

## THE EFFECTS OF DEMOCRATIZATION ON ECONOMY: THE CASE STUDY OF THE WESTERN BALKANS

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### Abstract

*The present study aims at tracing the correlations between the foreign direct investments (FDIs) and the key interest rates (KIRs) broken through the prism of the democratization processes in the Western Balkans. The paper represents the extension of the previous author's works dedicated on the region, and its challenges nowadays (Mancheva, 2015, 2016, 2018, 2019, 2021; Mancheva, Simeonova, 2019). The interest on the issue is driven by the ongoing European Union enlargement processes. It is trying to contribute by investigating economic growth via FDIs and KIRs trends in the context of the democratization of the region. Pearson's bivariate correlation is used to track whether: (1) there is a statistically significant linear relationship between three continuous random variables – foreign direct investments, key interest rate and democratic rating, (2) the strength of the linear relationship between these variables and (3) the direction of this connection. The study includes the following countries: the Republic of Albania, the Republic of Serbia, the Republic of Northern Macedonia, the Republic of Montenegro and the Federation of Bosnia and Herzegovina. Republic of Kosovo and Republic of Slovenia are excluded from the study as Kosovo is still partially recognized and Slovenia is an EU member since 2004. A 10-year data period is covered, namely between 2010 and 2019. After the analysis, it was found that the democratization processes of the countries included in the study do not affect their economic growth, represented by FDIs and KIRs.*

**Keywords:** democratization, Western Balkans, foreign direct investments, key interest rate, Pearson's bilateral correlation

**JEL:** C01, C81, C87, O10, O40, P16

### Introduction

The end of the Cold War, being accepted with hope and high expectations for positive change in the world, did not make it more stable and peaceful. On the contrary, conflicts are not only increasing, but even becoming particularly large-scale and violent. The Western Balkans are no exception to this trend. Torn by wars and conflicts in the 90s of XX c., they have been called “powder keg” (Todorov, 2015,

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p. 11). NATO's military operations in Serbia, the war in Bosnia and Herzegovina, the secession of Kosovo and a number of other events have sharpened the focus on the Western Balkans and made them a region of particular importance.

On the other hand, for Europe they continue to be a zone of permanent ethnic and political conflicts, which is a prerequisite for destabilizing the continent (Todorov, 2015, p. 12). In turn some researchers' outcome of the events in the Balkans as a whole is vitally important worldwide (Vaknin, 2000).

The present study is part of the author's series dedicated to the Western Balkans and provoked by his opportunity for field research in the region, as well as by changes in the geopolitical and economic aspect in recent decades.

The following hypotheses are tested:

(1) Zero hypothesis – democratization does not affect economic growth;

(2) Alternative hypothesis – democratization has an impact on economic growth.

Within the study, *economic growth* is represented by continuous random variables – *foreign direct investments (FDIs)* and *key interest rates (KIRs)*. The choice of quantities is dictated by the fact that in the long run the growth of FDIs leads to economic growth (Petkova, 2018), and low levels of KIRs in turn also stimulate the economy (Georgiev, 2009).

The study includes the Republic of Albania, the Republic of Serbia, the Republic of Northern Macedonia, Montenegro and the Federation of Bosnia and Herzegovina (FBiH). Kosovo and Croatia are excluded because Kosovo is partially recognized and Croatia joins the EU in 2013.

### ***The Western Balkans today***

The Western Balkans emerges as a concept at the end of 90s of XX century, after the disintegration of the Socialist Federal Republic of Yugoslavia (SFRY). It refers to a group of countries in the Balkans that remain outside NATO and the EU. Eight of the twelve countries on the peninsula are located in the region. Virtually all countries have participated in the SFRY (Slovenia, Bosnia and Herzegovina, Macedonia, Serbia, Montenegro, Croatia and Kosovo) and Albania. With the exception of the Republic of Serbia, all are limited in terms of territory and population. Their total territory within the geographical boundaries of the peninsula is 219.7 thousand sq km or 45.2% of the total area of all Balkan countries (Tsachevski, 2011, p. 377).

With the exception of Slovenia the Western Balkans have a special place in politics and the EU. Slovenia became a member of the EU in the fifth enlargement, as it easily and quickly overcame difficulties and undertook successful reforms, and is also the most economically developed country. For the rest of the region, European integration is more difficult and long-lasting. The

main reasons are the military conflicts, the unstable political situation and the slow pace of change (Tsatsevski, 2011, p. 379).

The Republic of Serbia and the Republic of Montenegro are the “leaders” in the pre-accession process and the only countries in the process of negotiations with the Union. Bosnia and Herzegovina is the last country to apply for accession. In articles on the subject, the author of the present paper proves that the Republic of Albania is a serious “competitor” of the so-called “leaders” Serbia and Montenegro, as it manages to achieve a relatively stable political environment and levels of political risk (Mancheva, Simeonova, 2019).

### ***Research methodology and application***

#### *Methodology and data*

A *Pearson bilateral correlation* is used for the study. It makes it possible to check:

- whether there is a statistically significant linear relationship between two or more continuous random variables;
- power of the linear minutes link between them;
- the direction of this connection (increasing or decreasing).

The formula of bilateral Pearson Correlation is, as follows:

$$r_{xy} = \frac{\text{cov}(x,y)}{\sqrt{\text{var}(x)} \cdot \sqrt{\text{var}(y)}} \quad (1)$$

Where:

cov (x, y) is the exemplary covariance of x and y;

var (x) is the variance of x;

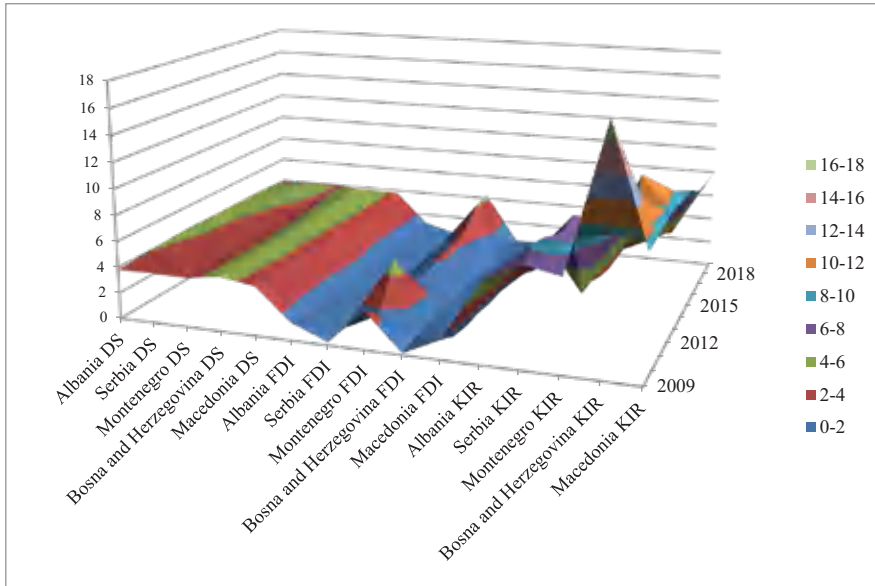
var (y) is a dispersion minutes for y.

The data used for the purposes of the survey cover the period 2010 – 2019 and are presented on an annual basis. Their source is a non-governmental organization “Freedom House”, the World Bank and regional central banks of the countries concerned.

#### *Application of the methodology and results*

For the purposes of the study, Pearson’s bilateral correlation was applied to three continuous random variables – *foreign direct investments, key interest rates and democratic rating*.

*Foreign direct investments* are investments made by a company in one country in a business located in another country. According to the economic theory and practice of the last few decades, FDI's have a significant role as an engine of growth in the host countries (Mihailova, 2019). Moreover, they influence the dynamics of economic growth through the so-called “levels of distribution” (Nowbutsing, 2009).



Source: Figure of the author.

**Figure 1:** Dynamics of the variables (2010 – 2019)

*The key interest rate* is set by the central bank of each country. In an independent monetary policy (i.e. without a currency board), it is one of the instruments with which the central bank conducts this policy. In market-developed economies, its movement is used as a direct tool to regulate the economy. KIR is a form of communication from the central bank to commercial banks on the exchange rate of monetary policy – to loosen or shrink the money supply, which respectively results in an increase or decrease in inflation.

*The Democratic rating* is compiled by the non-governmental organization Freedom House and is a scale from 1 to 7, with 1 being the highest level of democratic progress and 7 being the lowest.

Figure 1 presents the dynamics of the continuous random variables used in the study – foreign direct investment, key interest rates and democratic rating. According to it, the dynamics of the variable “democratic rating” is relatively

the most stable compared to the other two variables. In all the countries considered, they accept a value between 3.5 and 4.5, which puts them in the categories of hybrid regime and semi-consolidated democracies of the non-governmental organization Freedom House. The former are electoral democracies that meet only minimum standards for the election of national leaders, and the latter are electoral democracies that meet relatively high standards for the election of national leaders, but show some weaknesses in the protection of political rights and civil liberties. Of the countries represented, the Republic of Serbia and the Republic of Montenegro are semi-consolidated democracies, and all others are countries with a hybrid regime.

The next continuous and random variable is “foreign direct investments”. There is a certain dynamics in it. This is also the variable that has been most affected by the global economic crisis. During the period under review, the magnitude was affected by the “second wave” of the crisis in 2012. As can be seen, this is the period in which there is a sharp decline in FDIS, with the most significant decrease in the Republic of Serbia. This is normal because it is the country with the largest economy leading in the region.

The last continuous random variable is the “key interest rate”. It is also experiencing dynamics, as in the Republic of Albania and the Republic of Northern Macedonia there is a decline in its values, which is a signal of the attempts of these countries to maintain a stable economic environment.

Table 4 shows the Pearson correlation with respect to the variables correlated with democratic rating. It is clear that there is a correlation in several directions. In the first place – in terms of the democratic rating – the ratings of most countries (highlighted ones) have a strong linear relationship. For example, when the democratic rating of the Republic of Albania increases or decreases, those in BiH and Montenegro also increase or decrease. The case is similar with the other highlighted cells, namely: when the rating of the Republic of Northern Macedonia changes, those of the Republic of Serbia and the Republic of Montenegro change in the same direction; Serbia’s rating influences Macedonia’s; that of BiH affects Albania and Montenegro, and that of Montenegro affects Albanian, Macedonian and Bosnian.

**Table 4: Bilateral Pearson correlation**

	Albania DS	Serbia DS	Montenegro DS	Bosnia and Herzegovina DS	Macedonia DS	Albania FDI	Serbia FDI	Montenegro FDI	Bosnia and Herzegovina FDI	Macedonia FDI	Albania KIR	Serbia KIR	Montenegro KIR	Bosnia and Herzegovina KIR	Macedonia KIR
Albania DS Pearson Correlation	1	-.867*	-0.339	-0.336	0.435	0.363	-0.004	-0.148	0.342	0.271	-.821*	0.619	0.435	.799	.731*
Sig. (2-tailed)		0.001	0.355	0.344	0.206	0.393	0.999	0.698	0.333	0.445	0.004	0.058	0.209	0.011	0.026
N	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Serbia DS Pearson Correlation	.867*	1	0.547	.886	-0.1	0.656	0.164	-0.031	-0.487	-0.355	-.827*	-0.561*	-0.531	-0.604	-0.602*
Sig. (2-tailed)	0.001		0.192	0.006	0.783	0.679	0.651	0.933	0.174	0.314	0.003	0.14	0.114	0.064	0.006
N	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Montenegro DS Pearson Correlation	-0.339	0.547	1	.798*	0.14	0.191	0.114	-0.426	0.194	-0.332	-0.437	-0.212	-.688*	-0.172	-0.133
Sig. (2-tailed)	0.355	0.102		0.006	0.695	0.768	0.753	0.22	0.612	0.349	0.207	0.557	0.028	0.635	0.714
N	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Bosnia and Herzegovina DS Pearson Correlation	-0.336	.886	.798*	1	0.314	0.264	0.095	-0.379	-0.327	-0.375	-0.315	0.63	-0.611	0.969	0.032
Sig. (2-tailed)	0.344	0.006	0.006		0.377	0.482	0.615	0.285	0.307	0.295	0.379	0.003	0.001	0.955	0.93
N	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10
Macedonia DS Pearson Correlation	0.435	-0.1	0.14	0.314	1	0.334	-0.234	-0.679	0.087	0.213	0.412	0.667	0.23	.835	.687*
Sig. (2-tailed)	0.206	0.783	0.699	0.377		0.393	0.346	0.001	0.811	0.379	0.207	0.069	0.523	0.048	0.028
N	10	10	10	10	10	10	10	10	10	10	10	10	10	10	10

\*. Correlation is significant at the 0.05 level (2-tailed).  
 \*\*. Correlation is significant at the 0.01 level (2-tailed).

Source: Figure of the author.

Next – in terms of FDIs – there is only one correlation, namely the democratic rating of the Republic of Albania correlates negatively with FDIs in the Republic of Montenegro, i.e. with an increase in the democratic rating of the Republic of Albania there is a decline in FDIs in the Republic of Montenegro. Finally – in respect of the KIR – democratic rating has a negative correlation with KIRs to some of the countries. For example, the increase in the values of the democratic rating of the Republic of Albania leads to a decrease in the values of the KIR in the Republic of Serbia and BiH; raising the rating of the Republic of Macedonia correlates negatively with the KIR in Albania, Macedonia, BiH and Montenegro; when Serbia’s democratic rating changes, the KIR in Macedonia and Montenegro decreases.

To summarize, we can say that after the applied methodology – *Pearson’s bilateral correlation*, there is a strong linear relationship between the democratic ratings of the countries in question in the Western Balkans. Conversely, with regard to FDIs and KIRs, there is a strong linear relationship only between the democratic rating and the KIRs, and only in some of the countries concerned.

**Conclusion**

The Western Balkans continue to be a problematic region in Europe, requiring active international engagement. Difficulties in their Europeanization increased further in the context of the financial and economic crisis in 2008

– 2012. The countries of this region face a number of political, economic and social challenges, which slows down their reforms and Europeanization (Tsachevski, 2011, p. 501).

For this reason, this study aims to check whether the processes of democratization in selected countries of the Western Balkans influence economic growth. To achieve the set objective the methodology that was used was the *bilateral correlation of Pearson* applied to three continuous random variables: *democratic rating, FDI*s and *KIR*s.

The following hypotheses were tested:

- (1) Zero hypothesis – democratization does not affect economic growth;
- (2) Alternative hypothesis – democratization has an impact on economic growth.

With a risk of error 5% a **zero hypothesis** is accepted, meaning *democratization does not affect economic growth*. The main arguments are the lack of correlation with one of the selected continuous random variables – FDI and partial correlation with the second continuous random variable – KIRs.

In this sense, the study contributes with providing an update on democratization processes and economic growth after the global crises 2008 – 2012, and in the context of EU accession process. It raises the question on the types of appetites of EU on WB – political or economic, the future role of the region both – in the Balkans and in EU, etc.

Despite the progress made in the integration of the Western Balkan countries into the EU, the global economic crisis of 2008 – 2012 had a detrimental effect on the pace and effect of the ongoing reforms. In addition, the region must comply with stricter requirements set by the Union. All this poses a number of challenges that the region has to deal in the coming years.

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