Trade Agreement ... to improve the readiness of Parties for membership in the European Union as witnessed by the accession on 1 May 2004 of the Czech Republic, the Republic of Hungary, the Republic of Poland, Slovak Republic and the Republic of Slovenia and the forthcoming accession of the Republic of Bulgaria and Romania'.<sup>2</sup>

Especially given the remaining political tensions between (some of) the countries in the Western Balkans, there is a possibility that regional cooperation agreements make a strong contribution to increased economic integration.<sup>3</sup> We acknowledge right at the beginning that, besides BITs and FTAs, there have been a number of other regional cooperation initiatives that could have contributed to increased bilateral FDI and trade flows between the Western Balkan countries, such as activities involving regional cooperation in South East Europe under the leadership of the OECD, for example, or the South East Europe Investment Committee.<sup>4</sup> As the effects of these initiatives are more difficult to quantify or capture using econometric techniques, we follow the standard approach in the literature by focusing on BITs and FTAs as the significant forms of economic integration policies.

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<sup>1</sup> The cut-off date for data and information used is June 2019.

<sup>2</sup> This agreement is usually referred to as 'new' CEFTA, or 'CEFTA 2006'. The 'old' CEFTA was started in 1992 with the members comprising the Central and Eastern European (CEE) countries that joined the EU in 2004, 2007 and 2013. The first members were Poland, Hungary and Czechoslovakia (later Czech Republic and Slovak Republic), while Slovenia joined in 1996, Romania in 1997, Bulgaria in 1999, and Croatia in 2003. These countries left CEFTA as they joined the EU. This indicates how far Western Balkan countries were lagging behind in terms of economic integration initiatives.

<sup>3</sup> As found by Desbordes and Vicard (2009) in their analysis of the quality of political relations between host and home countries and FDI, the BITs are more effective in promoting FDI between countries with comparatively tense political relationships, which has been the case in the Western Balkans.

<sup>4</sup> See <http://www.oecd.org/south-east-europe/> and <http://www.seeic.rcc.int/pages/1/background>.



The study is structured as follows. After a general overview of the relevant bilateral and regional treaties and agreements we present a series of graphs based on data series that illustrate the flow of FDI in the Western Balkan economies. We then move on to an econometric investigation of the effects of closer economic cooperation within the region on economic outcomes. In the third section we analyse econometrically the relationship between the BITs and bilateral FDI flows. In the fourth section we present an econometric analysis of trade liberalisation policies on bilateral trade flows, and the last section is a brief summary of our findings.

## 2. Foreign direct investment and trade of the Western Balkan countries: an overview

### 2.1. POLICIES AND TREATIES

There is a broad range of potentially relevant factors that need to be taken into account in the analysis of trade and investment integration between countries, including, for example, the size of their economy (typically measured by their GDP), geographical proximity or shared border, common historical and cultural features (such as having been a part of the same state in the past or having a common language), relative factor endowments, quality of institutions or human capital and physical infrastructure availability, but also including macroeconomic policies that affect macroeconomic stability, real exchange rates, or costs of production more generally. The relevance of many of these factors, which are often interlinked, is an empirical question, as it may depend on specific circumstances of the analysed countries or on the specific type of FDI and (the types of) goods and services traded.<sup>5</sup>

In this research we focus on the relationship between FDI-promoting policies in the BITs and bilateral FDI, as well as the relationship between trade liberalisation policies, mostly in the form of FTAs, and bilateral trade flows. In addition to being potentially relevant as investment and trade flow determinants, such treaties and agreements may be seen as proxies for economic integration efforts in general. To our knowledge, this is the first empirical analysis focusing on BITs between the Western Balkan countries.

**Table 1 / Bilateral investment treaties in force among WB countries**

	Albania	Bosnia and Herzegovina	North Macedonia	Montenegro*	Serbia	Kosovo
Albania		2009	1998	2004	2004	2005
Bosnia and Herzegovina	2009		2004		2004	
North Macedonia	1998	2004		2011	1997	
Montenegro*	2004		2011		2010	
Serbia	2004	2004	1997	2010		
Kosovo	2005					

Note : \*According to the Decision on Proclamation of Independence of the Republic of Montenegro, adopted on 3 June 2006 by the Parliament of the Republic of Montenegro, which defines the taking over and implementation of international treaties that have been concluded or joined by the State Union of Serbia and Montenegro and related to Montenegro, which are fully compliant with Montenegro's legislations, Montenegro implements these Agreements and Conventions.

Source: CEFTA (<http://cefta.int/reports-and-related-documents/>).

The investment aspect of the Western Balkan countries' economic integration has proceeded unevenly. A couple of agreements (North Macedonia's BITs with Albania and Serbia) entered into force at the end

<sup>5</sup> See e.g. Blonigen and Piger (2014) for further insights into determinants of FDI, and Fugazza (2004) or Cerra and Woldemichael (2017) for findings on export (acceleration) determinants for broader samples of countries. Jirasavetakul and Rahman (2018) present a recent reference on FDI determinants into transition countries (including Western Balkans but do not analyse the role of BITs), while Kaloyanchev et al. (2018) and Petreski (2018) more recently looked into the broader determinants of intra-regional trade among Western Balkan countries.

of the 1990s, but momentum did not really pick up until the early 2000s (Table 1).<sup>6</sup> By the end of 2018 Albania had a BIT with every other Western Balkan country, but Kosovo has such an agreement only with Albania. Thus, there are ten BITs in force among Western Balkan countries that might be used as test cases to see whether they are related to FDI into the signees' countries.

Among many regional cooperation initiatives, probably the most important one in the context of strengthening regional economic integration is the aforementioned 'new' CEFTA. It came into force in 2007 and included, besides the six Western Balkan countries, also Moldova and Croatia (which left CEFTA when it joined the EU in 2013). It aims to rebuild the regional market by facilitating intra-regional trade, but it also contains provisions on promoting and protecting intra-regional FDI. CEFTA also consolidated the FTAs which already existed between Western Balkan countries (see Table 2).

**Table 2 / FTAs between WB countries before CEFTA**

	Albania	Bosnia and Herzegovina	North Macedonia	Montenegro*	Serbia	Kosovo
Albania		2004	2002	2004	2004	2003
Bosnia and Herzegovina	2004		2002	2002	2002	
North Macedonia	2002	2002		2006	2006	2006
Montenegro*	2004	2002	2006			
Serbia	2004	2002	2006			
Kosovo	2003		2006			

Note: \*Database does not contain information on these FTAs for Montenegro, but only for Serbia. However, the two countries formed a common country before separation in 2006.

Source: DESTA.

As mentioned earlier, regional economic integration is an important component in the process of integration with the EU. In this context, SAAs are likely to be relevant for trade, investment and also broader economic developments in the region. While all six countries have such an agreement in force by now,<sup>7</sup> only Montenegro and Serbia have an open accession negotiation process with the EU. Albania and North Macedonia are candidate countries, and Bosnia and Herzegovina and Kosovo are potential candidates for EU membership.

## 2.2. FDI IN THE WESTERN BALKANS

It has been recognised in the literature that the countries of the Western Balkans have been lagging behind Central and East European (CEE) countries in terms of attracting FDI (see e.g. Estrin and Uvalic, 2014), with stronger FDI inflows being recorded only after 2000. While the stock of FDI in the Western Balkan countries has been increasing over the past two decades, it is possible to observe different dynamics across individual countries. Figure 1 shows the share of total FDI stock as a percentage of GDP in these countries.<sup>8</sup>

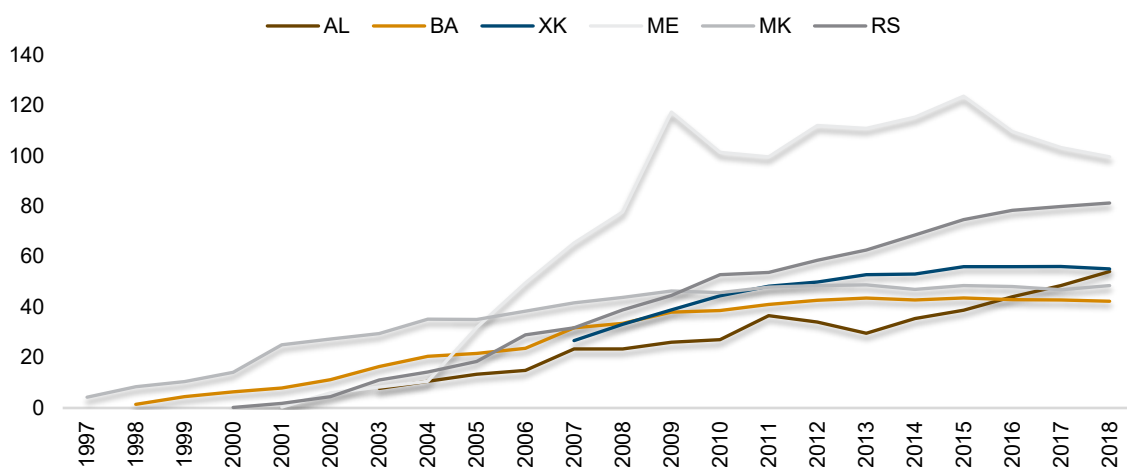
<sup>6</sup> In contrast, many transition countries in CEE had BITs in force (with other countries from the same group) already by 1995, many entered into force by 2000, and only a smaller fraction in early 2000s.

<sup>7</sup> Starting with North Macedonia (in force since 2004), Albania (2009), Montenegro (2010), Serbia (2013), Bosnia and Herzegovina (2015), and finally Kosovo (2016).

<sup>8</sup> The source for all data presented in this section is the wiiw database.

North Macedonia (MK) outperformed other countries in the region in terms of the foreign investment it attracted early in the period under review. However, the share of FDI stock in North Macedonia's GDP has been stagnating since 2009, at between 45% and 50%. Similar levels of stagnation can be observed in Bosnia and Herzegovina (BA) since 2012 (at around 43% of GDP), and in Kosovo (XK) since 2015 (at around 55% of GDP). Montenegro (ME), in contrast, was a latecomer even by regional standards, but it experienced a surge in FDI inflows between 2004 and 2009, after which the share of FDI stock in its GDP varied considerably at between 100% and 120% – the highest share among the six countries. Serbia (RS) has shown a relatively stable increase in FDI over time, with the FDI stock currently slightly exceeding 80% of GDP, while Albania (AL) recorded a somewhat stronger increase in its FDI stock over the last five years of the period being reviewed, from around 30% to roughly 55% of GDP. The region's average in 2018 amounted to 64% (i.e. 56% without Montenegro). This is higher than the average share of FDI stock in the GDP of the three EU member states from South East Europe (EU-SEE: Bulgaria, Croatia and Romania), which was 58% in 2018, with individual shares ranging between 40% in Romania and 78% in Bulgaria. The difference between the country groups is that the three EU-SEE countries had already reached their comparable average share by 2009, which has hovered closely around the 60% mark ever since. In contrast, the Western Balkan average share in 2009 amounted to 52% (39% without Montenegro) and has recorded a substantial increase since then.

**Figure 1 / Total FDI stock in % of GDP**



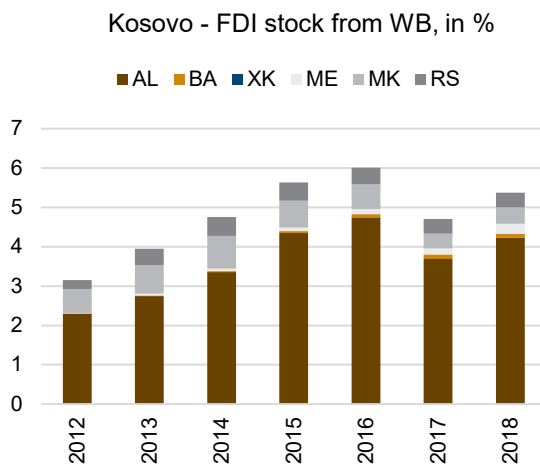
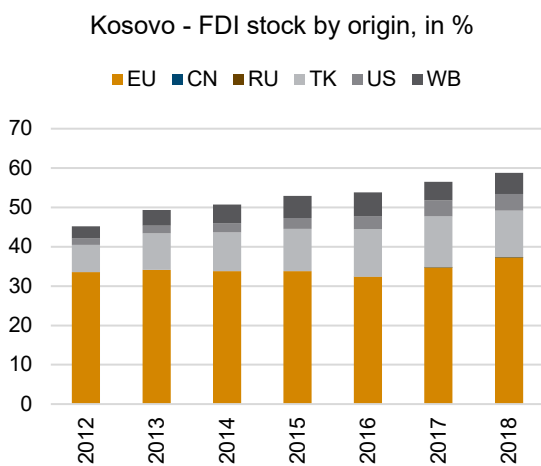
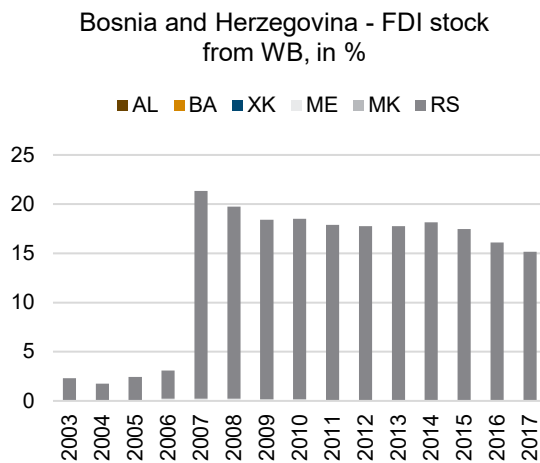
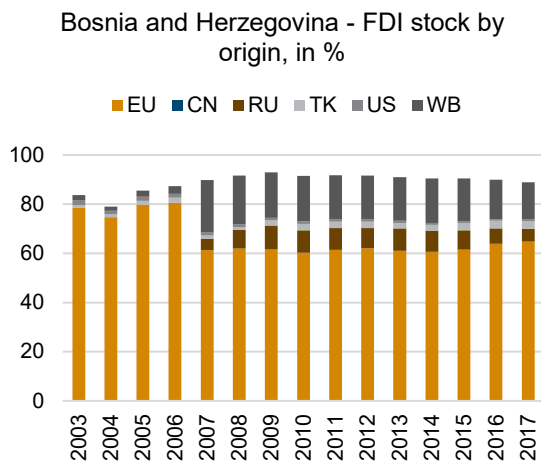
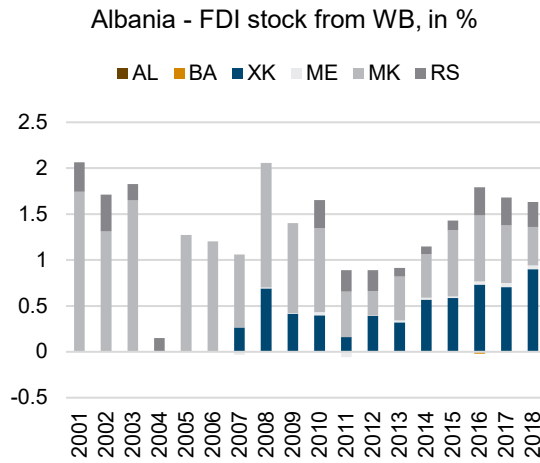
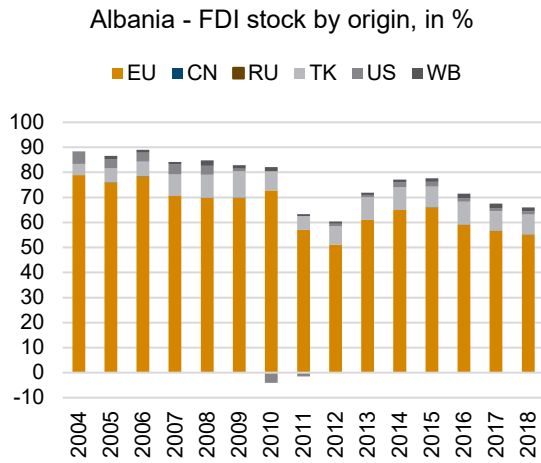
Panel 1 below consists of a series of graphs which illustrate the total inward FDI stock by country (or region) of origin as a percentage of total FDI stock. Each Western Balkan country is represented by two graphs: the graph on the left-hand side shows the share of FDI received from the EU, China (CN), Russia (RU), Turkey (TK), the US and the rest of the Western Balkans (WB) region. The graph on the right-hand side illustrates how much of the FDI received from individual Western Balkan countries accounts for the total FDI stock of the recipient country. The data do not start in the same year for all Western Balkan host countries (FDI recipients) or for all home countries (sources of FDI).

The first important observation is that the EU has been the main source of FDI into the region, with its share in total FDI ranging from 37% in Kosovo to above 80% in Serbia (latest available data). Over the period surveyed the share of FDI from the EU has been relatively stable, with some exceptions, such as

a slowly declining trend in Albania, or a decline in the EU share of Bosnian inward FDI in 2007 owing to a strong increase in investment from another country (Serbia). As for the other important investors from outside the region, Russia plays a comparatively important role in Montenegro, Serbia and Bosnia and Herzegovina, as does Turkey in Kosovo, Albania and North Macedonia. Their shares in the FDI stock, however, are much lower than the share of FDI from the EU. The FDI share of China, while slightly increasing, is still very modest, reaching a maximum of 2.3% in North Macedonia in 2017. FDI from the US does not account for a major share of FDI stock in any of the countries surveyed; its contribution has mostly been decreasing over the period, with the exception of Kosovo (and to smaller extent North Macedonia), where it rose above 4% in 2018.

The share of FDI stocks from other Western Balkan countries has mostly been rather small and declining over the period under review. One notable exception to the declining trend is Kosovo, whose share increased over the same period (with a decline recorded only in 2017), owing largely to the rising share of Albanian FDI into Kosovo, which increased from 2.3% to 4.2% between 2012 and 2017. The largest share was recorded in Bosnia and Herzegovina, where it amounted to 15% in 2017. This is related to a strong increase in FDI from Serbia in 2007. Another example of a considerable share of FDI stock from Western Balkan countries is Serbia's FDI in Montenegro, although this has also recorded a decline from 7.6% in 2010 to 5.2% in 2017. Additional descriptive data are available from Table A1 in Appendix A, showing the matrix of bilateral shares of inward FDI stocks across Western Balkan countries.

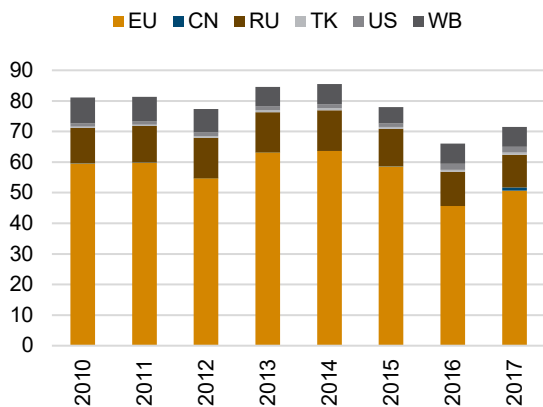
**Panel 1 / FDI inward stock by origin, in % of total FDI inward stock**



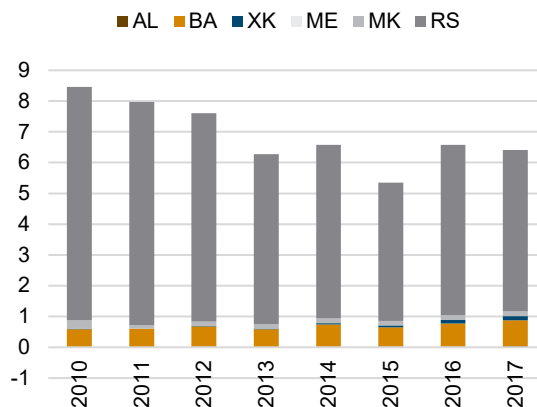
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Panel 1 / continued

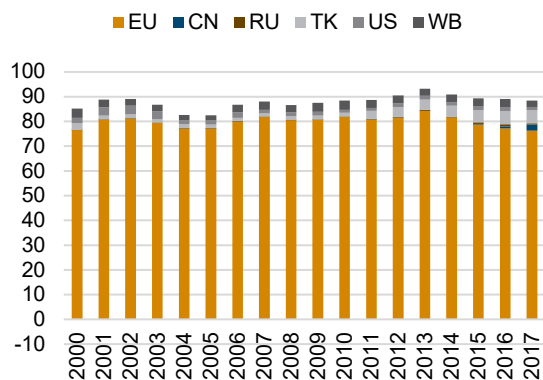
Montenegro - FDI stock by origin, in %



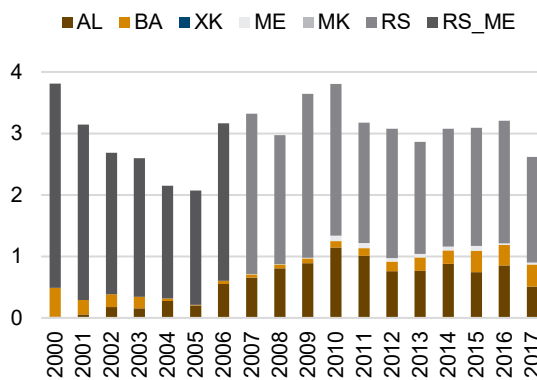
Montenegro - FDI stock from WB, in %



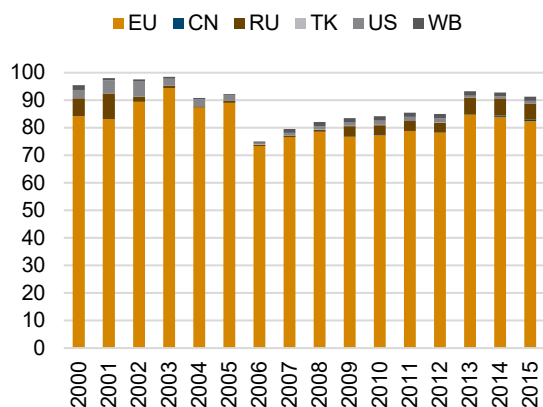
North Macedonia - FDI stock by origin, in %



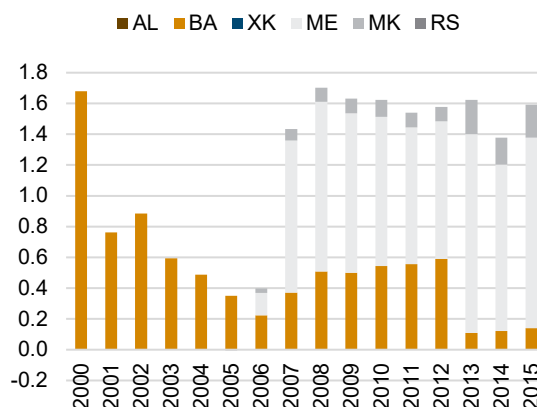
North Macedonia - FDI stock from WB, in %



Serbia - FDI stock by origin, in %



Serbia - FDI stock from WB, in %



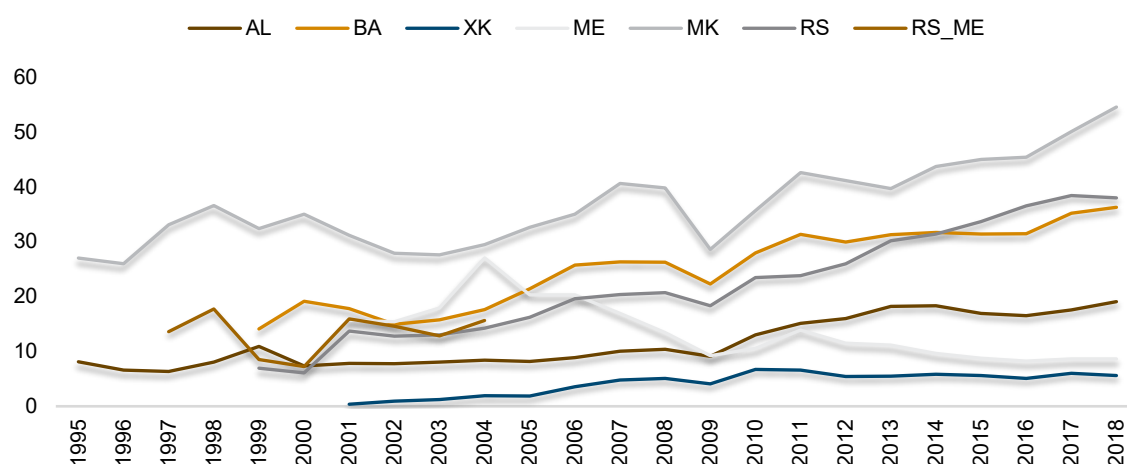
Note: North Macedonia also reported aggregated data on FDI stocks from Serbia and Montenegro (RS\_ME) before their separation in 2006.

## 2.4. MERCHANDISE TRADE RELATIONSHIPS BETWEEN WESTERN BALKAN COUNTRIES

This section gives a short description of the overall developments in merchandise exports, imports and trade openness of Western Balkan countries and then proceeds to provide additional information on the relative importance of different foreign markets for the exports of the regional economies, as well as the importance of single trade partner countries as a source of imports to the countries of the region.<sup>9</sup>

Export developments in Bosnia and Herzegovina, North Macedonia and Serbia can be described as positive, as their exports as a percentage of GDP recorded considerable increases over the past two decades, so that at the end of the period under review they stood at roughly 36%, 55% and 38% of GDP, respectively (Figure 2). Albania recorded an increase as well, but its corresponding share accounted for only 20% of GDP at the end of the period. Kosovo's export performance has been the least satisfying among the countries surveyed, with its share of exports in GDP never exceeding 7%. The case of Montenegro contrasts with all the other developments, as it has been characterised by a persistent decline after 2004 – very strong at first but reaching values below 10% by 2018.

**Figure 2 / Exports of goods in % of GDP**



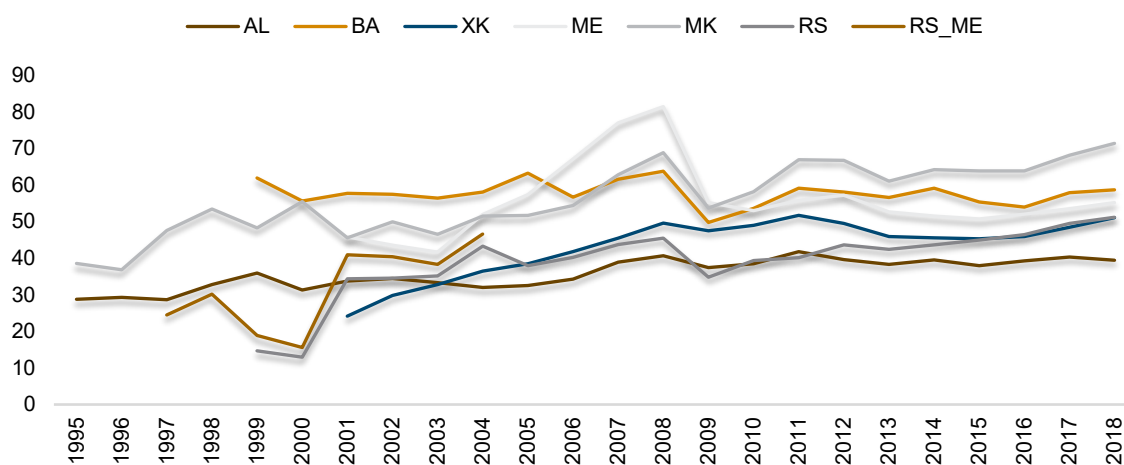
As for imports, North Macedonia and Bosnia and Herzegovina recorded the highest shares as a percentage of GDP towards the end of the review period, followed by Montenegro, Kosovo and Serbia, and finally by Albania. In all six countries it is possible to observe a more or less sharp crisis-related decline in 2009, usually after a considerable increase in 2008. This pattern is especially pronounced in the case of Montenegro. Generally, the share of imports as a percentage of GDP exceeded that of exports for all countries, implying that Western Balkan economies run (large) merchandise trade deficits. The trade deficits have been highest in Montenegro and Kosovo, where they amounted to around 40% of GDP (period average) and increased towards the end of the review period. Serbia recorded the lowest trade deficit over the whole period, as well as better than average values more recently (in the range of 10-13%). Although both North Macedonia and Bosnia and Herzegovina, in particular, narrowed their deficits more recently, they still remained high at 17% and 22% of GDP in 2018.

<sup>9</sup> The source for all data presented in this section is the wiiw database.

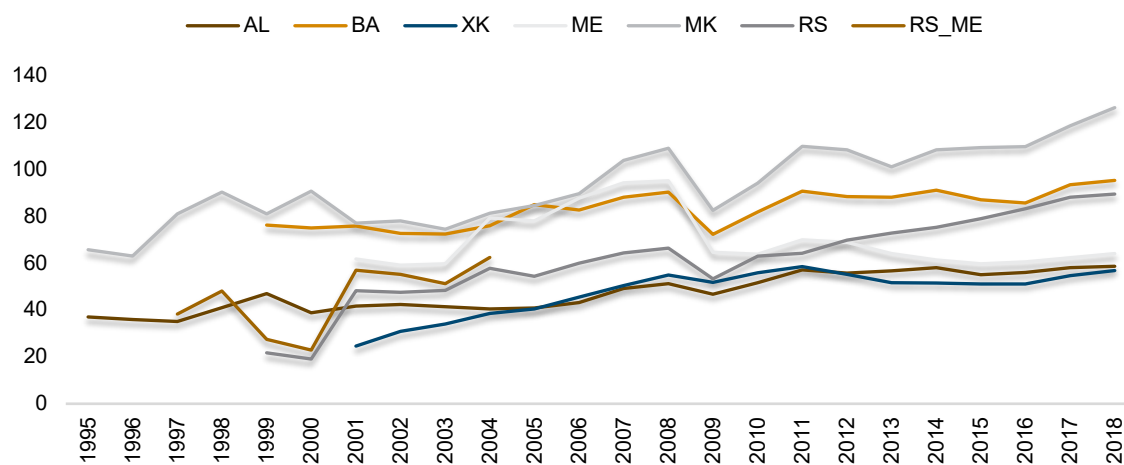


Figure 4 illustrates the developments in the overall trade openness (the share of exports plus imports in GDP). As expected after the inspection of the two figures above, North Macedonia, Bosnia and Herzegovina and Serbia are the three more open economies, with the shares of trade in GDP for the other three countries moving around the 60% mark more recently. The region's average trade openness in 2018 equalled 82%, i.e. 27% for exports and 55% for imports. This compares with the 2018 trade-openness average for the three EU-SEE countries of 86%, with the average share of 38% for exports and 48% for imports. Thus, the three EU-SEE countries recorded much smaller merchandise trade deficits on average. Interestingly, for both country groups the average trade openness in 2008 amounted to 78%, after which it declined strongly in 2009 owing to the global financial crisis.

**Figure 3 / Imports of goods in % of GDP**



**Figure 4 / Trade openness (exports plus imports of goods), in % of GDP**

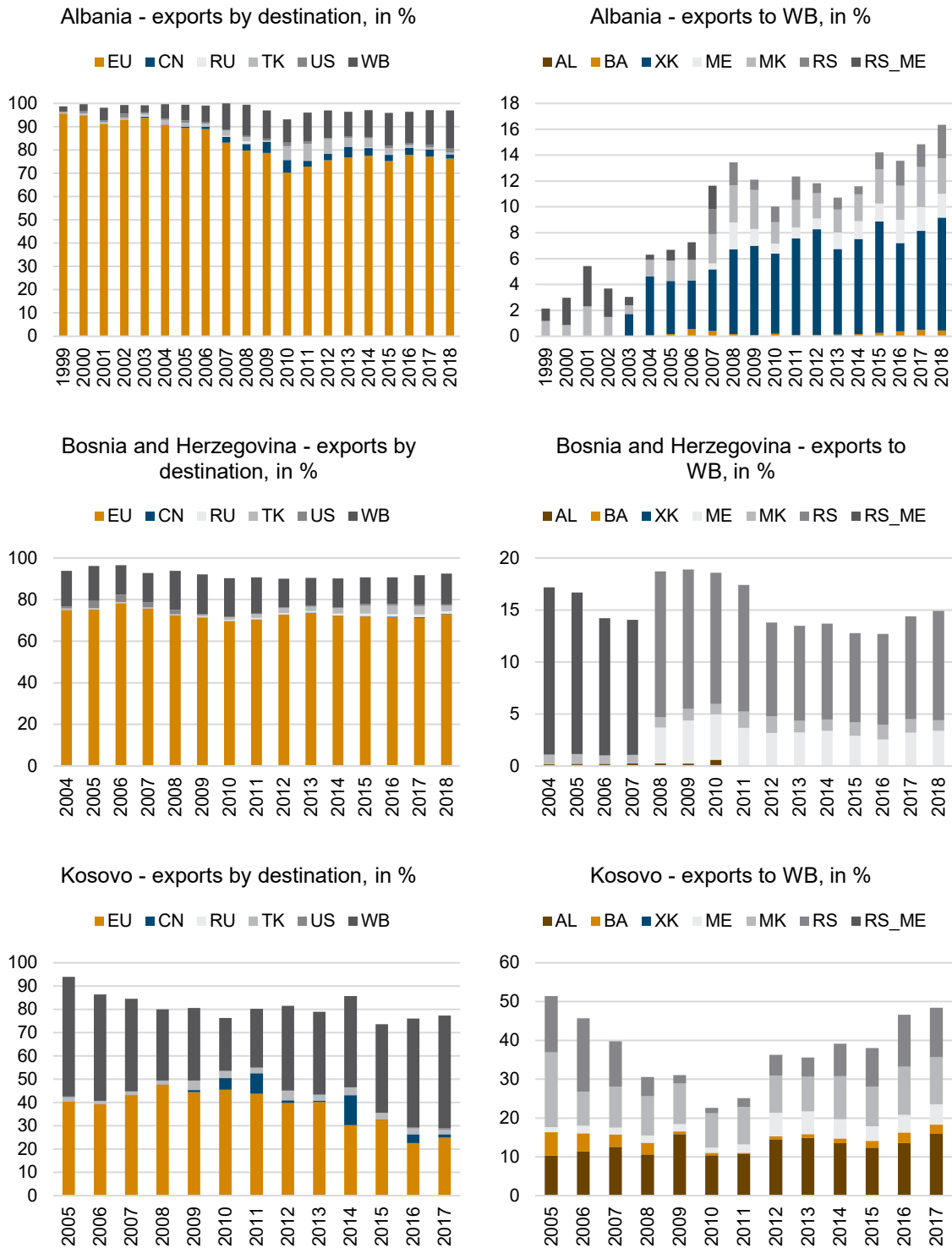


More detailed export developments are shown in Panel 2. Again, each Western Balkan country is represented by two graphs: the graph on the left-hand side shows the share of exports to the EU, China, Russia, Turkey, the US and other Western Balkan countries as a share of total exports. The graph on the right-hand side provides a more detailed display of export shares to single Western Balkan countries. The graphs in Panel 3, further below, illustrate the same developments for imports.

The most important export destination has been the EU market, with the shares of exports to the EU in total exports being the highest in Albania, Bosnia and Herzegovina, and in more recent years North Macedonia. The corresponding shares for Kosovo and Montenegro have been the smallest, and declining, especially towards the end of period under review. Although the exports of these two countries to other Western Balkan economies tend to be large, it should be recalled that these countries have the lowest shares of exports in GDP. Serbia is an intermediate case, but its export shares to the EU have been on the rise over the past ten years, reaching the value of 67% in 2018. At the same time, Serbian and North Macedonian exports to the other Western Balkan countries have been declining (as a share in total exports). As for other destinations, Russia is comparatively important for Serbian exporters (with a share of around 5%), as is Turkey for Bosnia and Herzegovina and for Montenegro (in some years), but with the relevant shares mostly below 5%. In some years shares of exports from Albania, Kosovo and Montenegro to China reached values around the 5% mark. As for intra-regional trade, export shares show a comparatively higher degree of trade integration between Albania and Kosovo, as well as between Serbia, Montenegro and Bosnia and Herzegovina. Macedonia's exports to Kosovo and Serbia are comparatively large, but these shares have been on a declining trend.

In line with the structure of exports by destination, the EU is the most important trade partner for the region when it comes to the origin of imports: in all countries (except Kosovo and Montenegro) imports from the EU consistently amount to more than 50% of total imports (Panel 3). For these two countries, imports from the other countries in the region are comparatively very important, but slightly less so than imports from the EU. Unlike export shares, imports from China have become more and more important in all countries, with the exception of North Macedonia. In the other five countries the share of imports from China amounted to close to 10% of total imports towards the end of the observed period. Similar shares have been recorded for Turkish imports to Albania and Kosovo, and slightly less so to North Macedonia and Bosnia and Herzegovina. Shares of imports from Russia to Serbia and North Macedonia were important in the years before the global financial crisis, when they amounted to close to 15%, but they have been decreasing since, especially in North Macedonia. Data on the share of imports in intra-regional trade indicate the relative dominance of Serbia as the country of origin of regional imports. Trade ties between Albania and Kosovo again seem comparatively strong. We note that additional descriptive data are available from Tables A2 and A3 in Appendix A, in the matrices of bilateral export and import shares across the Western Balkan countries.

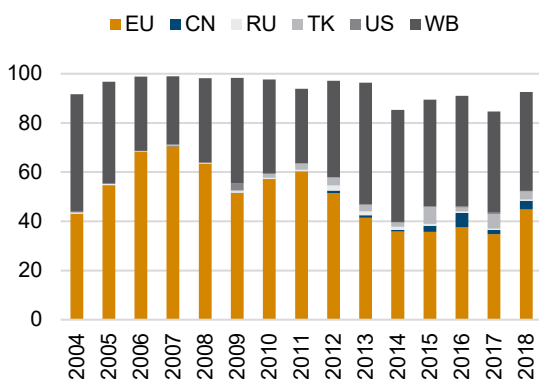
## Panel 2 / Exports by destination market, in % of total exports



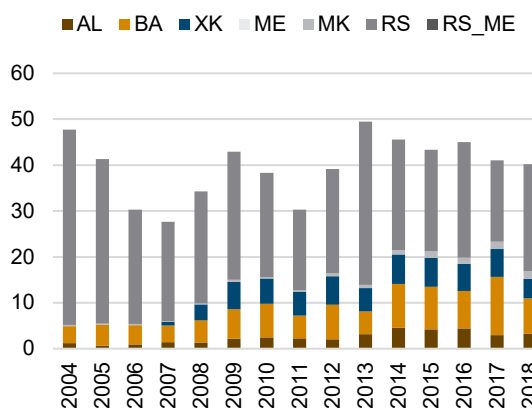
ctd.

Panel 2 / continued

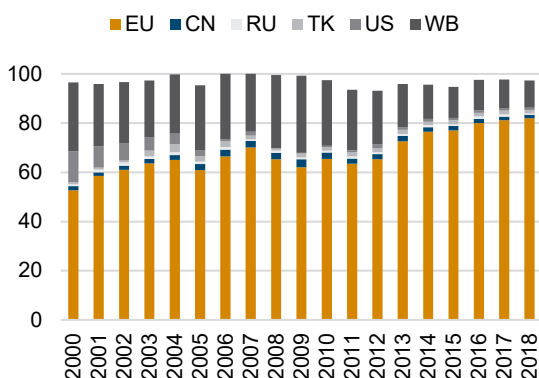
Montenegro - exports by destination, in %



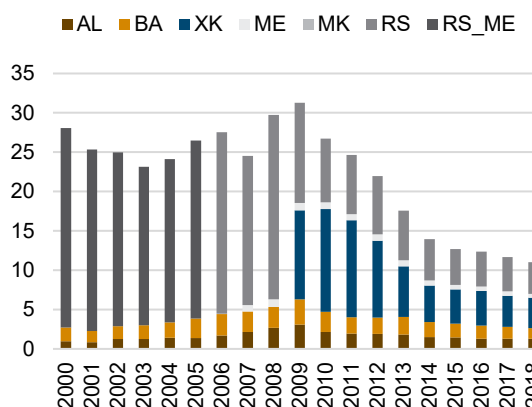
Montenegro - exports to WB, in %



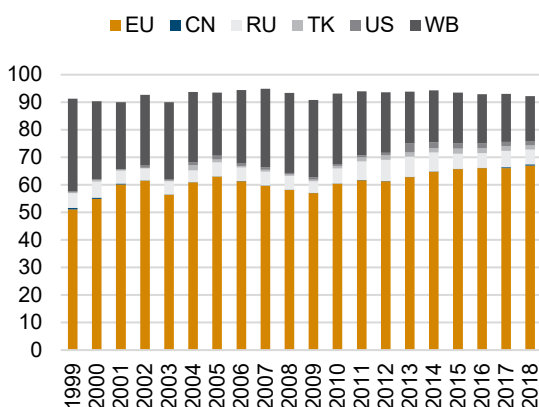
North Macedonia - exports by destination, in %



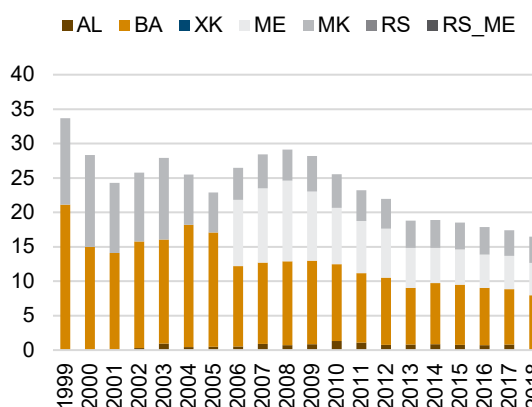
North Macedonia - exports to WB, in %



Serbia - exports by destination, in %

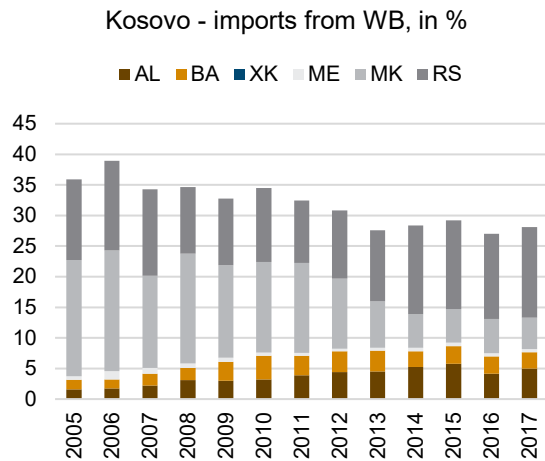
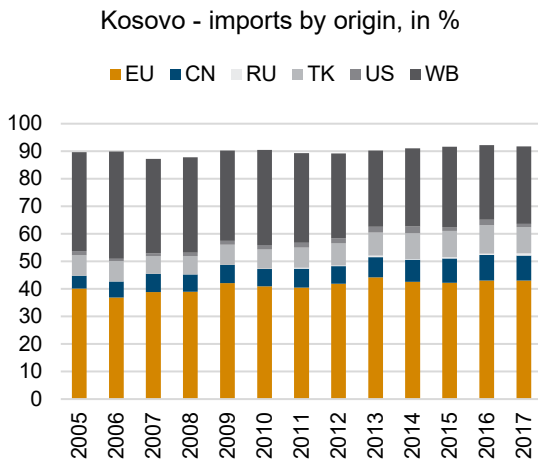
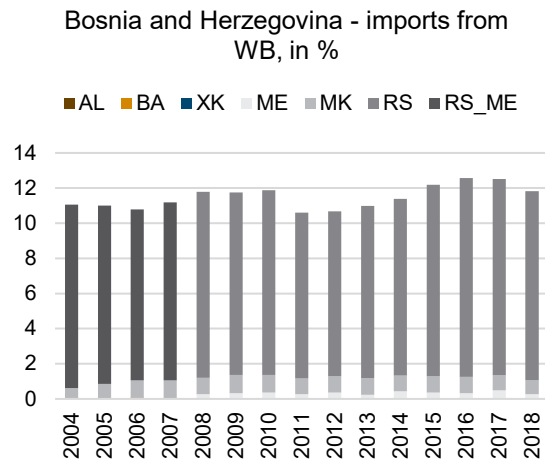
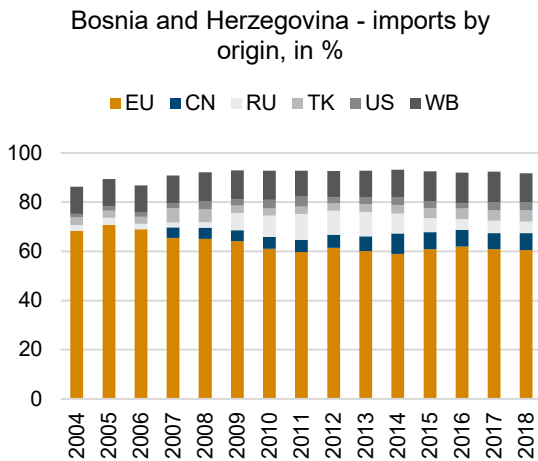
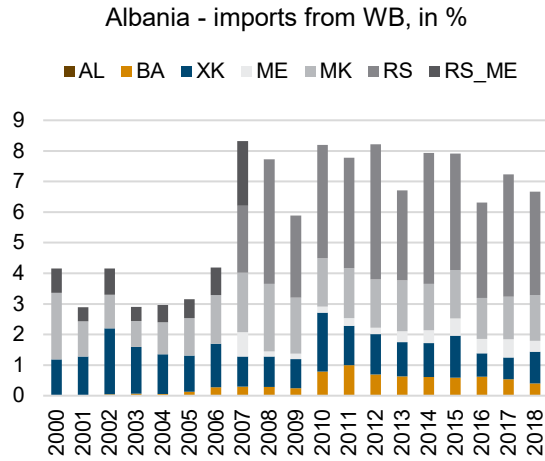
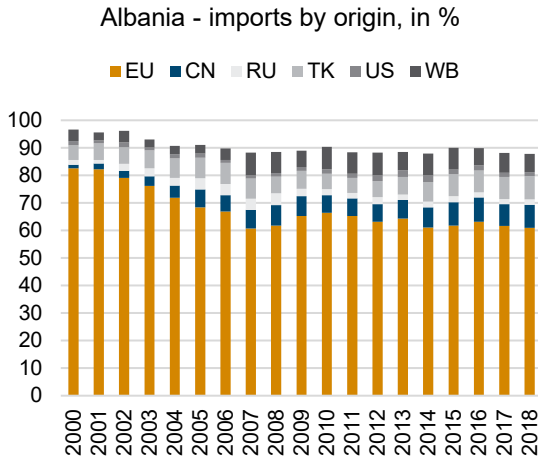


Serbia - exports to WB, in %



Note: Some trade partner countries also provide aggregate data for the state of Serbia and Montenegro (RS\_ME), before their separation in 2006, and sometimes also for 2007.

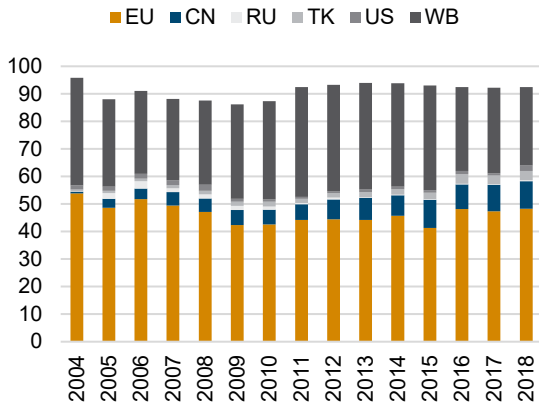
**Panel 3 / Imports by country of origin, in % of total imports**



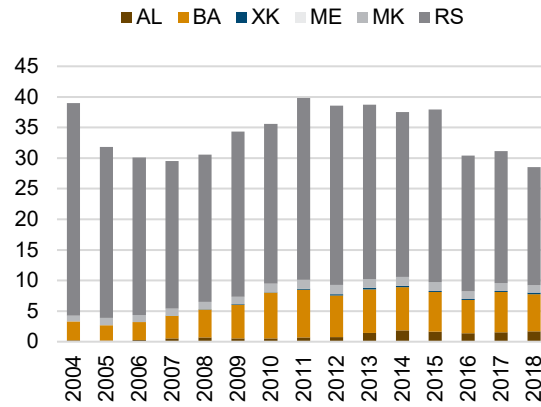
ctd.

**Panel 3 / continued**

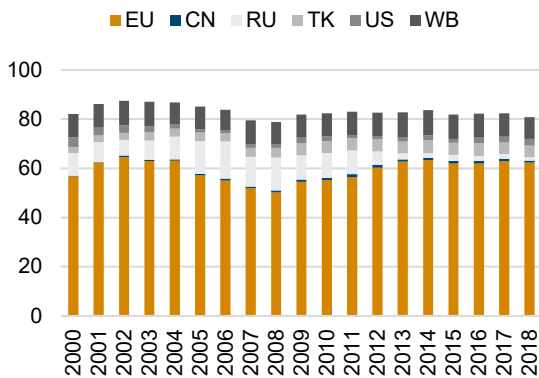
Montenegro - imports by origin, in %



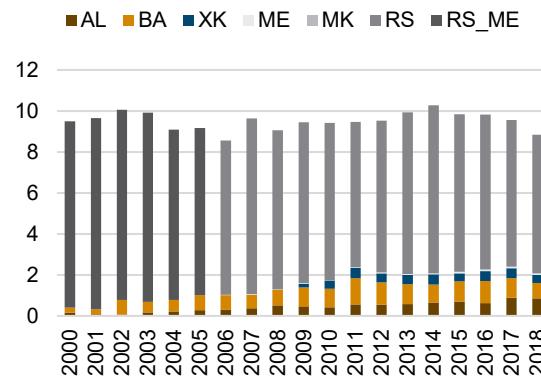
Montenegro - imports from WB, in %



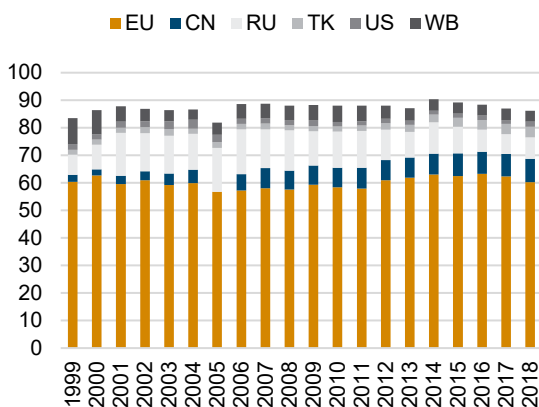
North Macedonia - imports by origin, in %



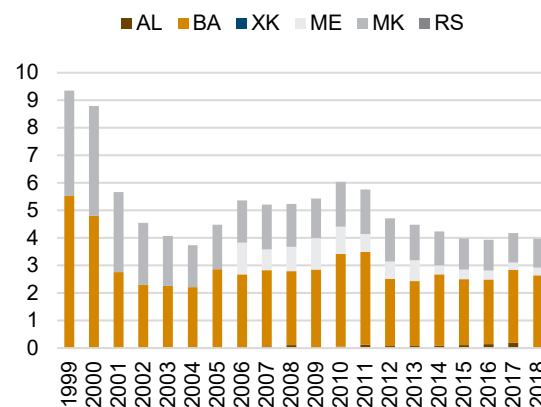
North Macedonia - imports from WB, in %



Serbia - imports by origin, in %



Serbia - imports from WB, in %



Note: Some trade partner countries also provide aggregate data for the state of Serbia and Montenegro (RS\_ME), before their separation in 2006, and sometimes also for 2007.

## 3. Bilateral investment treaties and foreign direct investment in Western Balkan countries

### 3.1. THE ROLE OF BILATERAL INVESTMENT TREATIES AND FTAS

We apply a structural gravity empirical modelling framework to test whether there is a relationship between bilateral investment treaties (BITs) and foreign direct investment (FDI) among six Western Balkan (WB) countries (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia, and Serbia). All the details regarding the sample and the methodological approach are given in Appendix B. Detailed descriptions and sources of variables are provided in Appendix C. Here we must note, however, that we devote special attention to the case of Serbian investment into Montenegro, as it has been found to affect our general results. Thus, the first set of results refers to the sample without this specific country pair, which we then discuss separately below. In all the specifications, following the recommendations from Yotov et al. (2016), we include host country-time, home country-time and bilateral fixed effects, which should account for all the other potentially relevant factors.

**Table 3 / FDI, SAAs and BITs**

	(1)	(2)	(3)	(4)
<i>EU</i>	0.30** (0.14)	0.28** (0.13)	0.27* (0.15)	0.30** (0.14)
<i>SAA</i>	0.35*** (0.08)		0.36*** (0.08)	0.35*** (0.08)
<i>BIT</i>	-0.03 (0.07)	-0.03 (0.07)		
<i>SAA_WB</i>		0.38*** (0.13)		
<i>SAA_no_WB</i>		0.33*** (0.09)		
<i>BIT_WB1</i>			0.11 (0.14)	
<i>BIT_no_WB1</i>			-0.06 (0.08)	
<i>BIT_WB2</i>				-0.14 (0.20)
<i>BIT_no_WB2</i>				-0.03 (0.07)
host-time FE	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes
observations	13765	13765	13765	13765

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

Our primary variable of interest is BIT, which equals 1 if there is a bilateral investment treaty between the countries in the pair (and zero otherwise).<sup>10</sup> Generally, BITs should encourage, promote and protect investments between two countries (UNCTAD, 2000; 2007). While influential empirical studies exist which find a strong positive relationship between BITs and FDI (e.g. Egger and Pfaffermayr, 2004), the evidence is generally mixed.<sup>11</sup>

Table 3 presents the results from regressions of the basic model with EU, SAA, and BIT explanatory variables, as well as with some of the variations in these variables. In the first two model specifications we include a single BIT variable but vary the SAA variable. Afterwards, we separate the BITs into those relating to the Western Balkan host countries (denoted with BIT\_WB1) and the rest (BIT\_no\_WB1); as well as into those BITs between Western Balkan host and home countries (BIT\_WB2) and the rest (BIT\_no\_WB2). The results show that there is no statistically significant correlation between BITs and the FDI stocks in host economies in any of the specifications. However, bilateral FDI stocks are higher among countries which are both EU members, and from current EU member states into the countries that have entered into an SAA (or similar agreement). Separating the SAA variable (column 2 in Table 3) into SAAs signed by the Western Balkan countries (denoted with SAA\_WB) and other SAAs (denoted with SAA\_no\_WB), i.e. similar agreements such as European Agreements, shows that they are both statistically significant.

In the next steps of the analysis we check for the robustness of the above findings to inclusion of additional potentially important variables. First, we turn to free trade agreements (FTAs), which may facilitate international trade by reducing trade costs. Given the relationship between FDI and international trade, FTAs may also affect FDI. While reviewing the literature on trade and FDI is not within the scope of this analysis (excellent references include Helpman, 2006; and Markusen, 2002), the relationship may best be illustrated by considering the simple case of two types of multinational enterprises (MNEs): horizontally and vertically integrated firms. In order to supply goods in a foreign market, a firm faces the dilemma of either producing abroad or exporting. High trade barriers in any form provide an incentive for horizontal integration of production, where the MNE produces the same product in multiple plants located in more than one country. Thus, horizontal FDI may be encouraged by high trade costs. In contrast, vertical FDI may be supported by the lower trade costs, as vertical integration implies geographical fragmentation of the production process across countries, so that the intermediate products need to be traded internationally. Thus, the overall effect of trade costs on FDI flows is an empirical question and depends on the prevailing type of FDI.<sup>12</sup>

We add several variables capturing free trade agreements to our empirical specification and present the results in Table 4. Free trade agreements for the whole sample are represented by the variable FTA. It equals 1 if there is either a bilateral FTA between the countries in the pair or if both countries belong to

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<sup>10</sup> The BIT variable assumes zero value for a pair of countries when they both become EU member states. Thus, in our main approach, there are no intra-EU BITs in force, i.e. BITs cannot go beyond the EU law. This is discussed in more detail below and in Appendix B.

<sup>11</sup> This is why the more recent studies try to look into the details of this relationship, e.g. by considering the varying effects of BITs across sectors of FDI (Colen et al., 2016), or the differences in the strength of BITs as an investment protection mechanism (since BITs are not uniform), as in Frenkel and Walter (2018), or Dixon and Haslam (2016). While our data do not allow for such detailed analysis, we do check for other factors that may influence the relationship between BITs and FDI, such as institutional development.

<sup>12</sup> It should be noted that the strategies of MNEs are often very complex, so that the traditional classification of FDI into strictly horizontal or vertical is not that meaningful in practice (Helpman, 2006).



the same multilateral/regional trade agreement. One example of the latter is the CEFTA, whose composition changed completely during the observed period, after the 2004 EU enlargement round and after the six Western Balkan countries, together with Croatia and Moldova, formed the 'new' CEFTA (which entered into force in 2007).<sup>13</sup> EU membership is treated separately. With EU accession a new member state adopts the common EU trade policy, so that the FTA variable has zero value in a pair with a non-EU country, unless the EU has some FTA with the same country. The SAAs are also analysed as a separate variable. As with the SAA and BIT variables, we also separate the FTA variable according to geographical criteria to specifically check for the FTAs of the WB countries: FTA\_WB1 refers to FTAs in the subsample of country pairs in which Western Balkan countries are host countries; while CEFTA refers to 'new' CEFTA, which captures the regional trade agreement currently including the six WB countries of our special interest, in addition to Moldova, and Croatia for the period 2007-2012.

**Table 4 / FDI and FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.29** (0.14)	0.26* (0.15)	0.29** (0.14)	0.27* (0.15)	0.29** (0.15)
<i>SAA</i>	0.34*** (0.08)	0.34*** (0.08)	0.34*** (0.08)	0.33*** (0.08)	0.34*** (0.08)
<i>BIT</i>	-0.02 (0.07)				
<i>FTA</i>	-0.05 (0.07)	-0.05 (0.07)	-0.05 (0.07)		
<i>BIT_WB1</i>		0.11 (0.14)		0.12 (0.14)	
<i>BIT_no_WB1</i>		-0.06 (0.08)		-0.06 (0.08)	
<i>BIT_WB2</i>			-0.14 (0.20)		-0.14 (0.20)
<i>BIT_no_WB2</i>			-0.02 (0.07)		-0.02 (0.07)
<i>FTA_WB1</i>				-0.23 (0.15)	
<i>FTA_no_WB1</i>				0.00 (0.08)	
<i>CEFTA</i>					-0.05 (0.13)
<i>FTA_no_CEFTA</i>					-0.05 (0.07)
host-time FE	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	13765	13765	13765	13765	13765

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

The estimates presented confirm our findings for the variables included in the models displayed in Table 3: EU membership and the existence of SAAs promote inward FDI, while BITs turn out not to be related

<sup>13</sup> Bulgaria and Romania were also meant to become members of the 'new' CEFTA, but they joined the EU in 2007. Other regional trade agreements include the Eurasian Economic Union, the Baltic Free Trade Area, or trade agreements with members of the European Free Trade Association.

to FDI stocks in a statistically significant way. As for the FTA variable (and its variations), it turns out not to be related to FDI in any of the specifications.

Our next robustness check includes redefining the BIT variable to assess its potential relationship with FDI by using the year in which the BIT was signed as a starting point, and not the year of the BIT's entry into force. We ran the same regressions as presented in Table 3, but with the new BIT variable (and its variations) denoted with BIT\_s. The results are presented in Appendix D, in Table 3D. The first two columns show that the coefficient of the (redefined) BIT variable, although positive, was not statistically significant in general. Results in column 3 show that for the BIT signed by the Western Balkan host countries (BIT\_s\_WB1) the coefficient increases to 0.49 and is statistically significant at 1% level. For the BITs only among Western Balkan countries the coefficient amounts to 0.2, but is not statistically significant. The positive and significant coefficient for the BIT\_s\_WB1 variable could imply that the signing of the treaty already had effects on FDI, probably based on the expectation that it would enter into force quickly.<sup>14</sup> However, if the signing of these treaties promoted FDI into the region, this effect did not persist, i.e. it was short-lived, so that the BITs are significant only if also the period between the signing of the treaty and its entry into force is considered. Moreover, this may suggest that the BITs were in fact motivated by the already existing investment plans into these countries (i.e. that the BITs are endogenous). Such investment could then materialise relatively quickly after signing the BIT, but the latter had no significant effect on future FDI inflows.

In addition, we also tried capturing the effects of trade tariffs on FDI in addition to FTAs, by adding the TARIFF variables into regressions presented in Table 4. The results of the extended models are provided in Appendix D, in Tables 4Da (for TARIFF variables calculated as weighted average) and 4Db (for TARIFF variables calculated as simple averages). We note that TARIFF\_host denotes the trade tariffs imposed by host countries on imports from home countries, and the other way around for TARIFF\_home. One should also bear in mind that the sample is reduced in these regressions due to the lower availability of TARIFF data, and that the other variables in our empirical models may already largely capture the changes in tariffs (as these are negotiated in FTAs and SAAs, and abolished in the EU). The results confirm our main conclusions stated above, with a somewhat larger estimated magnitude of the coefficient of the EU membership variable, especially in regressions with simple-average tariffs. Also, the coefficients of the BIT\_WB1 (and slightly less so for BIT\_WB2) variables, turn positive and sizable, but are not statistically significant. As for the TARIFF variables themselves, results for the weighted-average tariffs support the 'tariff-jumping' interpretation: the positive and statistically significant coefficient of the TARIFF\_host variable implies that higher trade costs of exporting to host countries make the (horizontal) FDI into these countries more profitable, other things equal. This result, however, is not confirmed in the regressions using the simple-average tariffs. As both simple-average and weighted-average tariffs have their advantages and disadvantages (see e.g. Reiter and Stehrer, 2018), one cannot draw any strong conclusions regarding the effects of tariffs on FDI based on these results.

Another observation is related to the treatment of intra-EU BITs, i.e. to the validity of these treaties between two countries after they have both become EU members. It has been questioned whether such treaties are compatible with EU law, given that they may provide additional rights to investors from only

<sup>14</sup> While this was the case for the large majority of BITs, sometimes there was a lag of several years between the signing and the enforcement of a treaty, and there were also (rare) occasions when a BIT was signed but did not enter into force during the period under observation, although several years had passed since the signing.

some EU countries, i.e. that they may discriminate based on nationality (see e.g. EC, 2015). This is discussed in more detail in Appendix B, but here we note briefly that assuming that these treaties remain in force after both countries become EU members, the estimated coefficient for the general BIT variable (columns 1 and 2 in Table 3) turns lower (equals -0.13) and is statistically significant at 10% level (our other conclusions remain unchanged). This is likely to indicate that such BITs were not perceived as protecting investors' interests to the same extent as before these BITs turned into intra-EU BITs (at least not with sufficient certainty), or beyond the protection provided by the EU rules (as EU membership is controlled for separately). This may have resulted in some investors (partly) withdrawing (or reinvesting less) capital, after realising that maybe some rights they had been granted before the EU accession of a host country were no longer guaranteed.

Finally, we evaluate the statistically significant relationships between the EU and SAA variables, and FDI stocks from our findings in Table 3. The estimated coefficient for the EU variable of 0.30 in the first model implies that the bilateral FDI stocks among EU member states are higher by 35% (calculated as  $(e^{0.30} - 1) * 100 = 35\%$ ). The coefficient of the SAA variable is slightly higher and implies that the FDI stock from an EU home country in a host country with an SAA agreement is 41.9% higher than without such an agreement. The estimates for both variables are stable across specifications. Note that in the second model, when the SAA variable is split into SAAs for WB and SAAs for non-WB countries (the latter largely being European Agreements), we find that the coefficients are rather similar in size, implying only a slightly stronger relationship between SAAs and FDI for the Western Balkan economies than for the other countries. The results on EU and SAA variables are expected given the free movement of capital in the EU, as well as the comparatively high level of investment protection. The SAAs can be seen as a road to EU membership, so that their implementation can be perceived by investors as a strong signal of decisiveness to undertake all the reforms needed to become an EU member, including fully liberalising capital flows and securing a high level of rule of law in general, i.e. of property rights and investment protection in particular. Most of the home countries (sources of investment) in our sample are EU countries, and most of the host countries (FDI recipients) have (had) an SAA or similar agreement in force (and some joined the EU during the observed period). Thus it is possible that BITs were only of secondary importance for our sample of countries, after SAAs. Furthermore, home countries' interest in investing into the transition host countries in our sample, as well as the corresponding investment dynamics, may have largely been influenced by the availability of acquisition opportunities in the host countries, for example through privatisation (as stated e.g. by Botrić, 2010, or Estrin and Uvalic, 2016, for the Western Balkans), which need not be correlated with the BITs being in force.

To summarise the above results, the BITs generally turn out not to be related to FDI stocks in our sample, and also not for the Western Balkan countries specifically. There are indications that BITs of Western Balkan host countries may have been signed as a result of the already existing investment plans (possibly through privatisation), which helped investment to take place, but the BITs were not relevant beyond the short term. The bilateral FDI stocks are higher between EU member states and from EU countries into countries that have signed an SAA or a similar agreement. Given that our subsample of six Western Balkan countries is rather small, the results may potentially be influenced by some specific developments in one country only, or by developments related to a single country pair. For that reason we tried altering our subsample by excluding single countries one by one to check whether our results changed. It turned out that our findings presented above are quite robust, except for the

aforementioned specific case of Serbian investment in Montenegro, which we left out of the main analysis and to which we devote the next subsection.

### 3.2. THE SPECIAL CASE OF SERBIA AND MONTENEGRO

Serbia and Montenegro formed a common state until their separation in 2006. Adding this country pair to our sample strongly affects our results regarding the relationship between BITs and FDI stocks among Western Balkan countries. Table 5 below displays the results of the same empirical model specifications as Table 3, but with this country pair included in the sample.<sup>15</sup> While this hardly changes any conclusions regarding the EU and SAA variables, as well as regarding the overall relationships of BITs and FDI for the whole sample, results for the BIT variables related only to Western Balkan countries (BIT\_WB1 and BIT\_WB2) do change. As for all the BITs of Western Balkan host countries (with any home country in the sample, i.e. BIT\_WB1), the coefficient now turns positive (equals 0.22) but misses the statistical significance threshold by a small margin. In contrast, the estimated coefficients for the BITs between Western Balkan host and home countries (i.e. BIT\_WB2) turn out to be highly statistically significant and large in magnitude. The coefficient of 1.64 would imply that with a BIT the FDI stock from one Western Balkan country into another is 416% higher than without a BIT. This result, however, cannot be interpreted as generally valid for the intra-regional BITs and FDI, as it is driven by the very special case of Serbian investment into Montenegro.

**Table 5 / BITs among Western Balkan countries – adding Serbian investment to Montenegro**

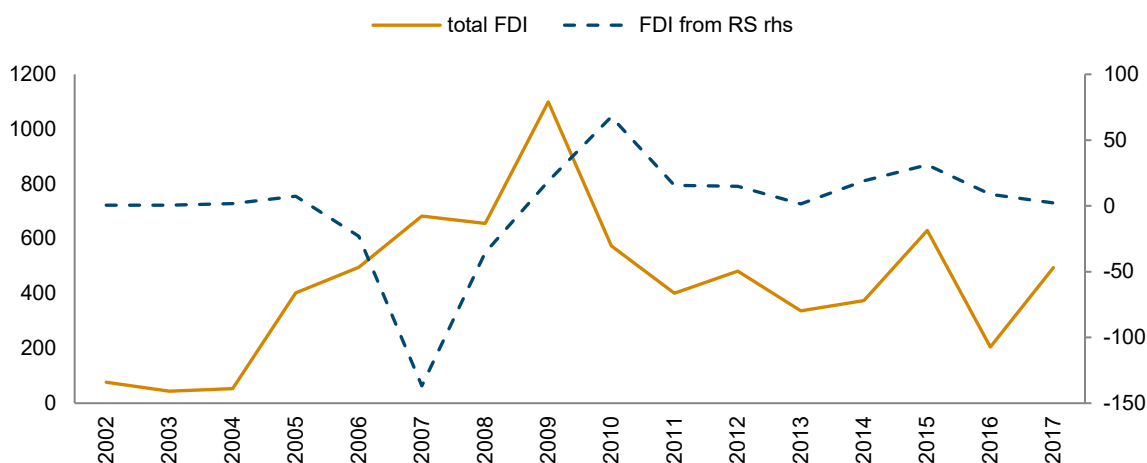
	(1)	(2)	(3)	(4)
<i>EU</i>	0.32** (0.14)	0.30** (0.13)	0.25* (0.15)	0.30** (0.14)
<i>SAA</i>	0.34*** (0.08)		0.34*** (0.08)	0.35*** (0.08)
<i>BIT</i>	0.00 (0.07)	0.00 (0.07)		
<i>SAA_WB</i>		0.35*** (0.13)		
<i>SAA_no_WB</i>		0.32*** (0.09)		
<i>BIT_WB1</i>			0.22 (0.14)	
<i>BIT_no_WB1</i>			-0.06 (0.08)	
<i>BIT_WB2</i>				1.64*** (0.40)
<i>BIT_no_WB2</i>				-0.03 (0.07)
host-time FE	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes
observations	13782	13782	13782	13782

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

<sup>15</sup> Results from Table 4, with the data on Serbian investment in Montenegro included in the sample, are given in Table 4E in Appendix E.

Figure 5 below depicts the FDI flows from Serbia to Montenegro and shows that, probably as a result of political developments between the two countries, there was a withdrawal of Serbian FDI between 2006 and 2008. As the BIT entered into force in 2010, its relationship with FDI turned out to be exceptionally strong. While the general relationship between BITs and FDI for the Western Balkan countries cannot be argued to have been strong based on this, this single BIT may have played an important role in this specific case. There is also a possibility that this BIT was ‘caused’ by the withdrawal of Serbian FDI after the separation of Montenegro. Regardless of whether this interpretation is correct, the treaty may have helped to stabilise (and increase) FDI inflows after it entered into force. Thus, while the development for this single country pair is potentially an example of a highly effective BIT, a similar general conclusion for Western Balkan countries is not supported by the empirical evidence.

**Figure 5 / Inflows of FDI from Serbia to Montenegro, in EUR million**



### 3.3. THE ROLE OF INSTITUTIONAL FACTORS

In the following section we devote more attention to institutional differences (or ‘institutional distances’) between countries in country pairs. We note that, generally, it has been found that institutions, and also more specifically the difference in institutional quality between host and home countries, may affect FDI flows (see e.g. Bénassy-Quéré et al., 2007). While we do not check for this directly beyond the extent that this effect is captured by the country-time fixed effects, we do perform a regression analysis of the interplay between institutional quality and BITs in affecting FDI stocks. As shown in the related paper by Desbordes and Vicard (2009), institutional quality and BITs may be complementary, in that the credibility of host-country governments’ commitment through BITs to protect investors’ property rights in future probably depends on the institutional quality. This may be relevant in the context of the Western Balkans, given the initiatives, often promoted by the EU or international institutions, to improve the quality of their institutions, which is important in the process of their EU accession but may also represent a means to enhance the efficiency of regional cooperation.

We use six different indicators readily available for all countries in our sample over most of the period under review from the World Bank’s Worldwide Governance Indicators database: Rule of Law; Control of

Corruption; Political Stability and Absence of Violence/Terrorism; Regulatory Quality; Government Effectiveness; and Voice and Accountability. Each indicator ranges from -2.5 to 2.5 for single countries, where higher values mean better institutions and zero corresponds to the average of the countries in the database. We calculate the difference for each indicator between the host and the home country in a country pair, so that the values for each country pair must lie between -5 and 5.

After running the preliminary regression for each institutional indicator separately, we centre the institutional variable (country-pair difference, i.e. institutional distance) for the observations included in the sample. Variables defined in this way are then interacted with the BIT variable in order to check whether its relationship to FDI depends on the differences in institutional quality of the countries in a pair. In these regressions, the interaction term is irrelevant for the average country pair in the sample (with institutional distance normalised to zero), but it may be used to interpret the results on the BIT coefficient for (the groups of) country pairs with institutional distance different from the sample average, i.e. from zero. Thus, we calculate the average institutional distance for all the country pairs where a Western Balkan country is a host country (denoted with *mean\_WB1*) and for the country pairs with both host and home countries being Western Balkan countries (denoted with *mean\_WB2*).

The results are displayed in Table 6 for each of the six institutional indicators. For all of them, the institutional distance for country pairs in which Western Balkan countries are host countries is negative (*mean\_WB1*), implying that the institutional quality in the region is lower than in the (average) home countries (with the set of home countries including also Western Balkan countries). As for the institutional distance among the Western Balkan countries themselves, it is very close to zero for all the indicators (*mean\_WB2*), implying that countries in the region are, on average, rather similar in this respect.

**Table 6 / Average institutional distance for groups of country pairs**

	Rule of law	Corruption control	Political stability	Regulatory quality	Government effectiveness	Voice and accountability
<i>mean_WB1</i>	-1.227	-1.218	-0.825	-1.014	-1.174	-0.861
<i>mean_WB2</i>	0.017	-0.040	-0.032	0.025	0.031	-0.025

Results from regressions with the interaction of the BIT and institutional variables (denoted as BIT x INST) are presented in Table 7. There are six specifications in which a different institutional variable is always added to our basic model of FDI stocks, with only EU, SAA and BIT variables. We thus keep following a parsimonious approach while focusing on institutions now, as introducing additional variables may cause high collinearity.<sup>16</sup>

First, we note that our earlier conclusions on the role of EU membership and SAAs are confirmed in the new specifications. The coefficients of BIT variable again turn out not to be statistically significant for the sample average (for which the interaction term is neglected, i.e. equals zero). However, the coefficient of the interaction term between the BIT and institutional distance variables is always positive and statistically significant for four out of six indicators. This implies that the higher institutional quality in host countries, as compared with home countries, is related to higher effectiveness of BITs, especially for Regulatory Quality, Voice and Accountability, and Corruption Control indicators. As shown in Table 6,

<sup>16</sup> We tried adding the institutional variables separately to each of the six specifications, which turned out to be infeasible, as this variable by itself appears collinear with the set of fixed effects. The same problem arises if we include only BIT and institutional distance variables without the interaction term, and if only institutional variables are included in the simplest model, only with the EU and SAA control variables.

the pairs with Western Balkan host countries are characterised by lower than average institutional distance, implying that the BITs they signed are less effective (than average) in promoting inward FDI than for the rest of the sample. For the group of Western Balkan countries, both host and home, the institutional difference is close to the sample average, so that the overall impact of BITs is (almost) the same as for the whole sample. The implications of the importance of institutional distance, along the lines of Bénassy-Quéré et al. (2007) and Desbordes and Vicard (2009), is that the Western Balkan host countries may increase the effectiveness of their BITs, and possibly attract more FDI, if they succeed in implementing the institutional quality-enhancing reforms. This is true for FDI from Western Balkan countries as well as from other economies.<sup>17</sup>

**Table 7 / FDI and institutional distance**

Institutional variable:	(1) Rule of law	(2) Corruption control	(3) Political stability	(4) Regulatory quality	(5) Government effectiveness	(6) Voice and accountability
<i>EU</i>	0.31** (0.14)	0.30** (0.14)	0.33** (0.14)	0.34** (0.14)	0.32** (0.14)	0.33** (0.14)
<i>SAA</i>	0.37*** (0.08)	0.39*** (0.08)	0.37*** (0.08)	0.38*** (0.08)	0.37*** (0.08)	0.37*** (0.08)
<i>BIT</i>	-0.02 (0.08)	0.00 (0.08)	-0.02 (0.07)	0.01 (0.08)	-0.01 (0.08)	-0.01 (0.07)
<i>BIT × INST</i>	0.06 (0.05)	0.12*** (0.04)	0.05 (0.04)	0.16*** (0.06)	0.09* (0.05)	0.16** (0.07)
host-time FE	yes	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes	yes
observations	13283	13283	13064	13139	13139	13283

Robust standard errors clustered by host-home pairs in parentheses; \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

It should, however, be stressed that institutional distance is not the only factor that may lead to higher effectiveness of BITs for some country pairs and groups than for others, and to more FDI in general. As shown by the related research, this relationship may depend on the strength of BITs (Frenkel and Walter, 2018) or the prevailing type or sector of foreign investment (Colen et al., 2016). Finally, the research by Estrin and Uvalic (2014) on the determinants of FDI shows that, after accounting for the broad set of other factors (including institutions), being a Western Balkan country affects FDI inflows negatively, which they interpret as a long-lasting consequence of their history of conflicts and political tensions.

<sup>17</sup> The statistics and regression results from Tables 6 and 7, with the data on Serbian investment in Montenegro included in the sample, are provided in Appendix E, in Tables 6E and 7E. In short, the above conclusions are not affected by the inclusion of this country pair.

## 4. Free trade agreements and trade flows between WB countries

In this section we apply the same methodology on the same sample of countries as in section 3 to study whether the export performance of the Western Balkan countries has been improved by trade liberalisation in general, and by intra-regional trade liberalisation in particular. The results of our main regressions are presented in Table 8 below. The FTAs are generally found to facilitate trade: introducing an FTA is related to a 27.1% increase in exports. These results are robust across different specifications.

**Table 8 / Exports, SAAs and FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.33*** (0.04)	0.35*** (0.04)	0.34*** (0.04)	0.32*** (0.04)	0.33*** (0.04)
<i>SAA</i>	0.53*** (0.03)		0.54*** (0.03)	0.53*** (0.03)	0.53*** (0.03)
<i>FTA</i>	0.24*** (0.03)	0.24*** (0.03)			
<i>SAA_WB</i>		0.22*** (0.05)			
<i>SAA_no_WB</i>		0.58*** (0.04)			
<i>FTA_WB1</i>			0.13** (0.05)		
<i>FTA_no_WB1</i>			0.25*** (0.03)		
<i>CEFTA</i>				0.32*** (0.06)	
<i>FTA_no_CEFTA</i>				0.23*** (0.03)	
<i>FTA_WB2</i>					-0.06 (0.10)
<i>FTA_no_WB2</i>					0.24*** (0.03)
exporter-time FE	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	18083	18083	18083	18083	18083

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

In the specifications (3) to (5) we examine the effects of separate groups of FTAs: first, by dividing the FTAs into those signed by Western Balkan countries (denoted by *FTA\_WB1*) and the rest of FTAs (*FTA\_no\_WB1*); then by examining separately the effects of “new” CEFTA, which entered into force in 2007 with all six WB countries and Moldova and Croatia as members (with the subset of other FTAs



being denoted with *FTA\_no\_CEFTA*); and finally, we introduce a separation of FTAs into all the agreements among Western Balkan countries (both those before CEFTA, and CEFTA, denoted by *FTA\_WB2*) and the rest of FTAs (*FTA\_no\_WB2*). Thus, the difference between CEFTA and *FTA\_WB2* variables is that CEFTA starts in 2007, and it also includes Croatia (from 2007 to 2012) and Moldova. The variable *FTA\_WB2*, in contrast, includes only six WB countries, and, in addition to CEFTA after 2007, also the older FTAs among these countries that were in force before CEFTA.

The results show that FTAs by the Western Balkan countries had a weaker relationship with their export performance than FTAs in general, with the estimated coefficient of *FTA\_WB1* variable implying exports higher by 13.9% under these FTAs. However, CEFTA turned out to be more strongly related to exports than the rest of the FTAs implemented by the Western Balkan and other countries: its entry into force is related to a 37.7% rise in exports. While our estimates turn out lower than those in Petreski (2018), who finds that CEFTA increased intra-regional trade by 74%, 118% or 127%, depending on the exact empirical approach, in our sample, and with our approach, CEFTA outperforms other FTAs. If the earlier FTAs and CEFTA only among Western Balkan countries are analysed together (the last column, variable *FTA\_WB2*), it turns out that these were not related to exports in a statistically significant way. This implies that there could be heterogeneity in the relationships between different FTAs and trade for different countries in Western Balkans – an issue to which we return below.

In order to arrive at additional insights related to the relationships between FTAs and trade in the region, we first alter the subsample of Western Balkan countries included in the regressions of the model (4) and check for the robustness of findings related to the CEFTA variable. We leave each Western Balkan country out of the sample, one by one, but also Croatia and Moldova (one by one and together), as their inclusion may also affect the estimates of CEFTA. The results are presented in Table 9.

**Table 9 / CEFTA – subsample variations**

Sample without:	(1) AL	(2) BA	(3) XK	(4) ME	(5) MK	(6) RS	(7) HR	(8) MD	(9) HR & MD
<i>EU</i>	0.33*** (0.04)	0.33*** (0.04)	0.33*** (0.04)	0.32*** (0.04)	0.32*** (0.04)	0.37*** (0.04)	0.40*** (0.04)	0.32*** (0.04)	0.41*** (0.04)
<i>SAA</i>	0.54*** (0.03)	0.57*** (0.04)	0.54*** (0.03)	0.54*** (0.03)	0.53*** (0.04)	0.59*** (0.04)	0.64*** (0.04)	0.54*** (0.03)	0.64*** (0.04)
<i>CEFTA</i>	0.30*** (0.06)	0.26*** (0.09)	0.30*** (0.06)	0.32*** (0.06)	0.36*** (0.05)	0.53*** (0.06)	0.26** (0.11)	0.33*** (0.06)	0.27** (0.11)
<i>FTA_no_CEFTA</i>	0.24*** (0.03)	0.24*** (0.03)	0.23*** (0.03)	0.24*** (0.03)	0.23*** (0.03)	0.26*** (0.03)	0.27*** (0.03)	0.24*** (0.03)	0.28*** (0.03)
exporter-time FE	yes	yes	yes	yes	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes	yes	yes	yes	yes
observations	16786	17008	17278	17181	16754	17088	16708	17734	16382

Robust standard errors clustered by host-home pairs in parentheses; \*  $p < 0.1$ , \*\*  $p < 0.05$ , \*\*\*  $p < 0.01$ .

It is clear that the positive and statistically significant relationship between CEFTA and bilateral exports holds for all the sample variations. However, Serbia seems to have a special place in these results: when we remove it from the sample, the positive impact of CEFTA on intra-regional trade increases to nearly 70%, which indicates that – all else being equal – CEFTA does not have as much of an impact on trade between Serbia and the rest of the region as for other countries in the region.

Next, in Table 10 below, we perform a similar sample variation procedure for the model with the FTA\_WB2 variable, which includes all FTAs among the six Western Balkan countries, i.e. both CEFTA after 2007 as well as the FTAs that were in force before CEFTA and were then replaced by CEFTA. The coefficient of the FTA\_WB2 variable is not stable across sample variations and turns out positive, large and statistically highly significant only if Serbia is excluded from the sample. If Kosovo is left out, the coefficient is again negative, slightly lower in magnitude, but turns out statistically significant at the 5% level. This indicates that some observations related to these countries may be strongly influencing the overall results.

To interpret the different findings for CEFTA and the FTA\_WB2, we note that the results in the last column in Table 9 show that CEFTA had a positive effect on trade even if only six Western Balkan countries are considered (after excluding Croatia and Moldova). Therefore, results in Table 10 can be driven by the fact that (some of) the older FTAs, which were in force before CEFTA, might not have been relevant for trade, so when these are merged with CEFTA to build the new variable FTA\_WB2, the latter turns out largely insignificant. Thus it appears that CEFTA was successful in promoting intra-regional trade in the Balkans, unlike the FTAs among the Western Balkan countries that it replaced. Begović (2011) reaches similar conclusions on the ineffectiveness of the regional FTAs in force before CEFTA (her sample encompasses the period 1999-2007). That the early FTAs in the region were only weakly enforced is also recognised in Kaloyanchev et al. (2018). They state that this was a motivation for renewing the trade-strengthening efforts, which then resulted in the “new” CEFTA.

**Table 10 / FTAs among WB countries – subsample variations**

	(1)	(2)	(3)	(4)	(5)	(6)
Sample without:	AL	BA	XK	ME	MK	RS
<i>EU</i>	0.34*** (0.04)	0.33*** (0.04)	0.34*** (0.04)	0.33*** (0.04)	0.33*** (0.04)	0.38*** (0.04)
<i>SAA</i>	0.54*** (0.03)	0.57*** (0.04)	0.54*** (0.03)	0.54*** (0.03)	0.53*** (0.04)	0.59*** (0.04)
<i>FTA_WB2</i>	-0.14 (0.11)	-0.04 (0.13)	-0.21** (0.09)	-0.01 (0.11)	-0.11 (0.15)	1.24*** (0.22)
<i>FTA_no_WB2</i>	0.24*** (0.03)	0.25*** (0.03)	0.24*** (0.03)	0.24*** (0.03)	0.24*** (0.03)	0.27*** (0.03)
exporter-time FE	yes	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes	yes
observations	16786	17008	17278	17181	16754	17088

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

Taking the analysis a step further, we left out Kosovo only as an exporter and only as an importer (columns 1 and 2 in Table 11 below), with the results implying that not accounting for imports to Kosovo affects our general result, i.e. it leads to negative and statistically significant estimates. Similarly, we tried leaving out Serbia only as an exporter and only as an importer country (columns 3 and 4). In the first case the coefficient for the regional FTAs is positive, large and significant (column 3), while in the second case the FTAs turned out not to be related to exports. Thus, there should be something about

Serbian exports to other WB countries that changes the positive and significant result of this variable.<sup>18</sup> Finally, in column 5, we leave out both Kosovo's imports and Serbia's exports from the analysis, which yields a positive, large and statistically significant coefficient of the FTA\_WB2 variable, thus showing that Serbian exports have had a dominant partial influence on the general results for this variable.

**Table 11 / FTAs among WB countries – subsample variations II**

Sample without:	(1) XK-ex	(2) XK-im	(3) RS-ex	(4) RS-im	(5) XK-im & RS-ex
<i>EU</i>	0.33*** (0.04)	0.33*** (0.04)	0.37*** (0.04)	0.34*** (0.04)	0.38*** (0.04)
<i>SAA</i>	0.54*** (0.03)	0.53*** (0.03)	0.59*** (0.04)	0.54*** (0.03)	0.59*** (0.04)
<i>FTA_WB2</i>	-0.06 (0.10)	-0.21** (0.09)	1.06*** (0.25)	-0.08 (0.11)	0.58*** (0.18)
<i>FTA_no_WB2</i>	0.24*** (0.03)	0.24*** (0.03)	0.26*** (0.03)	0.24*** (0.03)	0.26*** (0.03)
exporter-time FE	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	17589	17772	17348	17823	17037

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

It should be recalled that Figure 2 showed that the share of total Serbian exports in GDP expanded sharply – by more than five times – between 1999 and 2018. In addition, the figures on Serbia in Panel 2B show that the share of Serbian exports to Western Balkan countries in total exports declined strongly over the observed period. At the same time, the share of exports to the EU increased from 51% to 67%. Overall, this indicates the redirection of Serbian exports away from the region towards the EU, possibly (partly) facilitated by the SAA.<sup>19</sup>

Besides the sample variations, we performed further robustness checks of the results in Table 8. First, we redefined the FTA variable(s) to start with the year in which the agreements were signed, and not with the year of their entry into force. We denote this variable (and its variations) with FTA\_s, i.e. CEFTA\_s, and present the corresponding estimation results in Appendix D, in Table 8D. All of our conclusions from above are confirmed, with only slight differences in the size of estimated coefficients.

Finally, we tried also including a variable explicitly capturing trade tariffs (TARIFF) in addition to FTAs. The results are presented in Appendix D, in Tables 8Da and 8Db, for weighted-average and simple-average tariffs, respectively. They confirm our aforementioned main conclusions on EU, SAA and FTA variables, but the estimated coefficients for the two tariff measures are never statistically significant and

<sup>18</sup> We note that we also tried excluding single country pairs with Kosovo as importer and other Western Balkan countries as exporters; and with Serbia as exporter and other Western Balkan countries as importers. We found that no single country pair drives the above results to a large extent.

<sup>19</sup> A similar development, though less pronounced in terms of the increase in overall exports as a share of GDP, can be observed for Macedonia. Leaving Macedonia out from our regressions in Table 9 (column 4) also increases the estimated coefficient for CEFTA, but much more mildly than for Serbia.

differ in sign. The reason may be that the other variables in the model, FTAs, SAAs and EU membership, largely pick up the potential influence of tariff changes.<sup>20</sup>

As for the results on other variables, they show that both EU membership and an SAA in force are related to trade in a statistically significant way, with the estimated coefficients in Table 8 (column 1) implying a 39% increase in trade between EU members, and a 70% increase in exports to the EU from a country with an SAA in force. This is by no means surprising, given the low trade barriers within the EU and their strong reduction during the accession process, accompanied by other reforms that potentially improved the competitiveness of countries with SAAs in force. In the second model in Table 8, we check for the differences in the effects of SAAs for the Western Balkan countries and similar agreements for other countries that had already joined the EU. We find that for the Western Balkan countries the magnitude of a positive relationship is considerably smaller, i.e. down to 24.6%. This positive and significant coefficient of the SAA variable for the Western Balkan countries is in line with the findings in Reiter and Stehrer (2018). Their estimated effect amounts to 26.6%, in a somewhat different sample.

The positive relationship between SAAs and trade has potential consequences for the interpretation of the results for CEFTA, as indicated by the likely diversion of Serbian exports towards the EU. However, this relationship may be seen from another angle too: as stated by Petreski (2018), besides CEFTA's importance in building members' competitiveness and generally increasing their cooperation capacities, it may have played an important role in mitigating the even stronger dependence of Western Balkan countries on their trade with the EU by rebuilding the regional market.

One should also note that, while not testing for the impact of FTAs (including CEFTA) on intra-regional trade in the Western Balkans, Kaloyanchev et al. (2018) analysed other potential trade determinants and found a significant, negative impact of non-tariff trade barriers. A similar conclusion is obtained by Toševska-Trpčevska and Tevdovski (2014) for a broader sample of SEE countries, including Bulgaria, Croatia, Greece and Romania, in addition to the six Western Balkan countries. This implies that through additional efforts in regional economic cooperation, regional trade flows could be boosted further by removing or reducing non-tariff trade barriers.

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<sup>20</sup> We note again that the sample is reduced when adding the tariff variables. Specifically, Kosovo is left out completely owing to a lack of tariff data. For this reason, our results in the fifth columns of Tables 8Da and 8Db produce results for the FTA\_WB2 variable that are most similar to the result in the third column of Table 10, where Kosovo was also left out.

## 5. Summary and conclusions

We apply a structural gravity model to assess whether (1) stabilisation and association agreements (SAAs), (2) bilateral investment treaties (BITs) and (3) free trade agreements (FTAs) were important determinants of inward foreign direct investment (FDI) and exports of the Western Balkan countries. The primary interest of the study is in the effects of BITs and FTAs on intra-regional FDI and trade, and in the case of SAAs, whether and how they are related to FDI from the EU to the region, and to more exports from the region to the EU.

Our sample comprises country pairs between 22 FDI host countries (in the FDI regressions), i.e. exporters (in the trade analysis) including transition countries and Turkey, and the 43 FDI home countries, i.e. trade partners, including the same 22 countries, plus advanced European countries and the US. We collected data from 1995 to 2017, but due to the uneven availability of data our sample is largely unbalanced.

Our main conclusions can be summarised as follows:

- › Generally, the BITs were not related to intra-regional FDI or to FDI from other countries. However, in a separate discussion of Serbian FDI to Montenegro we argue that the corresponding BIT between these two countries may have been an exception.
- › CEFTA contributed to increased intra-regional trade. The relationship between CEFTA and exports was stronger than for the (average of) other FTAs covered in the analysis and was further magnified when Serbia was left out of the analysis. The latter finding may be due to a comparatively strong diversion of Serbian exports towards the EU over the observed period, which may have been partly facilitated by the SAA.
- › Our results also indicate that the early intra-regional FTAs, which were replaced by CEFTA, were weakly implemented and did not contribute a lot to stronger trade integration in the region.
- › The SAAs turn out to be strongly related to FDI from the EU to the Western Balkan countries, with the strength of the relationship comparable to that of similar agreements for other transition countries that had already joined the EU. The SAAs are also found to have promoted exports from the Western Balkan countries to the EU, although not as strongly as for the other transition countries with similar agreements, i.e. the new EU member states.
- › Overall, the SAAs increased the integration between the countries of the region and the EU economy. In the context of exports, CEFTA may have mitigated the stronger dependence of Western Balkan countries on trade with the EU by rebuilding the regional market: the estimated relationship between CEFTA and intra-regional exports of Western Balkan countries is somewhat stronger than the relationship between the SAAs of the countries in the region and their exports to the EU.

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## Appendix A: Additional descriptive data

**Table A1 / Bilateral shares of inward FDI stocks across WB countries, in %**

to:	from:	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Albania	2005-07		...	0.3	0.0	1.1	...
	2016-18		0.0	0.8	0.0	0.6	0.3
Bosnia and Herzegovina	2005-07	...		...	0.2	...	8.8
	2016-18	...		...	0.1	...	15.5
Kosovo	2005-07	...	...		...	...	...
	2016-18	4.2	0.1		0.2	0.5	0.4
Montenegro	2005-07	...	...	...		...	...
	2016-18	0.0	0.8	0.1		0.2	5.4
North Macedonia	2005-07	0.5	0.0	...	0.0		2.6
	2016-18	0.7	0.3	...	0.0		1.9
Serbia	2005-07	0.0	0.3	...	0.6	0.0	
	2015	0.0	0.1	...	1.2	0.2	

Note: for some country pairs, data are not available for all of the years entering average values. In these cases, only the available year(s) are used, i.e. 2015 for FDI to Serbia.

**Table A2 / Bilateral shares of exports across WB countries, in % of total exports**

exporter:	importer:	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Albania	2005-07		0.4	4.2	0.4	1.8	1.9
	2016-18		0.4	7.7	1.8	2.8	2.1
Bosnia and Herzegovina	2005-07 <sup>a</sup>	0.2		...	3.4	0.9	14.0
	2016-18	...		...	3.0	1.2	9.7
Kosovo	2005-07	11.4	4.6		1.7	12.9	15.0
	2016-18	14.8	2.5		4.9	12.3	13.1
Montenegro	2005-07	1.0	4.1	0.0		0.2	27.5
	2016-18	3.5	9.5	5.4		1.5	22.1
North Macedonia	2005-07	1.7	2.6	...	0.4		21.0
	2016-18	1.3	1.5	4.1	0.5		4.3
Serbia	2005-07	0.6	13.4	...	10.2	5.1	
	2016-18	0.8	8.1	...	4.8	3.9	

Note: for some country pairs, data are not available for all of the years entering average values. In these cases, only the available year(s) are used.

<sup>a</sup> For export shares of Montenegro and Serbia to Bosnia and Herzegovina, data for 2008 are used.



**Table A3 / Bilateral import shares across WB countries, in % of total imports**

importer:	exporter:	Albania	Bosnia and Herzegovina	Kosovo	Montenegro	North Macedonia	Serbia
Albania	2005-07		0.2	1.2	0.8	1.6	2.2
	2016-18		0.5	0.8	0.5	1.4	3.5
Bosnia and Herzegovina	2005-07 <sup>a</sup>	0.0		...	0.2	0.9	10.6
	2016-18	...		...	0.4	0.9	11.1
Kosovo	2005-07	1.9	1.6		1.0	18.0	14.0
	2016-18	4.6	2.8		0.5	5.4	14.3
Montenegro	2005-07	0.3	3.1	0.0		1.1	25.9
	2016-18	1.5	6.0	0.2		1.3	21.0
North Macedonia	2005-07	0.3	0.7	...	0.0		8.1
	2016-18	0.8	0.9	0.5	0.1		7.2
Serbia	2005-07	0.0	2.7	...	1.0	1.6	
	2016-18	0.2	2.5	...	0.3	1.1	

Note: for some country pairs, data are not available for all of the years entering average values. In these cases, only the available year(s) are used.

<sup>a</sup> For import shares of Montenegro and Serbian exporters to Bosnia and Herzegovina, data for 2008 are used.

## Appendix B: Sample and methodological details

### SAMPLE

Our sample comprises country pairs between 22 FDI host countries (investment destinations) and the corresponding FDI home countries (source of investment – primarily European, but also including the US, Russia and Turkey). The set of host countries in the analysis of FDI corresponds to the set of exporters in our trade analysis, while the set of home countries corresponds to trade partners. The 22 host countries (or exporters) include 11 current EU member states: eight countries of Central and Eastern Europe (CEE) which joined the EU in 2004 (Czechia, Estonia, Hungary, Latvia, Lithuania, Poland, Slovakia and Slovenia); Bulgaria and Romania, which joined the EU in 2007, and Croatia, which joined in 2013; the six Western Balkans countries (Albania, Bosnia and Herzegovina, Kosovo, Montenegro, North Macedonia and Serbia); as well as Belarus, Moldova, Russia, Turkey and Ukraine. The total number of home countries (i.e. importers) considered is 43, and the complete list is provided in Appendix C. We collected data from 1995 to 2017, but our sample is unbalanced, given that the time series on bilateral FDI stock and (to a lesser extent) bilateral exports (but also on some of control variables) for most of the host countries begin only in a later year. Furthermore, the FDI data are not methodologically consistent over the whole period under observation (even for more advanced countries) due to changes in the balance of payments methodology and the recording of FDI, i.e. the switch to a new Benchmark Definition of Foreign Direct Investment – BMD4. With no remedy available, we are forced to accept these methodological inconsistencies. However, the method we apply, using host country- and home country-time effects, should account for any country-year specific changes, including methodological ones.

We note that we inspected our data for potentially influential observations, i.e. potentially influential country pairs. We found that, for the estimate of the BIT variable coefficient (i.e. in FDI regressions), a single country pair (out of 924) was driving the results in the full sample (bilateral FDI from France to Turkey), and this has been robust across different model specifications. As one does not want to base conclusions on regression results driven by a single country pair, we excluded it from our sample in all the regressions. In contrast, excluding other potentially influential observations/country pairs did not affect our results and conclusions for the whole sample.

The issue of data availability is especially pronounced for the countries of the Western Balkans in which we are specifically interested. For a part of the period the FDI stock data for Kosovo and Montenegro had to be approximated by cumulating FDI inflows (for which there is a longer series), thus enabling us to capture additional periods and policy changes related to the Western Balkan countries, which is very important, given that the subsample of these countries is very small and it is at the centre of our interest. An additional issue is the treatment of the separation of Serbia and Montenegro in 2006, as well as the status of Kosovo. We exclude observations (if any) for a country pair of Serbia and Montenegro before 2006 (the year of separation) and for Serbia and Kosovo before 2008 (the year in which Kosovo declared its independence). We note that Serbia does not accept the independence of Kosovo and does not publish data on exports to Kosovo. We refrain from using trade mirror data, in this case data from

Kosovo on imports from Serbia, given the generally low quality of data for the region.<sup>21</sup> The robustness of our results for the Western Balkan countries, including their sensitivity to the aforementioned approximation of FDI stock data, is checked by excluding the single Western Balkan country pairs from the sample. As it turns out, for the FDI analysis the case of Serbian investment to Montenegro is specific, and we treat and discuss it separately. Other country pairs in the region do not exert a very strong influence on our results in the FDI regressions. In some export regressions, excluding Serbia as an exporter or Kosovo as an importer considerably changes the size of the estimated intra-regional FTA coefficients, which we also discuss in more detail. Definitions and sources of all variables are given in Appendix C.

## METHODOLOGY

We apply a structural gravity model, which is widely used in the empirical analysis of international trade, but the same modelling technique can be applied to study other flows and interactions, such as migration flows, tourism, or international portfolio investment (see Head and Mayer, 2014). More specifically, it has been shown that this type of model can be successful in explaining foreign direct investment stocks, with the two notable studies being Head and Ries (2008) and De Sousa and Lochard (2011). In order to estimate our gravity model, we use the Poisson Pseudo Maximum Likelihood (PPML) estimator, available in STATA. The PPML estimator has become increasingly popular because it has a number of attractive features that justify its utilisation (see Larch et al., 2019), including accounting for the endogeneity bias of the policy variables (Yotov et al., 2016, p. 21).

Our empirical model of bilateral FDI can be written in the standard formulation of the gravity equation as follows:

$$FDI_{ij,t} = \exp[\pi_{i,t} + \vartheta_{j,t} + \mu_{ij} + \beta_1 EU_{ij,t} + \beta_2 SAA_{ij,t} + \beta_3 BIT_{ij,t} + \gamma \mathbf{Z}_{ij,t}] \times \epsilon_{ij} \quad (1)$$

where  $i$  and  $j$  represent the host country and home country indices, while  $t$  stands for the time index. The dependent variable, denoted with  $FDI_{ij,t}$ , represents the bilateral FDI stocks from home country  $j$  to host country  $i$  in year  $t$ . Country-pair fixed effects are denoted by  $\mu_{ij}$ , while a set of host country-time and home country-time fixed effects are given by  $\pi_{i,t}$  and  $\vartheta_{j,t}$ . Our first control variable  $EU_{ij,t}$  is a dummy that captures the effect of the EU membership of both host and home countries (it equals 1 if both countries are EU members, 0 otherwise). The effects of the SAA are captured with the dummy variable  $SAA_{ij,t}$ , which equals 1 if the host country has such an agreement with the EU, in country pairs with the EU home countries. In the year of EU accession, the  $SAA$  variable becomes zero, while the EU dummy becomes 1 for the same country pairs.<sup>22</sup> We note that the  $SAA$  variable also includes European Agreements that CEE countries, now EU member states, had with the EU before their own EU accession. Finally, the last variable in our basic specification is  $BIT_{ij,t}$  which equals 1 if there is a bilateral investment agreement in force between the countries in the country pair. The last term in the brackets,  $\mathbf{Z}_{ij,t}$ , denotes the vector of additional control variables that were used in extended models. These include FTAs, trade tariffs and institutional variables. In many of the regressions we separated the SAAs, FTAs and BITs into segments to investigate whether their relationship with dependent variables varies across countries, or country groups. For example, we separate the BIT variable with BITs for the

<sup>21</sup> Guerin et al. (2010, p. 18, Table 2.9) present the large discrepancies in intra-regional bilateral trade values recorded by importer and exporter countries. While some differences are expected due to transport costs (which increase the value of imports relative to exports), for some country pairs the difference amounts to more than 50%. For other country pairs the value of exports exceeds the value of imports.

<sup>22</sup> For the sake of simplicity, we drop the subscripts of the variables after the first mention.

whole sample into BIT\_WB1 and BIT\_no\_WB1 variables. The BIT\_WB1 includes only the BITs in which the host-country signee is a Western Balkan country. Similarly, the BIT variable is separated into BIT\_WB2 and BIT\_no\_WB2 variables, with BIT\_WB2 including only the BITs between Western Balkan host and home countries. In a similar way, using consistent notation, we also separate the SAA and FTA variables.

Another note is needed on the BIT variable: if such an agreement exists between countries which are not both EU member states, the question arises as to what happens to this agreement when (both) countries join the EU. The BIT then becomes an intra-EU BIT, which possibly gives bigger rights to investors from one EU country than from other EU countries. This contradicts the EU principle of non-discrimination based on the nationality, and such treaties would be incompatible with EU law (and may constitute illegal state aid (see EC, 2015). In disputes with foreign investors, some (new) EU member states have argued that the provisions agreed in the BITs that existed prior to their EU accession no longer applied, or at least not to the same extent (see e.g. Anderer, 2010). Regardless of the outcome of the disputes, this may have shaken the confidence of investors that they could still enjoy the rights agreed to in the BIT before it became an intra-EU BIT. Similarly, arguing that EU law takes precedence over intra-EU BITs and that the latter may be incompatible with EU law, the European Commission invited the member states to terminate such intra-EU treaties (see EC, 2015), to which the member states committed in their Declaration of January 2019.<sup>23</sup> In this context, we were facing a choice of 1) defining the BIT variable as being equal to zero for the pairs of countries that are both EU members, although the BIT was valid before the accession, or 2) assuming that the BITs, now intra-EU BITs, still apply. Given the aforementioned Declaration, we opted for the first option, so that we assumed that all intra-EU BITs no longer applied. However, we also ran the regressions with the alternative assumption that such treaties still remain in force even after both countries have joined the EU. As noted in the text, this lowers the estimated coefficient for the BIT variable, likely indicating that the investors did not perceive the intra-EU BITs as being still in force, at least not with sufficient certainty. This is not surprising, given some known disputes between investors from member states and the new member states-host countries, in which, soon after the latter's accession, the precedence of EU law over intra-EU BITs was argued by the new member state (see Anderer, 2010).

As for the analysis of bilateral exports, our empirical model is written as follows:

$$EX_{ij,t} = \exp[\pi_{i,t} + \vartheta_{j,t} + \mu_{ij} + \beta_1 EU_{ij,t} + \beta_2 SAA_{ij,t} + \beta_3 FTA_{ij,t} + \gamma \mathbf{Z}_{ij,t}] \times \epsilon_{ij} \quad (2)$$

The dependent variable is bilateral gross exports from country  $i$  (exporter) to country  $j$  (importer) in year  $t$ . Again, we control for EU membership and SAA agreements. The third explanatory variable in our basic model is a dummy describing the FTAs, which equals 1 if there is a bilateral free trade agreement between exporter and importer in the pair, or if both countries belong to the same multilateral/regional trade agreement. EU membership and SAAs are treated separately. With EU accession the new member state adopts the common EU trade policy, so that the FTA variable has zero value in the pair with a non-EU country, unless the EU has some FTA with the same country. Generally, all the variables are defined in the same way as before in regressions of FDI-dependent variables, with the difference that the countries in a country pair now refer to exporters and importers, instead of host and home countries. As in equation (1), the last term in the brackets denotes the vector of additional control variables that were used in extended models. For the exports equation, these include the Western Balkan subsets of the SAA and FTA variables, as well as trade tariffs.

<sup>23</sup> Available at: [https://ec.europa.eu/info/publications/190117-bilateral-investment-treaties\\_en](https://ec.europa.eu/info/publications/190117-bilateral-investment-treaties_en).

## Appendix C: Data definitions and sources

FDI – Stock of bilateral Foreign Direct Investment, in EUR million. Source: wiiw. The sample comprises 22 FDI host countries, i.e. countries receiving the FDI from (up to) 43 FDI home countries, i.e. FDI source countries.

*Host countries:* Albania, Belarus, Bosnia and Herzegovina, Bulgaria, Croatia, Czechia, Estonia, Hungary, Kosovo, Latvia, Lithuania, Moldova, Montenegro, North Macedonia, Poland, Romania, Russia, Serbia, Slovakia, Slovenia, Turkey and Ukraine.

*Home countries* (in addition to above 22 host countries): Austria, Belgium, Cyprus, Denmark, Finland, France, Germany, Greece, Iceland, Ireland, Italy, Luxembourg, Malta, Netherlands, Norway, Portugal, Spain, Sweden, Switzerland, United Kingdom and United States.

BIT – dummy for Bilateral Investment Treaty; 0 if no treaty, 1 in and after the year the treaty comes into force; no intra-EU bilateral investment treaties. Sources: World Bank, International Centre for Settlement of Investment Disputes, Database of Bilateral Investment Treaties.

(<https://icsid.worldbank.org/en/Pages/resources/Bilateral-Investment-Treaties-Database.aspx>)

FTA – dummy for Free Trade Agreement “in force”. Source: DESTA.  
(<https://www.designoftradeagreements.org/downloads/>)

EU – EU membership dummy, equals 1 if both countries in a pair are EU members. In the years of EU accession and thereafter, any bilateral investment treaty dummy, free trade agreement dummy, (including the dummy for CEFTA) is set to 0.

SAA – dummy for Stabilisation and Association Agreement entry in force (or European Agreement for countries that joined the EU in 2004 and 2007), equals 1 for a country pair with EU members as home countries and host countries with an SAA in force. Sources: European Commission and DESTA. (<https://www.designoftradeagreements.org/downloads/>)

CEFTA – dummy for “new” CEFTA agreement in force, equals 1 for six WB countries and Moldova in 2007 and thereafter (current composition of CEFTA countries), and for Croatia in 2007-2012.

WB – geographical dummy for Western Balkans countries (Albania, Bosnia and Herzegovina, Kosovo, North Macedonia, Montenegro, Serbia). WB geographical dummy is used to create variations in other variables, such as *SAA\_WB*, which equals 1 only for (country pairs of) WB countries (and EU member states). Correspondingly, *SAA\_no\_WB* denotes SAA (i.e. European Agreements) of (country pairs of) non-WB countries (with EU members). Similarly, *BIT\_WB1* is a dummy variable which equals 1 for country pairs of WB host countries with all the other countries if there is a BIT in force. Also, *FTA\_WB* equals 1 for country pairs of WB host countries with all the other countries if there is an FTA in force.

Alternatively, *BIT\_WB2* equals 1 for country pairs of WB countries (both as host and home countries) if there is a BIT in force.

INST – institutional variables including Rule of Law; Control of Corruption; Political Stability and Absence of Violence/Terrorism; Regulatory Quality; Government Effectiveness; Voice and Accountability. For details, see Kaufmann et al. (2010). Data stem from the World Bank’s Worldwide Governance Indicators database. The variable enters regressions as a difference between the host country and the home country value of each indicator (and centred). (<https://databank.worldbank.org/data/source/worldwide-governance-indicators>)

EX – bilateral exports from the set of exporting countries (equal to the set of host countries above) to the set of importing countries (equal to the set of home countries above), in EUR million. Source: wiiw.

TARIFF – weighted-average and simple-average tariffs (ad valorem equivalents – AVEs). Source: UNCTAD Trade Analysis Information System (TRAINS), collected through WITS, complemented by data from WTO Integrated Data Base (IDB).

## Appendix D: Additional results

**Table 3D / FDI, SAAs and signed BITs (without MERS country-pair)**

	(1)	(2)	(3)	(4)
<i>EU</i>	0.38*** (0.14)	0.35** (0.14)	0.29* (0.15)	0.38*** (0.14)
<i>SAA</i>	0.35*** (0.08)		0.35*** (0.08)	0.35*** (0.08)
<i>BIT_s</i>	0.05 (0.09)	0.05 (0.10)		
<i>SAA_WB</i>		0.38*** (0.13)		
<i>SAA_no_WB</i>		0.32*** (0.09)		
<i>BIT_s_WB1</i>			0.49*** (0.16)	
<i>BITs_no_WB1</i>			-0.05 (0.11)	
<i>BIT_s_WB2</i>				0.20 (0.32)
<i>BIT_s_no_WB2</i>				0.05 (0.10)
host-time FE	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes
observations	13765	13765	13765	13765

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

**Table 4Da / FDI, FTAs and weighted-average tariffs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.392** (0.167)	0.361** (0.171)	0.391** (0.167)	0.361** (0.171)	0.379** (0.176)
<i>SAA</i>	0.389*** (0.097)	0.388*** (0.097)	0.389*** (0.097)	0.377*** (0.093)	0.381*** (0.101)
<i>BIT</i>	-0.008 (0.092)				
<i>FTA</i>	-0.073 (0.072)	-0.073 (0.072)	-0.073 (0.072)		
<i>TARIFF_host</i>	0.016** (0.007)	0.016** (0.007)	0.016** (0.007)	0.015** (0.007)	0.016** (0.007)
<i>TARIFF_home</i>	-0.004 (0.005)	-0.004 (0.005)	-0.004 (0.005)	-0.004 (0.005)	-0.004 (0.005)
<i>BIT_WB1</i>		0.250 (0.263)		0.254 (0.263)	
<i>BIT_no_WB1</i>		-0.039 (0.098)		-0.038 (0.098)	
<i>BIT_WB2</i>			0.096 (0.254)		0.087 (0.256)
<i>BIT_no_WB2</i>			-0.009 (0.092)		-0.008 (0.092)
<i>FTA_WB1</i>				-0.187 (0.152)	
<i>FTA_no_WB1</i>				-0.043 (0.081)	
<i>CEFTA</i>					0.027 (0.150)
<i>FTA_no_CEFTA</i>					-0.080 (0.077)
host-time FE	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	11895	11895	11895	11895	11895

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.



Table 4Db / FDI, FTAs and simple-average tariffs

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.521*** 0.171	0.489*** 0.176	0.521*** 0.171	0.491*** 0.176	0.526*** 0.181
<i>SAA</i>	0.383*** (0.097)	0.382*** (0.097)	0.383*** (0.097)	0.366*** (0.093)	0.386*** (0.101)
<i>BIT</i>	0.000 (0.092)				
<i>FTA</i>	-0.053 (0.075)	-0.053 (0.075)	-0.053 (0.075)		
<i>TARIFF_host</i>	0.005 (0.010)	0.005 (0.010)	0.005 (0.010)	0.004 (0.010)	0.005 (0.010)
<i>TARIFF_home</i>	0.032** (0.015)	0.032** (0.015)	0.032** (0.015)	0.033** (0.015)	0.032** (0.015)
<i>BIT_WB1</i>		0.263 (0.262)		0.268 (0.261)	
<i>BIT_no_WB1</i>		-0.031 (0.099)		-0.030 (0.099)	
<i>BIT_WB2</i>			0.121 (0.265)		0.125 (0.266)
<i>BIT_no_WB2</i>			-0.001 (0.093)		-0.001 (0.092)
<i>FTA_WB1</i>				-0.210 (0.153)	
<i>FTA_no_WB1</i>				-0.011 (0.085)	
<i>CEFTA</i>					-0.102 (0.148)
<i>FTA_no_CEFTA</i>					-0.050 (0.080)
host-time FE	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	11895	11895	11895	11895	11895

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

**Table 8D / Exports, SAAs and signed FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.29*** (0.04)	0.32*** (0.04)	0.30*** (0.04)	0.28*** (0.04)	0.30*** (0.04)
<i>SAA</i>	0.50*** (0.03)		0.50*** (0.03)	0.50*** (0.03)	0.50*** (0.03)
<i>FTA_s</i>	0.19*** (0.03)	0.20*** (0.03)			
<i>SAA_WB</i>		0.20*** (0.05)			
<i>SAA_no_WB</i>		0.55*** (0.04)			
<i>FTA_s_WB1</i>			0.11** (0.05)		
<i>FTA_s_no_WB1</i>			0.20*** (0.03)		
<i>CEFTA_s</i>				0.31*** (0.05)	
<i>FTA_s_no_CEFTA</i>				0.18*** (0.03)	
<i>FTA_s_WB2</i>					-0.01 (0.12)
<i>FTA_s_no_WB2</i>					0.19*** (0.03)
exporter-time FE	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	18083	18083	18083	18083	18083

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

**Table 8Da / Exports, SAAs, weighted-average tariffs and FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.341*** (0.041)	0.370*** (0.042)	0.350*** (0.043)	0.331*** (0.043)	0.345*** (0.041)
<i>SAA</i>	0.543*** (0.036)		0.547*** (0.037)	0.542*** (0.036)	0.543*** (0.036)
<i>FTA</i>	0.224*** (0.028)	0.232*** (0.028)			
<i>TARIFF</i>	0.003 (0.002)	0.003 (0.002)	0.003 (0.002)	0.003 (0.002)	0.003 (0.002)
<i>SAA_WB</i>		0.217*** (0.049)			
<i>SAA_no_WB</i>		0.598*** (0.041)			
<i>FTA_WB1</i>			0.123** (0.054)		
<i>FTA_no_WB1</i>			0.232*** (0.030)		
<i>CEFTA</i>				0.340*** (0.052)	
<i>FTA_no_CEFTA</i>				0.217*** (0.029)	
<i>FTA_WB2</i>					-0.211* (0.127)
<i>FTA_no_WB2</i>					0.228*** (0.028)
exporter-time FE	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	15956	15956	15956	15956	15956

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

**Table 8Db / Exports, SAAs, simple-average tariffs and FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.325*** (0.044)	0.349*** (0.045)	0.334*** (0.046)	0.314*** (0.046)	0.329*** (0.044)
<i>SAA</i>	0.544*** (0.037)		0.548*** (0.037)	0.544*** (0.037)	0.544*** (0.037)
<i>FTA</i>	0.224*** (0.028)	0.232*** (0.028)			
<i>TARIFF</i>	-0.003 (0.005)	-0.005 (0.006)	-0.003 (0.005)	-0.003 (0.005)	-0.003 (0.005)
<i>SAA_WB</i>		0.203*** (0.050)			
<i>SAA_no_WB</i>		0.605*** (0.042)			
<i>FTA_WB1</i>			0.130** (0.055)		
<i>FTA_no_WB1</i>			0.231*** (0.030)		
<i>CEFTA</i>				0.341*** (0.052)	
<i>FTA_no_CEFTA</i>				0.216*** (0.029)	
<i>FTA_WB2</i>					-0.195 (0.125)
<i>FTA_no_WB2</i>					0.227*** (0.028)
exporter-time FE	yes	yes	yes	yes	yes
importer-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	15956	15956	15956	15956	15956

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

## Appendix E: Tables 4, 6 and 7 including Serbian investment to Montenegro

**Table 4E / FDI and FTAs**

	(1)	(2)	(3)	(4)	(5)
<i>EU</i>	0.30** (0.14)	0.24* (0.15)	0.29** (0.14)	0.26* (0.15)	0.29** (0.15)
<i>SAA</i>	0.32*** (0.08)	0.33*** (0.08)	0.34*** (0.08)	0.32*** (0.08)	0.34*** (0.08)
<i>BIT</i>	0.00 (0.07)				
<i>FTA</i>	-0.06 (0.07)	-0.06 (0.07)	-0.05 (0.07)		
<i>BIT_WB1</i>		0.23 (0.14)		0.24 (0.14)	
<i>BIT_no_WB1</i>		-0.06 (0.08)		-0.06 (0.08)	
<i>BIT_WB2</i>			1.63*** (0.40)		1.63*** (0.40)
<i>BIT_no_WB2</i>			-0.02 (0.07)		-0.02 (0.07)
<i>FTA_WB1</i>				-0.24 (0.15)	
<i>FTA_no_WB1</i>				0.00 (0.08)	
<i>CEFTA</i>					-0.06 (0.13)
<i>FTA_no_CEFTA</i>					-0.05 (0.07)
host-time FE	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes
observations	13782	13782	13782	13782	13782

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.

**Table 6E / Average institutional distance for groups of country pairs**

	<b>Rule of law</b>	<b>Corruption control</b>	<b>Political stability</b>	<b>Regulatory quality</b>	<b>Government effectiveness</b>	<b>Voice and accountability</b>
<i>mean_WB1</i>	-1.218	-1.211	-0.819	-1.009	-1.168	-0.857
<i>mean_WB2</i>	0.007	-0.030	-0.010	0.028	0.035	-0.023

**Table 7E / FDI and institutional distance**

	(1)	(2)	(3)	(4)	(5)	(6)
<b>Institutional variable:</b>	<b>Rule of law</b>	<b>Corruption control</b>	<b>Political stability</b>	<b>Regulatory quality</b>	<b>Government effectiveness</b>	<b>Voice and accountability</b>
<i>EU</i>	0.33** (0.14)	0.31** (0.14)	0.35** (0.14)	0.35** (0.14)	0.33** (0.14)	0.34** (0.14)
<i>SAA</i>	0.36*** (0.08)	0.37*** (0.08)	0.36*** (0.08)	0.36*** (0.08)	0.36*** (0.08)	0.36*** (0.08)
<i>BIT</i>	0.01 (0.08)	0.02 (0.08)	0.01 (0.07)	0.04 (0.08)	0.02 (0.08)	0.02 (0.07)
<i>BIT × INST</i>	0.06 (0.05)	0.12*** (0.04)	0.06 (0.04)	0.17*** (0.06)	0.10** (0.05)	0.17** (0.07)
host-time FE	yes	yes	yes	yes	yes	yes
home-time FE	yes	yes	yes	yes	yes	yes
bilateral FE	yes	yes	yes	yes	yes	yes
observations	13300	13300	13076	13152	13152	13300

Robust standard errors clustered by host-home pairs in parentheses; \* p<0.1, \*\* p<0.05, \*\*\* p<0.01.



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