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**THE CAUSAL LINKAGE BETWEEN POLITICAL STABILITY
AND FOREIGN DIRECT INVESTMENTS IN BOSNIA AND
HERZEGOVINA¹**

**KAUZALNA POVEZANOST POLITIČKE STABILNOSTI
I DIREKTNIH STRANIHNINVESTICIJA U BOSNI I
HERCEGOVINI**

Abstract

This research aims to explore the causal link between political stability (PS) and foreign direct investments (FDI) in the case of Bosnia and Herzegovina (B&H). The motivation to conduct this study lies in the fact that literature to date has paid little attention to the impact of political stability on FDI in the country of interest. In order to investigate the present causal linkage, annual time-series data were collected in the time-span running from 2002 to 2016. To provide empirical evidence we have employed the time-series econometrics. The obtained results indicate that political stability causes foreign direct investments. In addition, the results suggest that foreign direct investments have a causal link with the political stability. This result is of particular importance, given that Bosnia and Herzegovina can benefit significantly from the FDI, especially in the initial period, although long-term

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economic growth requires a sustainable and stable political environment. The outcome of this paper can provide significant insights for policy makers. This is why the concluding remark summarizes in detail the policy implications together with the recommendations for future research.

Key words: Bosnia and Herzegovina, causality, foreign direct investments, political stability

Sažetak

Ova studija istražuje kauzalnu vezu između političke stabilnosti (PS) i direktnih stranih investicija (FDI) u slučaju Bosne i Hercegovine (BiH). Motivacija za provođenje ove studije leži u činjenici da je dosadašnja literatura posvetila nedovoljno pažnje utjecaju političke stabilnosti na direktne strane investicije u BiH. Da bi se istražila kauzalna veza, prikupljeni su podaci vremenskih serija u periodu od 2002. do 2016. godine na godišnjem nivou. Kada je u pitanju metodologija, koristila se ekonometrijska analiza vremenskih serija. Dobiveni rezultati ukazuju da politička stabilnost utiče na direktne strane investicije. Pored toga, rezultati pokazuju da direktne strane investicije utiču na političku stabilnost. Ovaj je rezultat od posebnog značaja, uzimajući u obzir činjenicu da Bosna i Hercegovina može imati značajne koristi od FDI, posebno u početnom periodu, iako dugoročni ekonomski rast zahtijeva održivo i stabilno političko okruženje. Očekuje se da rezultati ove studije daju važne informacije za donosiocje odluka. Zbog toga se u zaključku prezentuju preporuke za donosiocje odluka kao i preporuke za buduća istraživanja.

Ključne riječi: Bosna i Hercegovina, direktne strane investicije, kauzalnost, politička stabilnost

1. INTRODUCTION

There is still no general consensus in contemporary economic theory as to what is the key recipe for transition countries like Bosnia and Herzegovina to reach sustainable economic growth with minimum short-run costs. One of the first steps in this direction is to have a certain systematic understanding of the role of political stability. In addition, it is of particular importance to use the heuristic approach while defining the role of political stability in attracting foreign direct investors as well as the role of political stability in economic development.

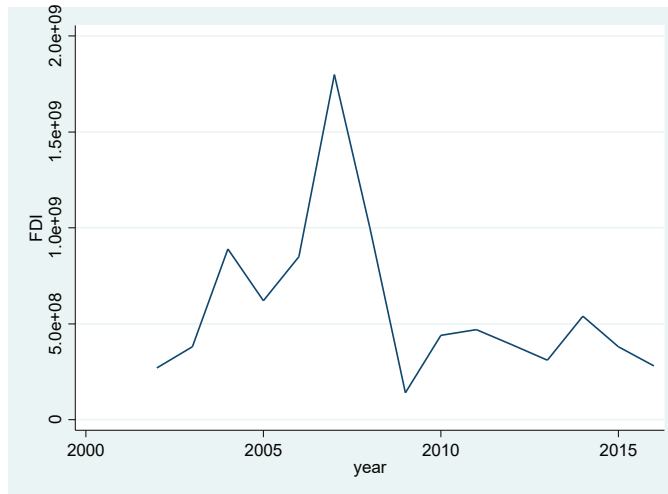
Consequently, this paper addresses these issues, which can be seen in the context of contemporary globalization processes, but also in the much

narrower scope of the analysis of political and other factors that generate and stimulate FDI inflows and overall national competitiveness. New approaches to the evaluation of development flows inevitably bring changes to the fundamental principles of economics, that is, to the very models of measuring the competitiveness of an economy.

The presence of different political structures and factors of development indicated that it was difficult to define a universal model of development that would produce equally successful results, which implied that economic growth could not be viewed unilaterally through an exclusive analysis of the correlation between political stability and FDI. This has shown that the impact of FDI cannot be successful in the absence of complementary policies and institutions, since they generate effective gains only if there is a link to simultaneous improvements to the country's overall legal, political and regulatory framework.

The paper therefore states that with adequate choice of available economic policy measures, Bosnia and Herzegovina should create prerequisites for engaging FDI on strategic foundations of political stability. This would lead to the effective integration of FDI into the national economy, with domestic and foreign resources playing an equally important role in the formation of productive capital volume with a focus on strategically designed development projects.

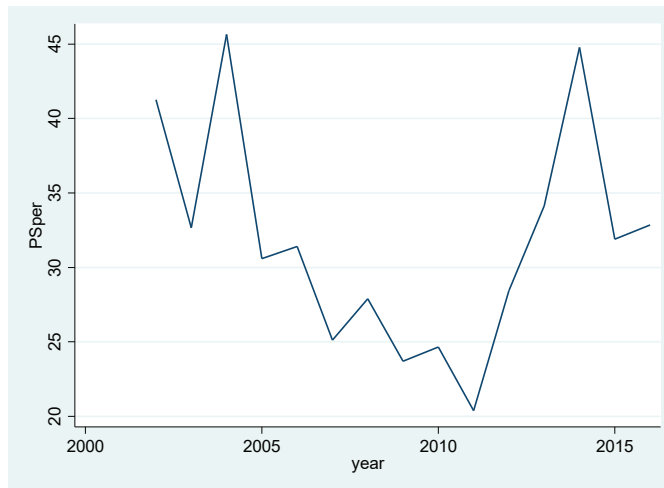
This claim is of particular importance given that B&H can benefit significantly from FDI especially in the initial period, although long-term economic growth primarily requires a sustainable and politically stable environment, financial adjustment and mobilization of domestic financial resources. Thus, the findings of this paper display a bidirectional causal link between the two variables of interest. When it comes to FDI statistics, Graph 1 indicates a growing trend towards the global financial crisis when FDI records a significant decline. After the crisis period, there was a steady increase in FDI by the end of the observed period.

Graph 1: Inflow of foreign direct investments (B&H)

Source: Authors

The importance of exploring the link between political (in)stability and FDI is reflected in the fact that political instability can seriously undermine a country's economic performance (Nazeer and Masih, 2017). Alesina et al. (1996) define political instability as a tendency for government collapse. This collapse may be the result of conflict or intense competition between different political parties. Similarly, a government change case would increase the possibility of successive change. Furthermore, Milutinović (2011) points out that political instability in B&H is linked to a complex, inefficient and corrupt political system. The author also points to the necessary reform of the political system since it is a source of frequent misunderstandings and contributes to instability. When it comes to the proxy variable of political stability, Graph 2 indicates significant fluctuations in political stability and absence of violence/terrorism: percentile rank in B&H over the observed period.

Graph 2: Political stability and absence of violence/terrorism: percentile rank in B&H



Source: Authors

In order to achieve political stability in B&H, it is necessary to adjust the interest of all political parties. Political stability is crucial for the improvement in the standard of living as well as to reduce inequality. Considering the preceding paragraphs, political stability is also an important factor in economic development. Due to the need to improve political stability, this paper explores the aforementioned economic phenomenon in B&H and its connection with FDI. After the introductory part, a detailed literature review is presented. The data and methodology used as well as the research results are further displayed. At the very end, concluding remarks are presented together with the policy implications.

2. LITERATURE REVIEW

A large body of research analyzes the link between FDI and economic growth (Muslija, 2017; Sarajčić, 2004). Also, a great deal of research points to the importance of political stability for achieving sustainable economic growth (Carmignani, 2003; Alesina et al., 1996; Barro and Lee, 1994). However, to the authors' knowledge, few studies address the link between FDI and political stability in the case of Bosnia and Herzegovina, which motivated the authors to conduct this research.

One of the key factors that drive foreign investors in making investment decisions is political risk (Moosa, 2002). Political risk is associated with confiscation or damage to property, production problems, and threats to staff, including operational restrictions that prevent the investor from taking certain actions (Daniels et al., 2002). With regard to Asian countries, Woo and Heo (2009) indicate that politically motivated corruption has a significant negative effect on FDI.

Nazeer and Masih (2017) analyzed the impact of political instability on foreign direct investment and economic growth in the case of Malaysia. The time-series data were collected between 1984 and 2013. The results of this study indicate the linkage amid these economic phenomena, both in the long and the short term, where economic growth emerges as the most important determinant of political instability and foreign direct investment in Malaysia. Therefore, the authors outline the need to stimulate economic growth in order to achieve political stability and to attract a significant inflow of foreign direct investments.

Kim (2010) explored the link between FDI and political stability. Survey results indicate that countries with high levels of political risk have a greater outflow of foreign direct investment. Also, the author points out those countries with high corruption and low democracy have a higher outflow of foreign direct investment. It is therefore concluded that political risk is an important determinant of FDI. Similar results are also presented in Lucas (1990) and Singh and Jun (1995), which indicate that political risk is an important determinant of FDI, especially in countries with high FDI inflows.

Nadeem (2015) examined the link between FDI and political stability in Pakistan. In order to investigate the aforementioned relationship, data were collected in the period between 1972 and 2012. The results indicate a long-term causal link between the aforementioned economic phenomena in the case of Pakistan. Therefore, the author emphasizes the need to change policies in order to achieve a greater inflow of foreign direct investment into Pakistan.

Musibah (2017) analyzed the impact of macroeconomic variables such as business environment on foreign direct investment (FDI) inflows into selected countries in the Middle East and North Africa. In this respect, these countries are categorized into two groups, the republic and the monarchical countries, to better examine whether political stability plays a moderating role between macroeconomic variables, business environment and FDI. This study used annual data from 2000 to 2016. Data were collected from official

sources such as UNCTAD and the World Bank. The Generalized Least Squares (GLS) method was used. The results indicate a strong influence of political stability as a moderating variable between macroeconomic variables, business environment and FDI for republic countries; unlike the monarchical countries. In the context of this study, it is important to emphasize that political risk is highly dependent on political stability, thus political stability is necessary to attract direct foreign investment (Musibah et al., 2015).

Musibah et al. (2015) point out that political instability is undesirable because it adversely affects the economic development and growth of the country through a negative impact on physical and human resources. In the case when a country has a low level of political stability, foreign investors often hesitate to invest in that country. Undoubtedly, the causes of political unrest and the growth of investment risks such as changes in the political regime, inappropriate involvement of government in economic factors; rigid property and legislative procedures, bureaucracy and so on can mark a serious negative impact on foreign investment (Yimer, 2017). Moreover, global investors and international organizations place great emphasis on the FDI decision-making process.

Milutinović (2015) points out that the political system in B&H is complex and as such often causes misunderstandings and irregularities. The author also emphasizes the need for democratic dialogue of all political parties in order to create the conditions for sustainable economic development. Political instability in B&H has contributed to a decline in the country's credit rating. Instability also increases the risk for foreign investors and reduces the inflow of FDI. All this significantly slows down the country's economic growth. Furthermore, financial institutions do not show great willingness to finance development projects precisely because of the downgrading of the credit rating. Consequently, interest rates are much higher and banks have very strict operating restrictions.

The preceding paragraphs indicate the importance of political stability not only in attracting foreign direct investment but also in the growth of the economy as a whole. The papers presented in the literature review prove this claim not only in the case of European but also Asian and African countries. The motive for writing this paper lies in the fact that few papers provide empirical evidence on the link between political stability and foreign direct investment in Bosnia and Herzegovina. An additional motive is the fact that B&H aspires to join the European Union (EU). However, the country is still not ready to take the full obligations of EU membership. For this purpose,

it is of key importance to enforce related legislation and to make necessary changes towards the development of political stability that will attract foreign direct investment and finally support economic growth.

3. DATA AND METHODOLOGY

This part of the paper summarizes the employed methodology together with the data used. To perform the empirical research, the researchers have collected the annual time-series data in the period between 2002 and 2016 from The World Bank for the case of Bosnia and Herzegovina. The main criterion to select the time-frame was the data availability with the particular aim to include the latest available data. In terms of the proxy variable of political stability, Jewel (2015) suggests the Political Stability and Absence of Violence/Terrorism: Percentile Rank (PS) as appropriate. Thus, this measure is employed in the present research. PS actually measures the probability of the political instability or violence that is politically motivated including terrorism. The rank positions the country at the global scale whereas 0 indicates the lowest rank and 100 highest rank.

With regards to the proxy variable of foreign direct investments, it is worthwhile noting that the inflow of foreign direct investments in USD (FDI) is considered as appropriate in various studies (Sothan, 2017; Mehic et al., 2013; Dritsakia and Stiakakisb, 2014 and Pegkas, 2015). Thus, this measure is considered appropriate in the present research examining the linkage amid political stability and foreign direct investments in the case of Bosnia and Herzegovina.

As indicated above, the researchers have employed the time-series econometrics. At first, they tested for the stationarity properties of the variables employed. For this purpose the Augmented Dickey Fuller test and Phillips–Perron test have been employed. Furthermore, they have tested for the causal links between the variables of interest by employing the Toda and Yamamoto approach. The Toda and Yamamoto approach may be outlined within the eight steps explained below. The first step presents the main measures of the location. These measures are used to describe the data. The motivation behind selecting Toda and Yamamoto approach lies in the fact that it does not require a specific order of integration i.e. variables may also be non-cointegrated. This assumption is of particular importance in this research, taking into account the fact that the study operates with a relatively short time-series. Toda and Yamamoto (1995) describe in details the procedure used to analyze the causal

link between two or more variables. The formalization is given in Equations 1 and 2 as following:

$$y_t = \mu + \sum_{i=1}^{p+m} \alpha_i y_{t-i} + \sum_{i=1}^{p+m} \beta_i x_{t-i} + u_{1t} \quad (1)$$

$$x_t = \mu + \sum_{i=1}^{p+m} \gamma_i x_{t-i} + \sum_{i=1}^{p+m} \delta_i y_{t-i} + u_{2t} \quad (2).$$

To give a brief explanation, it is important to emphasize that m indicates the order of integration; whereas optimal number of lags is denoted by p . Very important assumptions are normal distributions of the error as well as no serial correlation. It is of particular importance to determine the order of integration. Thus, the Toda and Yamamoto approach starts with the examination of the stationary properties of the variables. As indicated above, the Augmented Dickey-Fuller-ADF (Satrovic, 2017) and Phillips-Perron-PP tests have been employed. Augmented Dickey-Fuller test is based on the following regression equation (Eq. 3):

$$y_t = \beta' D_t + \varphi y_{t-1} + \sum_{j=1}^p \omega_j \Delta y_{t-j} + \varepsilon_t \quad (3)$$

where D_t denotes the vector of deterministic terms, ε_t is not autocorrelated. With regards to the PP test, Phillips and Perron (1988) formalize the test regression as Equation 4:

$$\Delta y_t = \beta' D_t + \pi y_{t-1} + u_t \quad (4)$$

where $I(0)$ is stationary and can be heteroskedastic.

Moreover, the maximum order of integration is denoted by d . The optimal number of lags is determined following the common criteria: Akaike's information criterion (AIC) and the Hannan and Quinn information criterion (HQIC). Further steps include the formalization of the VAR model (Eq. 5 and 6):

$$y_t = \mu + \sum_{i=1}^{p'+m'} \alpha_i y_{t-i} + \sum_{i=1}^{p'+m'} \beta_i x_{t-i} + u_{1t} \quad (5)$$

$$x_t = \mu + \sum_{i=1}^{p'+m'} \gamma_i x_{t-i} + \sum_{i=1}^{p'+m'} \delta_i y_{t-i} + u_{2t} \quad (6).$$

Due to the fact that VAR does not solely give much information, we proceed to the Granger causality test. Therefore, the inference on the link between political stability and foreign direct investments in the case of Bosnia and Herzegovina is based on the findings of the Granger causality test.

4. RESULTS OF THE RESEARCH

Findings of this study will be presented within the eleven steps explained below. The first step provides the main measures of descriptive statistics. The minimum inflow of FDI is recorded in the year 2009 whereas the maximum value is recorded in 2007 (Table 1).

Table 1: Descriptive statistics

stats	FDI	PS
mean	584000000	31.56
sd	417000000	7y.44
max	1800000000	45.63
min	140000000	20.38
skewness	1.752	0.619
kurtosis	5.804	2.551

Source: Authors

Standard deviation indicates significant dynamics in the variable of interest. With regards to the political stability, the average rank is 32. The maximum rank is recorded in 2004 whereas the minimum rank is recorded in 2011. As in the case of FDI, standard deviation implies significant fluctuations in terms of this variable. For this reason, we have calculated the natural logarithm and this value is used in the research to follow. The next steps of this analysis aim to determine the order of integration. For this purpose, the Augmented Dickey-Fuller-ADF and Phillips-Perron-PP tests have been utilized. Tables 2 and 3 provide the obtained findings.

Table 2: Augmented Dickey-Fuller (ADF) test

Variable		Test Statistics	1% Critical Value	5% Critical Value	10% Critical Value
lnFDI	Z(t)	-3.422	-4.380	-3.600	-3.240
	MacKinnon approximate p-value Z(t) = 0.0485				
D.lnFDI	Z(t)	-4.045	-4.380	-3.600	-3.240
	MacKinnon approximate p-value Z(t) = 0.0076				
lnPS	Z(t)	-1.307	-4.380	-3.600	-3.240
	MacKinnon approximate p-value Z(t) = 0.8863				
D.lnPS	Z(t)	-5.149	-4.380	-3.600	-3.240
	MacKinnon approximate p-value Z(t) = 0.0001				

Source: Authors

Table 2 outlines the findings of the Augmented Dickey-Fuller-ADF test. Log levels of both variables are found to contain unit root for a 1% significance level. For this purpose, it was necessary to test for the stationary properties of the first difference. The findings of the ADF test suggest that null on unit root should be rejected implying that the first differences are found to be stationary. We further proceed to the Phillips-Perron-PP tests.

Table 3: Phillips-Perron test

Variable		Test Statistics	1% Critical Value	5% Critical Value	10% Critical Value
lnFDI	Z(t)	-2.704	-3.750	-3.000	-2.630
	MacKinnon approximate p-value Z(t) = 0.0733				
D.lnFDI	Z(t)	-4.117	-3.750	-3.000	-2.630
	MacKinnon approximate p-value Z(t) = 0.0009				
lnPS	Z(t)	-2.395	-3.750	-3.000	-2.630
	MacKinnon approximate p-value Z(t) = 0.1432				
D.lnPS	Z(t)	-5.160	-3.750	-3.000	-2.630
	MacKinnon approximate p-value Z(t) = 0.0000				

Source: Authors

Table 3 outlines the findings of the Phillips-Perron-PP test. Log levels of both variables are found to contain unit root for a 1% significance level. For this purpose, it was necessary to test for the stationary properties of the first difference. The findings of PP test suggest that null on unit root should be rejected implying that the first differences are found to be stationary. Thus, PP test supports the ADF test's outcome which indicates that the stationary properties of variables have been satisfied. Therefore, we proceed further to the determination of the number of lags to be employed in the empirical section. Table 4 summarizes the obtained findings. AIC and HQIC agree that the optimal number of lags is 3, therefore we proceed further with 3 lags.

Table 4: The number of lags needed

lag	LL	LR	Df	p	FPE	AIC	HQIC	SBIC
0	-8.86199				0.02097	1.81033	1.78041	1.89115*
1	-6.52313	4.6777	4	0.322	0.028243	2.08719	1.99742	2.32964
2	-5.44965	2.1469	4	0.709	0.050143	2.57494	2.42533	2.97903
3	5.69522	22.29*	4	0	.01916*	1.38413*	1.17468*	1.94985

Source: Authors

In the next step, we have tested for the serial correlation. The employed test suggests no autocorrelation at the first and second lag. At last, we have tested for the causal link between the variables by employing the Granger causality test. Table 5 summarizes the obtained findings. Null assumes no causal link.

Table 5: Granger causality tests

Equation	Excluded	Prob>chi2
lnFDI	lnPS	0.000
lnPS	lnFDI	0.000

Source: Authors

Political stability is found to Granger cause foreign direct investments in Bosnia and Herzegovina. This outcome is expected taking into account that foreign investors prefer to invest in a country that will protect their rights; that pays much attention to doing business; as well as having highly transparent activities in the business sector. Additionally, FDI is also found to Granger

cause foreign direct investments, suggesting that political stability can be enhanced by the inflow of foreign capital. This evidence is of particular importance for decision makers in Bosnia and Herzegovina, assuming that political stability is of key importance to attract foreign investors as that will contribute not only to political stability but to the economy as a whole. Thus, Table 5 suggests a bidirectional link between the variables of interest in the case of Bosnia and Herzegovina in the period between 2002 and 2016.

5. CONCLUSION

This study analyzes the causal link between FDI and political stability in the case of Bosnia and Herzegovina. The annual time-series data were collected between 2002 and 2016. The methodology employs the Toda and Yamamoto approach. The contribution of this paper to the literature is reflected in the fact that the researchers explore the link of interest while focusing on the case of Bosnia and Herzegovina. Furthermore, the latest available data is used in comparison with previous research with special focus on policy recommendation. The findings of this paper suggest that political stability is found to Granger cause foreign direct investment in Bosnia and Herzegovina. This outcome is expected taking into account that foreign investors prefer to invest in a country that will protect their rights; that pays much attention on 'doing business' as well as having highly transparent activities in the business sector. Additionally, FDI is also found to Granger cause foreign direct investment, suggesting that political stability can be enhanced by foreign capital inflows. The results of this study are particularly important given that B&H can benefit significantly from FDI, especially in the initial period, although long-term economic growth requires a sustainable and stable political environment, financial adjustment and the mobilization of domestic financial resources. Therefore, with adequate selection of available economic policy measures, Bosnia and Herzegovina should create the preconditions for engaging FDI on strategic foundations of political stability that would lead to their effective integration into the national economy, with domestic and foreign resources playing an equally important role in the formation of productive capital. Additionally, FDI should be directed to the strategic projects that are well designed and that will lead to sustainable economic growth.

However, this research also has some limitations. The analysis considers only two variables that were deemed relevant. Therefore, future researchers are advised to include more variables in order to obtain a more comprehensive

picture of the linkage amid these macroeconomic variables. It is primarily necessary to investigate the impact of energy, given its key role in the production process (Abul et al., 2019). It is worthwhile noticing that Bosnia and Herzegovina has a great potential for attracting foreign direct investment in renewable energy. Additionally, it will be of great importance to include the role of tourism in the nexus of interest (Muslija et al., 2017). Furthermore, this paper aims to highlight the need for the further exploration of the link between political stability and FDI so that adequate comparisons can be made and better recommendations given to decision makers. Based on the results presented in this research, it is concluded that decision makers should create adequate policies that will facilitate foreign investors' business operations and thus increase their interest in investing in B&H. In addition, special attention should be paid to raising the level of 'doing business'. Finally, investor confidence needs to be boosted by sending a positive political message and creating an image that will present Bosnia and Herzegovina as a very attractive country to invest in, rather than a country with a low rank in terms of political stability at the global level.

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