



## DO AUDIT AND ACCOUNTING PRACTICES MATTER FOR GREENFIELD FDI INFLOWS?

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**Abstract:** The study examines how the strength of the application of audit and accounting standards, as a component of the institutional infrastructure, affects the greenfield FDI in the four countries of the former Socialist Federal Republic of Yugoslavia over a twelve-year period (2006-2017). Using standard panel data econometric techniques, we conclude that stronger application of audit and accounting standards has a positive impact on attracting greenfield FDI, and that the strength of the application seems to be more important in stable business conditions. Our results are relevant to policy makers, as they point to the need for constant improvement in the accounting and audit system, thus encouraging better transparency and lower transaction costs for investors.

**Keywords:** Greenfield foreign direct investments, audit and accounting standards, compliance, Western Balkan countries

**JEL classification:** F21, F40, M40

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## 1. Introduction

Foreign capital inflows which support new capital formation, so called greenfield investments (greenfield FDI), are essential for developing countries in expanding their capital stocks, generating new economic activity and creating jobs (e.g., Canton & Solera, 2016). Developing economies constitute 70% of global FDI and demonstrate greater vulnerability during systemic events (such as, Covid-19 pandemic) with respect to the variation of greenfield FDI inflows compared to the developed world. To be more specific, transition economies have been heavily affected during the pandemic experiencing a drop in greenfield FDIs by 60%, of which Serbia had one of the biggest declines (78%) (UNCTAD, 2021). The supply chain disruptions, caused by the pandemic, have elevated the risks of FDI outflows, but also created opportunities for developing world to attract new investments as the multinational companies reconsider their supply chain networks. Consequently, understanding the drivers of greenfield FDIs is of great importance, especially for Western Balkan countries which have different absorption power of FDI.

The increasing amount of FDI flowing into transition and emerging countries has attracted high academic attention. The quality of the regulatory environment, institutions and application of law, can play an important role in affecting FDI location within these economies (Demirbag et al., 2010; Peres et al., 2018; Bhasin & Garg, 2019; Vučković et al., 2020). Foreign investors are likely to avoid countries with instable legal framework (Bénassy-Quéré et al., 2007) and high levels of corruption and bureaucracy (Wei, 2000). In regard with the institution environment in host country, many studies have recognized the significant positive effect of International Financial Reporting Standards (IFRS) and International Standards on Auditing (ISA) adoption on FDI inflows across different economies (for a review see: Siriopoulos et al., 2021), which are found to be stronger in the developing countries (Gordon et al., 2012). However, economic literature does not provide enough research on the topic of the effectiveness of the audit and accounting regulatory framework and FDI inflows.

This study aims at providing insights to bridge this gap by offering evidence for the nexus of the strength of the audit and accounting standards (SAAS) and greenfield FDI inflows in the context of the selected emerging European countries. The effective audit and accounting standards supply foreign investors with the reliable and adequate financial information, i.e. impact the quality of financial reporting and auditing. As Achim (2018) states, strong reporting standards result in accounting information which are more reliable and less manipulative. The level of compliance, which is closely connected with the institutions in the country, determines the effectiveness of standards. In this regard, the adoption of IFRS and ISA, without the full compliance of the disclosure requirements and auditing practices, reduces their efficacy (Hodgdon et al., 2008). Furthermore, as Márquez-Ramos (2011) indicates that the interpretation and implementation of IFRS and

ISA may differ across countries with different legal regimes, which also has impact on the effectiveness of standards' implementation. The changes in accounting and disclosure systems driven by audit and accounting standardization should, therefore, appear with simultaneous improvements in the country's institutions, which is particularly important in developing and emerging economies.

In this study, we consider SAAS as a constituent of the institutional environment for greenfield FDI in emerging economies. Our analysis covers a twelve-year period (2006-2017) and refers to four countries of the former Socialist Federal Republic of Yugoslavia (SFRY). Two countries are not yet members of the European Union (EU), such as the Republic of Serbia and Bosnia and Herzegovina (B&H), and the remaining two have a membership - the Republic of Croatia and the Republic of Slovenia. We hypothesize that SAAS in the selected countries promotes greenfield FDI since it reduces information asymmetry and accompanying transaction costs for foreign investors. Our study contributes to the existing literature on location advantages proposed by the eclectic theory of FDI (Dunning, 1979) by demonstrating that the compliance with audit and accounting standards are an important component of the national institutional infrastructure that significantly affects the greenfield FDI inflows.

The paper is structured as follows: In the following section, we present the research context. Section 3 presents the methodology and data description, while Section 4 and 5 provide the empirical results with discussions and conclusions, respectively.

## **2. The research context**

To examine the importance of SAAS for the greenfield FDI inflows, we concentrate on a narrow sample of former SFRY countries which are peculiar due to the following reasons: first, all, except Slovenia, belong to the European emerging economies experiencing different levels of economic development and vulnerability during systemic events; second, the coexistence in the common state and geographical proximity created close historical and cultural relationships and converging development paths, however, the discrepancies in the speed of transition to the accession towards the EU generated divergence, especially with regard to the efficiency in developing market and regulatory institutions; finally, the four countries differ with respect to their FDI absorption power.

While the period of analysis was constrained by data availability, it covers a specific timeline and passage through the 2008 global financial crisis. To analyze the vulnerability during the financial crisis and the co-movements of the variables in question, we divide the period in three subperiods: pre-crisis (2006-2007), crisis (2008-2009) and post-crisis (2010-2017). Figure 1 (lower panel) shows the dynamics of the greenfield FDI to GDP per capita and the index of SAAS during

the three subperiods. B&H, Croatia and Serbia show similar patterns of their greenfield FDI dynamics. These three countries experienced growth in their greenfield FDIs during the crisis period, dropping back to the pre-crisis levels after the crisis subsided. Differently, Slovenia had constant decrease in the greenfield FDIs through the selected subperiods. Evidently, the emerging group showed greater resilience of their greenfield FDI inflows during the crisis. Moreover, the emerging group outperforms Slovenia regarding the greenfield FDIs to GDP per capita ratio, of which Serbia and B&H form the leading group.

On the other side, the cross-country and cross-year differences in the index of SAAS are case-specific. For instance, as Serbia and Slovenia encounter improvement in SAAS during the crisis period, B&H and Croatia experience deterioration. In the post-crisis period, the decrease of the index is apparent for Croatia, Serbia and Slovenia, while B&H is the only that strengthens its audit and accounting standards. Despite the different patterns, the EU group outperforms the non-EU group with respect to the value of the index. Once we consider the comovements of the index of SAAS and greenfield FDI to GDP per capita ratio, we observe regularity for three countries (Croatia, Serbia and Slovenia) in the post-crisis period, as the index decreases the greenfield FDIs dwindle. Moreover, the clarity and usability of financial reports may be impaired by the excessive parsing of balance sheet and income statement items. To highlight the cross-country differences in the degree of parsing of items in these financial reports, we present in Figure 1 (upper panel) the number of balance sheet and income statement items. The number of balance sheet and income statements items in the sample countries is on average 2 to 2.5 times higher than the EU's.<sup>2</sup>

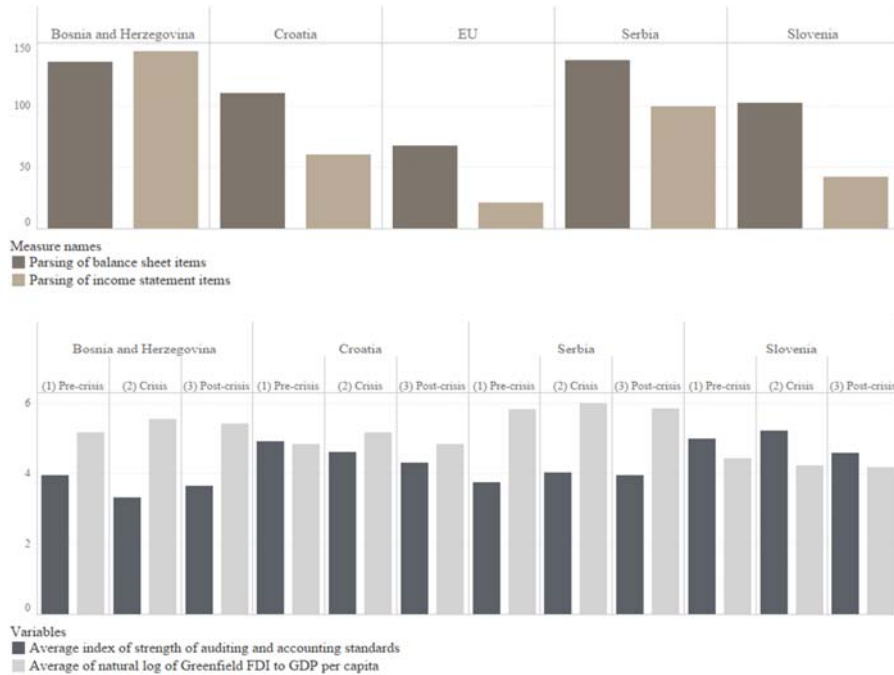
A comparative analysis of the clarity of financial reports of the countries of the former SFRY reveals that all countries have similar problems in this area, which may be a consequence of „copying“ between countries when creating regulations (Malinić, 2015). Increasing the number of items beyond the normal volume jeopardizes clarity. This practice is contrary to the standards offered by EU regulations.

In summary, the selected countries are still behind EU's SAAS, with important cross-country differences in the group. While the countries (B&H and Serbia) with lower SAAS experience higher greenfield FDI to GDP per capita, the time dynamics show that as the SAAS weakens, the greenfield FDIs contract, especially in the post-crisis period.

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<sup>2</sup> In order to gain an idea of the comparability of regulations in these countries, the number of items prescribed by Directive 2013/34/EU is included in the review (Malinić, 2015).

**Figure 1: Cross-country comparison of the main variables during three subperiods and the parsing of the balance sheet and income statement items**



Source: UNCTAD (2018); World Economic Forum (WEF) and Global competitiveness report; and Malinić (2015)

### 3. Data and methodology

We collect annual data for the four countries over the period 2006-2017, resulting in a balanced panel set. Variables' definitions and sources are given in Table 1. We measure the size of the greenfield FDI as a percentage of Gross Domestic Product (GDP) per capita extracting it from UNCTAD's World Investment Report. To proxy for the SAAS, we use the index of the strength of the application of audit and accounting standards collecting it from the World Economic Forum (WEF) and Global Competitiveness report. The index reflects business leaders' perceptions over the strength of application of audit and accounting standards in each country. The variation of greenfield FDI inflows is determined by other important factors, hence we include the most important drivers of greenfield FDI as control variables in the modeling process. We follow Denčić-Mihajlov et al. (2021) and control for economic development (real GDP per capita), price stability (inflation), human capital development (quality of the education system), trade (openness) and labor market constraints (unemployment rate).

**Table 1: Variables' definitions and sources**

Variables	Definition	Source
Dependent variable		
Greenfield FDI to GDP per capita	Natural logarithm of greenfield FDI scaled to GDP per capita, in country $i$ in year $t$ .	United Nations Conference on Trade and Development (UNCTAD), <i>World Investment Report</i> .
Independent variable		
Strength of audit and accounting standards	Index in the country $i$ in year $t$ . This index represents the strength of the application of audit and accounting standards. It is calculated on the basis of a survey conducted among business leaders who rank the strength of the application of these standards in their country (1 - extremely weak, 7 - extremely strong).	World Economic Forum (WEF) and Global competitiveness report.
Control variables		
Real GDP per capita	The natural logarithm of the real gross domestic product per capita (in US dollars), in the country $i$ in the year $t$ .	World Bank Open Data database.
Inflation	Inflation rate, presented as the annual consumer price index, in the country $i$ in the year $t$ .	United Nations Conference on Trade and Development (UNCTAD), <i>World Investment Report</i> .
Quality of the education system	Index of the quality of the education system in the country $i$ in the year $t$ .	World Economic Forum (WEF) and Global competitiveness report.
Openness	The degree of openness of the economy in the country $i$ in the year $t$ . The logarithmic value of the sum of imports and exports in relation to GDP.	World Bank Open Data database.
Unemployment	Unemployment, total (% of total labor force)	World Bank Open Data database.

*Source:* Authors' calculations

Table 2 summarizes descriptive statistics of the variables included in our analysis together with their correlations. The greenfield FDI, openness proxies and real GDP per capita have been transformed in logarithmic values. We observe a greater variation in the sample with regard to the inflation and unemployment rates which reflect the unstable nature of these economies. With respect to SAAS, the variation in the sample is limited which confirms the qualitative analysis in the previous section. The correlation analysis shows that greenfield FDIs are negatively correlated with the index of strength of audit and accounting standards which goes against the main hypothesis. However, the relationship may be

confounded by many observable and unobservable variables. This necessitates robust panel data analysis controlling for any confounding effects.

**Table 2: Descriptive statistics and correlations**

	Greenfield FDI to GDP per capita (log)	Real GDP per capita (log)	Audit and account. (index)	Infl.	Educ. system	Openness (log)	Unempl
Mean	5.09	9.21	4.19	2.99	3.44	0.82	17.38
Standard Deviation	0.67	0.66	0.51	3.39	0.51	0.25	7.42
Min	3.81	8.34	3.05	-1.13	2.36	0.23	4.39
Max	6.42	10.16	5.27	12.4	4.48	1.4	31.1
Correlations							
Greenfield FDI to GDP per capita (log)	1	-0.84	-0.62	0.52	-0.49	-0.64	0.67
Real GDP per capita (log)		1	0.85	-0.31	0.65	0.5	-0.89
Audit and accounting (index)			1	-0.07	0.73	0.32	-0.79
Inflation				1	0.22	-0.38	0.1
Education system					1	0.38	-0.72
Openness (log)						1	-0.44
Unemployment							1

Source: Authors' calculations

We implement standard panel data econometric techniques accounting for fixed and random effects. Panel data models capture the variation of data across units and time and control for various time-invariant unobservable characteristics (such as tax, regulation, religion, culture), which may influence variations in greenfield FDI inflows. Additionally, we re-run simple OLS regressions pooling the panel data to check the robustness of the results. We specify the following model:

$$GF_{i,t} = \gamma' AAI_{i,t} + \beta' X_{i,t} + \alpha_i + \varepsilon_{i,t} \quad (1)$$

where  $GF_{i,t}$  is the natural logarithm of greenfield FDI to GDP per capita ratio for each country  $i$  and each period  $t$ ,  $AAI_{i,t}$  is the index of the strength of the application of audit and accounting standards for each country  $i$  and each period  $t$  with its corresponding estimation parameter  $\gamma'$ ,  $X_{i,t}$  is a time-variant vector of controls with its corresponding matrix of parameters  $\beta'$ ,  $\alpha_i$  is the unobserved time-

invariant country effect, and  $\varepsilon_{i,t}$  is the error term.<sup>3</sup> The fixed-effects model allows for correlation between the time-invariant  $\alpha_i$  and the explanatory variables in any period, while the random-effects model assumes no correlation between them in any period.

#### 4. Empirical results and discussion

The limited sample imposes constraints over a more complex specification within the modeling process. To test the relationship between SAAS and greenfield FDI inflows, we initially define a basic model including the real GDP per capita and index of the strength of audit and accounting standards as covariates (Model 1). Further, we extend the basic model by adding (one by one) each of the controls (Models 2-5). Additionally, we control for the time effects including the trend variable to the basic model (Model 6). Finally, we specify a complex model considering all control variables for the whole sample (Model 7) and the same model excluding the crisis 2009-year (Model 8).<sup>4</sup> Table 3 reports the variables' estimates within each (fixed-effects and random-effects) model, together with the required diagnostic tests. The high values of F and Wald test statistics show that the models are appropriately specified except in the last two models which are overspecified.

The results provide support for the importance of SAAS in stimulating greenfield FDIs. The index's coefficient is positive and statistically significant at 5% within the fixed-effects models and at 1% within the random-effects models. It loses its significance when the model includes the quality of education system or time effects in the fixed-effects models, and inflation in the random-effects models. However, those models have abnormal values of F and Wald statistics which may indicate for potential specification issues. The coefficient remains positive and statistically significant when we run pooled OLS regressions (Table 4) which confirms the robustness of the results. Referring to the control variables, we observe that the relationship between real GDP per capita and greenfield FDIs is inconclusive. The coefficient is mainly insignificant in the fixed-effects models, while significantly negative in the random-effects and pooled OLS regressions. Moreover, the inflation is positive and stable across models and significantly explains the variation of greenfield FDI inflows. On the contrary, countries' openness negatively affects their greenfield FDI inflows. Finally, the panel data analysis does not provide a robust relationship between unemployment and greenfield FDIs, however the pooled OLS model shows that the unemployment destimulates greenfield FDI inflows.

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<sup>3</sup> To account for the time effects, we include trend variable in one of the model extensions.

<sup>4</sup> To limit the loss of observations, we take only 2009 as the crisis year since these economies suffered more during the 2009 rather than 2008 at the inception of the crisis.



Our results indicate that SAAS improves institutional transparency and motivate companies to provide relevant information to investors. In the business environment with weaker accounting and auditing regulations (Serbia and B&H), companies are more prone to manipulations with financial information, and such an opacity effects foreign investors portfolio decisions and FDI. The relation SAAS and FDI inflows in the EU group shows that the issue of compliance is crucial, as it affects the effectiveness of standards, and it is related to the institutions of the countries. Siriopoulos et al. (2021) provide similar conclusions for the GCC countries. The results from both fixed effect and random effect models excluding the crisis 2009-year prove that SAAS seems to be more important determinant of FDIs in the stable business conditions. The positive association between the SAAS and FDI inflows is consistent with findings from many empirical studies that generally prove that accounting quality affects FDI inflows to developed countries (Chen et al., 2014; Nam et al., 2020) and particularly to host countries with less developed investor protection and greater financial risk (Okpala, 2012, Haliti Rudhani et al., 2017).

**Table 3: Fixed and random effects estimations**

Dependent: Greenfield FDI to GDP per capita (log)								
VARIABLES	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Basic	Extended	Extended	Extended	Extended	Time-effects	All controls	Crisis excl.
Fixed-effects models (FEM)								
Real GDP per capita (log)	-0.128 (-0.356)	0.503 (1.976)	0.308 (0.358)	-0.058 (-0.201)	-0.219 (-0.846)	0.895*** (5.984)	1.147 (1.204)	0.999 (0.691)
Audit and accounting (index)	0.295** (4.009)	0.196** (4.404)	0.218 (1.193)	0.289** (5.205)	0.291** (4.269)	0.086 (0.906)	0.113 (0.958)	0.402*** (6.588)
Inflation		0.038*** (6.242)					0.031** (3.527)	0.045* (2.578)
Education system			0.161 (0.714)				0.054 (0.188)	0.122 (0.385)
Openness				-0.125 (-0.391)			0.006 (0.013)	-0.248 (-0.582)
Unemployment					-0.004 (-0.785)		0.009 (0.563)	0.015 (0.604)
Trend						-0.030** (-3.661)	-0.012 (-1.832)	0.017 (0.824)
Constant	5.033 (1.574)	-0.475 (-0.208)	0.786 (0.099)	4.511 (1.777)	5.959* (2.779)	-3.319* (-2.378)	-6.307 (-0.672)	-6.520 (-0.435)

(Continues)

<b>Table 3</b> (Continued)		Random-effects models (REM)						
Real GDP per capita (log)	-1.155*** (-4.417)	-0.920*** (-4.000)	-1.156*** (-4.334)	-0.944*** (-4.220)	-1.427*** (-6.216)	-1.213*** (-4.817)	-1.058*** (-9.884)	-1.196*** (-16.557)
Audit and accounting (index)	0.441*** (3.384)	0.209 (1.425)	0.435*** (3.372)	0.319** (2.442)	0.380*** (4.305)	0.524*** (4.028)	0.388*** (3.986)	0.647*** (7.514)
Inflation		0.052*** (6.830)					0.056*** (7.619)	0.061*** (6.346)
Education system			0.010 (0.064)				-0.086 (-0.494)	0.005 (0.039)
Openness				-0.678*** (-2.849)			-0.537*** (-3.723)	-0.537*** (-12.695)
Unemployment					-0.031 (-1.459)		-0.016*** (-2.623)	-0.012 (-1.138)
Trend						0.011 (0.963)	0.036* (1.888)	0.056** (2.014)
Constant	13.873*** (6.828)	12.528*** (7.737)	13.874*** (6.749)	12.996*** (8.661)	17.181*** (7.065)	13.993*** (7.030)	13.822*** (16.370)	13.465*** (10.093)
Number of economies	4	4	4	4	4	4	4	4
Observations	48	48	48	48	48	48	48	44
Within R-squared (FEM)	0.081	0.188	0.100	0.083	0.083	0.134	0.195	0.253
Within R-squared (REM)	0.0651	0.1317	0.0654	0.0506	0.0636	0.0517	0.1308	0.2025
F-test (FEM)	9.184	65.82	340.3	10.49	25.03	1712	.	.
Wald chi-sq (REM)	21.19	2713.73	21.21	359.55	63.17	26.41	.	.

Note: Robust t-statistics (FEM) and z-statistics (REM) in parentheses; \*\*\*  $p < 0.01$ , \*\*  $p < 0.05$ , \*  $p < 0.1$

Source: Authors' calculations

**Table 4: Pooled OLS estimations**

VARIABLES	Dependent: Greenfield FDI to GDP per capita (log)							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
	Basic	Exten.	Exten.	Exten.	Exten.	Time-effects	All controls	Crisis excl.
Real GDP per cap. (log)	-1.2*** (-7.1)	-0.9*** (-5.4)	-1.2*** (-6.9)	-0.9*** (-5.2)	-1.4*** (-9.8)	-1.2*** (-7.1)	-1.1*** (-7.3)	-1.2*** (-7.9)
Audit and acc. (index)	0.4** (2.3)	0.2 (1.1)	0.4** (2.1)	0.3* (1.7)	0.4* (2)	0.5** (2.4)	0.4** (2.1)	0.7*** (2.9)
Inflation		0.1*** (4.1)					0.1*** (4.1)	0.1*** (4.2)
Educ. sys.			0.01 (0.07)				-0.1 (-0.4)	0.01 (0.01)
Openness				-0.7*** (-3.3)			-0.5*** (-3.3)	-0.5*** (-3)
Unempl.					-0.03** (-2.1)		-0.02 (-1)	-0.01 (-0.7)
Trend						0.01 (0.7)	0.04* (1.9)	0.06** (2.3)
Constant	13.9*** (14.9)	12.5*** (12.7)	13.9*** (14.7)	13*** (13.1)	17.2*** (13.2)	14*** (15.5)	14*** (9.9)	13.5*** (9.3)
Observations	48	48	48	48	48	48	48	44
R-squared	0.74	0.79	0.74	0.79	0.77	0.75	0.86	0.86
F-test	56.3	69.6	38.8	93.4	73.9	41	109.3	130.0

Note: Robust *t*-statistics in parentheses

Source: Authors' calculations

## 5. Conclusion

This paper presents an empirical analysis of the location advantages for the selected European emerging countries, investigating the extent to which SAAS regulation may impact FDI. We conduct a panel analysis, implementing two different models (the fixed effect and the random effect model), and confirm a strong significant and positive effect between the implementation of IFRS/ISA and greenfield FDI. The results clearly imply that the accounting and auditing system, supported by high quality international standards and established regulatory frameworks, is an essential factor that encourages FDI.

This study includes some important economic implications. First, a better understanding of the adoption of uniform accounting and audit standards is vital for international institutions, investors and policy makers. To the extent that this convergence process reduces disagreements in these standards between different countries, a reduction of information asymmetry and transaction costs for investors

can be expected, providing a basis for shaping the direction and dynamics of modern economic flows.

Given the public nature of financial reports and their importance to investors and other stakeholders, it becomes clear how much responsibility regulators have in developing and adopting quality accounting and audit standards and how dangerous improvisations can be in this area. The policy makers in the analyzed countries of the Western Balkans should improve their efforts in institutional quality, with special emphasis on convergence, i.e., closer financial reporting to world best practices and consistent application of international professional regulations, as well as EU directives, which would influence the attraction of FDI and the encouragement of international entrepreneurs.

In the end, we list some limitations of the study and possible extensions for the future research. Assessing the impact of audit and accounting practices on the greenfield inflows is performed on the relatively small sample used in the panel analysis, due to the fact that data for two remaining countries of the former SFRY (Montenegro and North Macedonia) were not available. The future research could be extended to other economies in the Balkans, such as Bulgaria, Romania and Albania, in order to overcome the mentioned shortcoming. Furthermore, as a measure of the strength of auditing and reporting standards we used the World Economic Forum index constructed upon a survey of the leading business executives. However, this indicator is not easily determined since it is affected by a range of factors such as the institutional infrastructure and the legal system, the development of financial market or the level of accountants and auditors' education and training. Specifically, foreign capital itself can exert pressure on the entities to adopt international accounting and auditing standards. Taking this into consideration, an interesting extension of this study would be to examine the role of the prevalence of the overall FDI/greenfield FDI in the developing countries of the Western Balkan on the strength of the implementation of IFRS and ISA.

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### DA LI SU REVIZORSKE I RAČUNOVODSTVENE PRAKSE RELEVANTNE ZA PRIVLAČENJE GRINFILD STRANIH DIREKTNIH INVESTICIJA?

**Rezime:** Ova studija istražuje na koji način jačina primene revizorskih i računovodstvenih standarda, kao komponenta institucionalne infrastrukture, utiče na grinfield SDI u četiri zemlje SFRJ tokom dvanaestogodišnjeg perioda (2006-2017). Koristeći standardne panel ekonometrijske tehnike koje uzimaju u obzir fiksne i slučajne efekte, zaključili smo da efikasnija primena revizorskih i računovodstvenih standarda ima pozitivan uticaj na privlačenje grinfield investicija, posebno u stabilnim uslovima poslovanja. Naši rezultati su relevantni za kreatora politika, jer ukazuju na neophodnost konstantnog poboljšanja računovodstvenog i revizorskog sistema, podstičući na taj način bolju transparentnost i niže transakcione troškove za investitore.

**Ključne reči:** Grinfield strane direktne investicije, standardi revizije i računovodstva, komplajans, zemlje Zapadnog Balkana

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