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THE ROLE OF CAPITAL INFLOWS IN SHAPING EXTERNAL (IM)BALANCE IN THE WESTERN BALKAN COUNTRIES: HETEROGENEOUS PANEL APPROACH

УЛОГА КАПИТАЛНИХ ПРИЛИВА У ОБЛИКОВАЊУ ЕКСТЕРНЕ (НЕ)РАВНОТЕЖЕ ЗЕМАЉА ЗАПАДНОГ БАЛКАНА: ХЕТЕРОГЕНИ ПАНЕЛ ПРИСТУП

Summary: *The Western Balkan countries exhibit persistent current account deficits (CAB), mainly driven by trade deficits and negative primary income balances. At the same time, surpluses in the financial account of the balance of payments (FAB), mainly due to foreign direct investment (FDI) inflows, finance the CAB imbalance. This paper examines the long-run relationship between CAB and FAB using a Pooled Mean Group (PMG) panel approach for Albania, Bosnia and Herzegovina, Montenegro, North Macedonia and Serbia over the period 2007–2024. The results reveal a negative and statistically significant long-run relationship between FAB and CAB, indicating a dual effect of external capital inflows that both finance and deepen the current account deficit. To ensure long-run external sustainability, economic policies should focus on the efficient use of capital inflows to strengthen export capacity and reduce import dependence, rather than relying on external capital as a permanent financing source of negative CAB.*
Keywords: *current account, financial account, FDI, Western Balkans, PMG model*
JEL Classification: *C23, F21, F32, F41*

Резиме: *Земље Западног Балкана суочавају се са хроничним дефицитом текућег рачуна (ТР) који је последица дефицита робне размене, као и негативног рачуна примарног дохотка у појединим економијама. Суфицит у финансијском делу платног биланса (ФР), првенствено услед значајног прилива по основу страних директних инвестиција (СДИ) покрива дисбаланс ТР. У овом раду се испитује дугорочна веза између ФР и ТР применом модела Здружених групних средина (PMG) на узорку од пет земаља: Албаније, Босне и Херцеговине, Црне Горе, Северне Македоније и Србије у периоду 2007-2024. Резултати истраживања показују дугорочну негативну и статистички значајну везу између ФР и ТР, што указује на двоструки ефекат екстерног капитала - истовремено покривање и продубљивање дефицита ТР. У циљу одрживости екстерне равнотеже у дугом року, полуге економске политике требало би усмерити ка ефикаснијем коришћењу капиталних прилива ради повећања извозних капацитета и смањења увозне зависности, уместо искључивог ослањања на екстерни капитал као извор финансирања дефицита ТР.*
Кључне ријечи: *текући рачун, финансијски рачун, СДИ, Западни Балкан, PMG модел*
ЈЕЛ касификација: *C23, F21, F32, F41*

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INTRODUCTION

The Western Balkan countries are undergoing real convergence towards advanced European economies amid pronounced external imbalances accompanied by chronic current account deficits. Limited export capacity and high import dependence have led to a structural trade deficit, a key component in assessing external (im)balance. In this macroeconomic setting, the sustainability of balance-of-payments equilibrium depends largely on the composition and stability of capital inflows recorded in the financial account, which finance the current account deficit.

Foreign direct investment (FDI) provides a stable, long-term source of external financing, unlike the riskier, volatile short-term flows associated with portfolio and other investment, which can increase national economies' vulnerability to external shocks and international developments.

This paper uses a heterogeneous panel approach to analyse the long-run relationship between the financial account balance (FAB) and the current account balance (CAB) in Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia. The study examines how an increase in financial account inflows affects the current account balance in these countries over the period 2007–2024, taking into account the characteristics of the individual economies. Accordingly, the study tests the following hypothesis:

> *(H0): There is a negative and statistically significant long-run relationship between the FAB and the CAB in the Western Balkan countries over the period 2007–2024, with heterogeneous adjustment towards that long-run relationship.*

Although the economic literature addresses the role of capital flows in transition economies, relatively few studies systematically examine the long-run relationship between the FAB and the CAB in these countries. This paper contributes to the literature in several ways. First, it examines the long-run relationship between the FAB and the CAB in the Western Balkan countries over a period encompassing the global financial crisis, the COVID-19 pandemic, and ongoing geopolitical turbulence. Second, the heterogeneous panel approach, based on the Pooled Mean Group (PMG) estimator, distinguishes the long-run relationship from short-run dynamics and estimates the speed of adjustment towards long-run equilibrium in individual countries. Third, the study offers empirical insights into the sustainability of a growth model based on capital inflows, with implications for policies aimed at strengthening external sustainability in the region.

The introduction is followed by a review of the literature on the role of capital inflows in shaping external (im)balance (Section 2). The third section presents a descriptive analysis of the current and financial accounts of the Western Balkan countries, followed by a section on the methodology and empirical findings; the fifth and final section presents the conclusions and recommendations for policymakers.

1. LITERATURE REVIEW

External imbalances in the Western Balkan countries are reflected in persistent current account deficits, driven largely by chronic trade deficits. Negative primary income balances exert additional pressure. A current account deficit need not be a cause for concern if reliable and sustainable means of financing it are available. More serious problems arise when the imbalance deepens and persists (Devadas and Loayza 2018). Under the balance-of-payments identity, the current account deficit is financed by a surplus on the financial account, which comprises flows of foreign direct investment (FDI), portfolio investment (PI), and other

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investment (OI). The economic literature and numerous empirical studies underscore the importance of net FDI inflows in financing current account deficits, as they provide a stable, long-term source of external financing (Botrić 2010; Hlivnjak 2010; Kovačević 2022; Čakajac, Janković and Dimitrijević 2024; Sekulić, Beker Pucar and Glavaški 2024). In addition to its stabilising role, FDI stimulates economic growth through technology transfer, productivity gains, improved export performance, and employment growth, thereby strengthening long-run external sustainability. Attracting FDI into new production capacity is therefore an objective for any export-oriented economy (Stanišić 2020; Nikolić 2021; Ercegovac and Beker Pucar 2022; Uvalić 2025). Reliance on short-term capital inflows such as portfolio and other investment is a riskier strategy because these flows are more volatile and prone to sudden reversals. Dependence on foreign capital exposes national economies to a greater risk of destabilising "sudden stop" episodes and costly adjustment in the real economy (Svrtinov et al. 2015).

Previous research also points to the dual role of capital inflows, particularly FDI. Although such inflows help finance current account deficits, the long-run accumulation of foreign capital increases primary income outflows through the repatriation of profits and dividends and the payment of interest. Capital inflows can thus have a dual effect on balance-of-payments (im)balance, financing existing deficits while generating future income outflows (Yan and Yang 2008; Sarialioglu Hayali 2020).

Research also points to a significant relationship between capital inflows, the trade balance, and external (im)balance. Studies of the Western Balkans confirm that capital inflows can stimulate domestic demand and investment, often increasing imports and widening the trade deficit, particularly in economies with limited export capacity (Trpeski et al. 2021; Sekulić, Beker Pucar and Stojkov 2025). Capital inflows play an important role in the region's economic development, but their effect depends on their sectoral composition, institutional quality, and the economy's capacity to generate sustainable long-run growth (Vučković et al. 2020; Gebre Borojo and Yushi 2020; Disha and Fetai 2024).

2. DESCRIPTIVE ANALYSIS OF CURRENT AND FINANCIAL ACCOUNTS IN THE WESTERN BALKANS

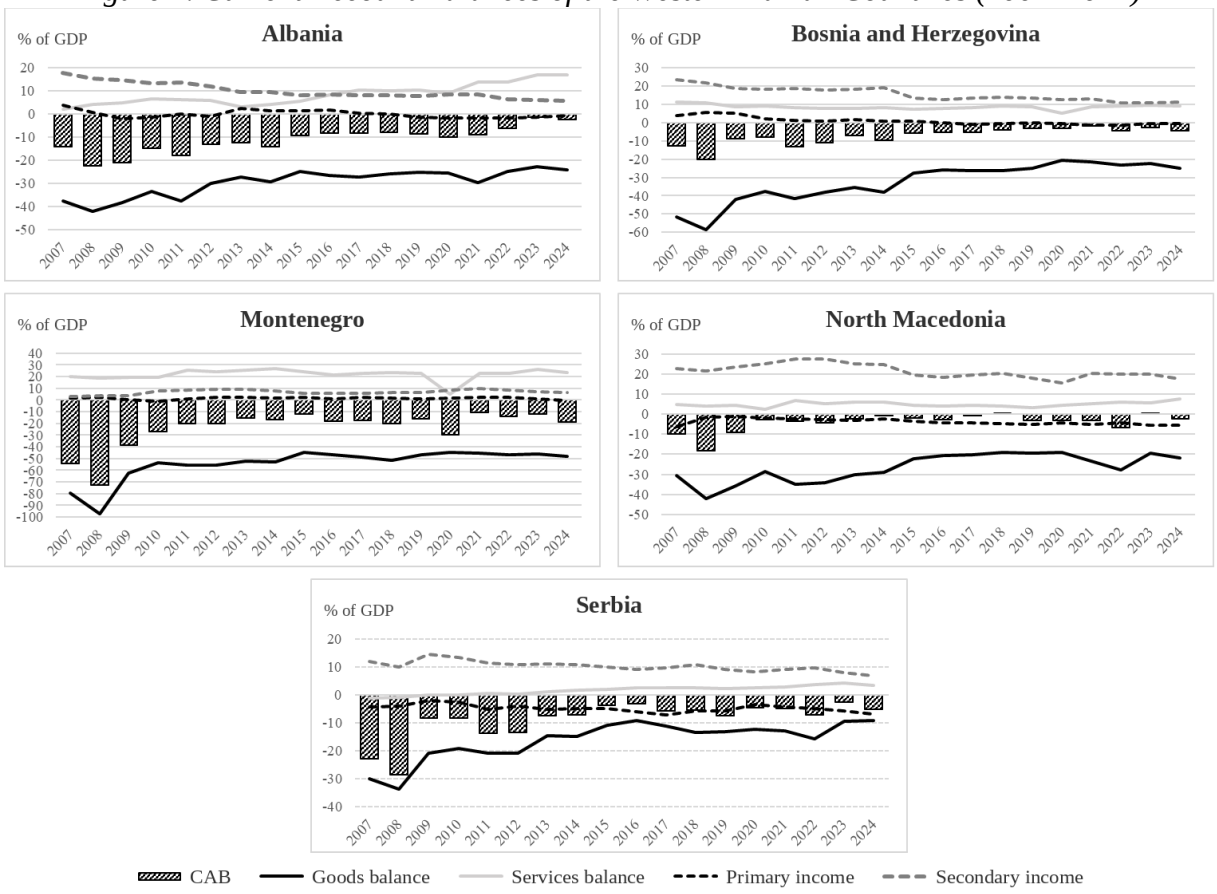
Analysis of the current account provides a comprehensive view of the main drivers of balance-of-payments (im)balance and illustrates policymakers' capacity to address external imbalances. The Western Balkan countries record persistent current account deficits, driven by large deficits in goods trade and negative primary income balances. The services trade surplus and the positive secondary income balance help offset the current account deficit; the secondary income surplus largely reflects remittance inflows from abroad. Over the period 2007–2024, the current account deficit as a share of GDP was most pronounced in Montenegro, followed by Serbia, Albania, and Bosnia and Herzegovina, while North Macedonia posted a small surplus in some years. Figure 1 presents the current account balance and its components: the goods balance, the services balance, primary income, and secondary income.

Small, open economies undergoing real convergence towards advanced economies are characterised by high import dependence and limited export capacity (Estrin and Uvalić 2016). Consequently, the structural deficit in goods trade is the main source of the current account deficit in all economies under study. The primary income deficit reflects the composition of capital inflows, primarily FDI but also other forms of external financing, which give rise in the long run to primary income outflows through the repatriation of profits

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and dividends and the payment of interest. Among the countries analysed, the primary income deficit is most pronounced in Serbia, followed by North Macedonia and, to some extent, Albania.

Figure 1. Current Account Balances of the Western Balkan Countries (2007–2024)



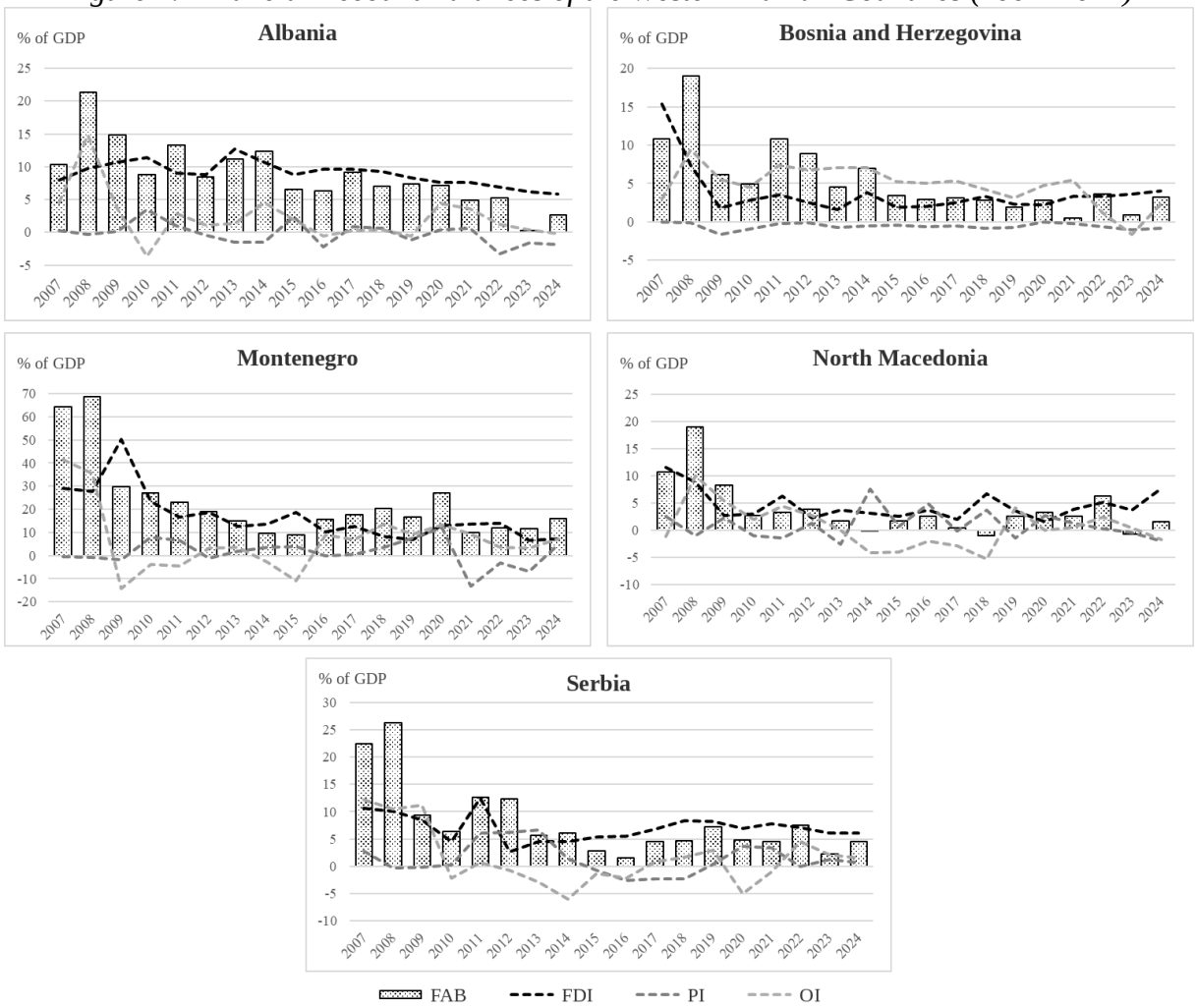
Source: Authors' compilation based on data from the International Monetary Fund (IMF) 2025 and Eurostat.

By contrast, all five Western Balkan countries record a surplus in services trade. The surplus is largest in Montenegro, where tourism is the main source of foreign exchange inflows. Albania's services surplus shows a clear upward trend, while Serbia, Bosnia and Herzegovina, and North Macedonia record modest but steady growth. In addition to surpluses in services trade, all countries in the sample have positive secondary income balances, which play a key role in mitigating external imbalances. Over the period under review, secondary income surpluses were largest in Bosnia and Herzegovina and North Macedonia, where remittances from abroad contribute substantially to reducing the current account deficit. Serbia also relies heavily on these inflows. In Albania, the relative importance of secondary income has gradually declined, while its contribution in Montenegro remains small. Although the services and secondary income surpluses help narrow the current account deficit, they cannot fully offset the sources of external imbalances in the region.

The analysis now turns to the components of the financial account, their role in financing current account deficits, and their contribution to external (im)balance. All Western Balkan countries record financial account surpluses, owing mainly to positive net FDI inflows, which provide a stable source of long-term external financing. Portfolio and other investment also play an important role, although they are considerably more volatile and

sensitive to external shocks and changes in financial conditions. Figure 2 illustrates the financial account flows, including foreign direct, portfolio, and other investment.

Figure 2. Financial Account Balances of the Western Balkan Countries (2007–2024)

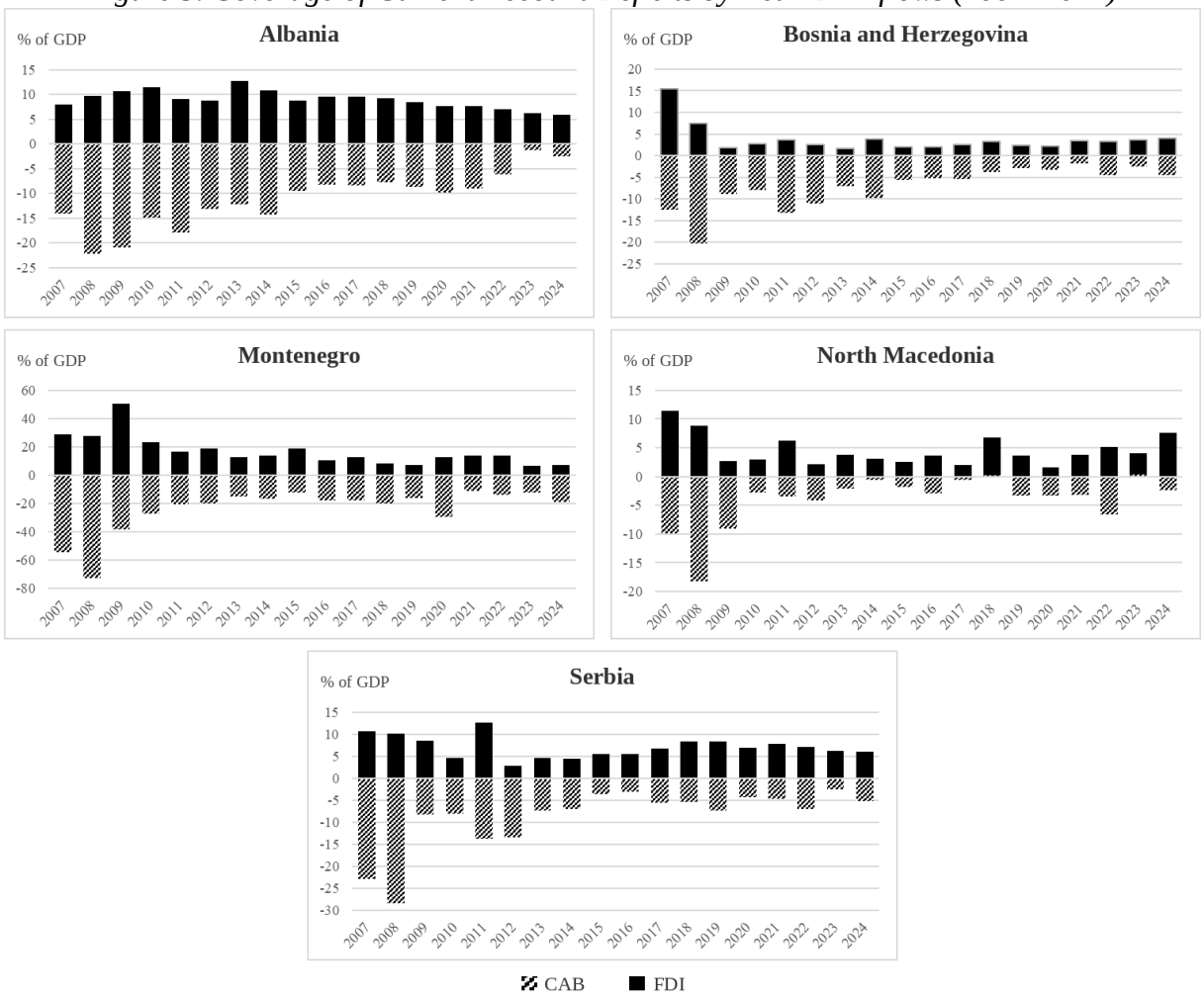


Source: Authors' compilation based on IMF 2025 and Eurostat data 2025

In Albania's financial account, FDI plays a dominant and relatively stable role, while portfolio and other investment play a smaller part. The composition and flows of the financial account showed no major fluctuations during the global financial crisis or in the ensuing years up to the outbreak of the COVID-19 pandemic. FDI inflows fell during the pandemic and the ongoing geopolitical crisis. In Bosnia and Herzegovina, other investment plays a prominent role as a short-term source of financing compared with FDI, which fell sharply after the onset of the global financial crisis and remained relatively low through the end of the period. Montenegro experiences cyclical FDI inflows and noticeable fluctuations in other investment. The pandemic and the geopolitical crisis further increased the volatility of capital inflows. These patterns reflect Montenegro's heavy reliance on external capital and the greater vulnerability of its economy to external shocks. North Macedonia's financial account is characterised by variable FDI inflows and frequent fluctuations in portfolio and other investment. The global financial crisis and the pandemic temporarily weakened capital flows without causing major disruptions, while intensifying geopolitical tensions increased the volatility of short-term capital inflows. In Serbia, FDI is the main and most stable source of external capital compared with portfolio and other investment. The crises temporarily reduced

capital inflows, but net FDI inflows remained positive throughout the period, averting the riskier scenario of financing deficits with volatile short-term capital. Figure 3 shows the extent to which net FDI inflows covered current account deficits in Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia from 2007 to 2024.

Figure 3. Coverage of Current Account Deficits by Net FDI Inflows (2007–2024)



Source: Authors' compilation based on IMF 2025 and Eurostat data 2025

In most Western Balkan countries, net FDI inflows play a significant role in financing current account deficits, with coverage often exceeding 100%. From the perspective of balance-of-payments equilibrium, this means of financing a current account deficit is considered favourable because it relies on more stable, longer-term capital inflows. However, reliance on foreign capital has limitations when it comes to ensuring long-run external sustainability. Rising FDI inflows give rise to income outflows over the medium and long run, thereby widening the current account deficit. FDI can thus have a dual effect, financing the current account deficit while also potentially deepening it. For these reasons, the role of FDI should extend beyond financing deficits to expanding export capacity and reducing import dependence, so that its beneficial effects prevail and help sustain balance-of-payments equilibrium.

3. METHODOLOGICAL FRAMEWORK AND EMPIRICAL RESULTS

The empirical analysis uses a panel data econometric framework to examine the long-run relationship between the FAB and the CAB. The sample comprises five Western Balkan countries: Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia, over the period 2007–2024. The period covers three global crises: the global financial crisis, the pandemic, and the ongoing geopolitical crisis. The study uses the (Pooled) Mean Group estimation approach. The Hausman specification test was used to select the more efficient of the Mean Group (MG) and Pooled Mean Group (PMG) estimators within the panel autoregressive distributed lag (ARDL) framework.

PMG assumes a homogeneous long-run relationship between the variables across all countries in the sample. This assumption is suitable for the Western Balkan countries given their similar patterns of external (im)balance, their reliance on external financing, and their comparable institutional and transition characteristics. PMG allows both the error correction coefficient, which measures the speed of adjustment towards long-run equilibrium, and the short-run coefficients to vary across countries in the sample. This study focuses on the long-run relationship.

The study uses data from the publicly available international databases of the International Monetary Fund and Eurostat, ensuring methodological consistency and international comparability. The dependent variable, the current account balance (CAB), and the independent variable, the financial account balance (FAB), are both expressed as percentages of gross domestic product (GDP). For the purposes of this analysis, the FAB excludes changes in foreign exchange reserves and comprises net flows of foreign direct investment (FDI), portfolio investment (PI), and other investment (OI).

The econometric analysis begins by testing for cross-sectional dependence (CSD). Table 1(a) presents the results of Pesaran's CD test. The findings reject the null hypothesis of independence and indicate dependence in the variables under study. These results call for a second-generation unit root test, specifically Pesaran's CIPS test, which allows for CSD (Mohammad Hashem Pesaran, 2007). The unit root tests suggest that the null hypothesis of nonstationarity cannot be rejected, implying that the CAB and the FAB are nonstationary in levels.

Table 1. Pesaran's CD Test, Pesaran's CIPS Test, and Westerlund's Cointegration Test

Sample: Western Balkan countries, 2007–2024							
(a)			**(b)**				
Variables	**Pesaran's CD test**	**p-value**	**Lags**	**CIPS test in levels**	**p-value**	**CIPS test in first differences**	**p-value**
CAB	10.53	0.000	0	-2.629	0.025	-4.423	0.000
			1	-2.218	0.145	-4.129	0.000
			2	-1.839	0.407	-2.084	0.221
FAB	10.82	0.000	0	-2.586	0.031	-4.574	0.000
			1	-1.909	0.349	-4.073	0.000
			2	-1.143	0.899	-2.069	0.231
(c)							
Westerlund's cointegration test					**p-value**		
-2.0136					0.0220		

Source: Authors' calculations.

Both series were then tested in first differences and found to be stationary, indicating that they are integrated of order one, I(1) (Table 1(b)). The Westerlund test was used to examine cointegration between the variables (Damiaan Persyn and Joakin Westerlund 2008). The test results reject the null hypothesis of no cointegration in favour of the alternative hypothesis that the CAB and the FAB are cointegrated (Table 1(c)).

Table 2 presents the homogeneous coefficients estimated using the (P)MG models. The results indicate a negative and statistically significant long-run relationship between the FAB and the CAB over the period 2007–2024, confirming hypothesis H0. Thus, in the long run, an increase in the FAB of one percentage point of GDP deepens the current account deficit by 1.1 percentage points of GDP under MG and by 1.0 percentage point of GDP under PMG. The error correction coefficient is negative and statistically significant, indicating the speed of adjustment towards long-run equilibrium: 85.6% (MG) or 70.9% (PMG) of the CAB's deviation from equilibrium is corrected each year. The Hausman test provides the basis for choosing between MG and PMG. If the null hypothesis of parameter homogeneity cannot be rejected (p-value > 0.05), PMG is the more efficient estimator, as in this study, where the p-value is 0.2334.

Table 2. MG and PMG Model Results for Homogeneous Coefficients

Sample: Western Balkan countries, 2007–2024				
Dependent variable: CAB **Independent variable: FAB**	**Long-run equilibrium relationship (θ)**		**Error correction (Φ_i)**	
	Coefficient	**p-value**	**Coefficient**	**p-value**
MG	-1.107091	0.000	-0.8564296	0.000
PMG	-1.017213	0.000	-0.7088334	0.000
Hausman test	0.2334			

Source: Authors' calculations.

Estimating the error correction coefficient reveals how the adjustment towards long-run equilibrium differs across economies, one of the main advantages of the heterogeneous panel approach. The error correction coefficient is negative and statistically significant at the 5% level in Albania, Montenegro, North Macedonia, and Serbia, and at the 10% level in Bosnia and Herzegovina. This points to a relatively weaker, though still present, mechanism for correcting long-run imbalances in Bosnia and Herzegovina and to differences in adjustment speeds across countries (Table 3). Serbia and Montenegro adjust most rapidly to long-run equilibrium, followed by North Macedonia, Albania, and finally Bosnia and Herzegovina. In Serbia and Montenegro, adjustment is particularly rapid: within one year, the correction exceeds the initial deviation from equilibrium, indicating overshooting.

Table 3. PMG Model Results with Heterogeneous Coefficients

Sample: Western Balkan countries, 2007–2024		
PMG	**Error correction (Φ_i)**	
	Coefficient	**p-value**
Albania	-0.4579635	0.006
Bosnia and Herzegovina	-0.2601314	0.081
Montenegro	-1.074663	0.000
North Macedonia	-0.6639671	0.001
Serbia	-1.087442	0.000

Source: Authors' calculations.

In Serbia, this pattern may indicate a relatively effective external adjustment mechanism, whereby the current account can respond quickly and move back towards long-run equilibrium after shocks arising from changes in the financial account. A similar pattern in Montenegro reflects the structure of its economy, particularly the important role of the services sector, which may help the current account adjust more rapidly after changes in capital flows. North Macedonia and Albania exhibit moderate rates of adjustment, reflecting the gradual correction of imbalances between the FAB and the CAB. By comparison, the slower adjustment in Bosnia and Herzegovina reflects more persistent external imbalances and a weaker adjustment response to changes in international capital flows.

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CONCLUSION

This paper used the Pooled Mean Group (PMG) estimator to examine the long-run relationship between the financial and current account balances of the balance of payments in Albania, Bosnia and Herzegovina, Montenegro, North Macedonia, and Serbia over the period 2007–2024. Drawing on the balance-of-payments identity and the dual role of capital inflows, the study assessed whether an increase in foreign direct, portfolio, and other investment inflows recorded in the financial account helps stabilise the external position or deepens external imbalances.

The empirical findings confirm a negative and statistically significant long-run relationship between the financial account and the current account. The results indicate that an increase in the financial account surplus is associated with a deeper current account deficit in the long run. This relationship confirms that inflows of external capital absorb existing imbalances while also generating future liabilities. The estimated error correction coefficient points to a mechanism for adjustment towards long-run equilibrium in all the Western Balkan countries studied, although the speed of adjustment varies across economies. In our sample, adjustment is fastest in Serbia and Montenegro, followed by North Macedonia in third place, then Albania and, finally, Bosnia and Herzegovina.

The results have implications for policymakers in the region. Relying on capital inflows to finance current account deficits cannot provide a sustainable long-run development model unless the export base also expands. Economic policy should improve the sectoral allocation of investment, encourage productive and export-oriented activities, and strengthen the institutional and financial framework so that economies are more resilient to external shocks and crises. Reducing reliance on short-term and volatile investment flows through appropriate macroprudential and regulatory instruments is particularly important.

Future research could extend the sample to include emerging EU member states, cover a longer period, and examine the short-run adjustment coefficients in more detail, allowing for a broader comparison of patterns of external adjustment.

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