Why Foreign Direct Investment- Albanian Case

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Abstract: Among other financial inflows, foreign direct investment makes a major stimulus to economic growth in many developing countries. The ability to deal with two major obstacles, namely, the shortages of financial resources and the lack of technology and skills, has put foreign direct investments in the centre of attention for policy-makers, particularly in developing countries. Albania is committed to maintaining an open environment for investments. This is vital for a long-term and sustainable economic growth. As a low-savings developing economy, with high domestic investment requirements, Albania needs to attract foreign direct investment in order to support domestic investment financing requirements. However, Albania has not been successful in obtaining substantial and consistent FDI inflows. Furthermore, the meagre inflows that the country has received have not been utilized appropriately to enhance the economic performance. The type of FDI and its structural composition matter as much for economic growth. This paper reviews the recent evidence on the scale of FDI to Albania. The paper reviews also some of the main areas of the existing policy framework for inward FDI in Albania among the major factors determining foreign companies’ decisions to invest in Albania. We discuss these issues and try to make the case for a more coherent, harmonized and transparent framework to cover all foreign direct investment into Albania. The regulation of inward investment is one of several policy and institutional variables likely to influence the volume of FDI.

Key words: foreign direct investment (FDI); developing countries; policy framework; structural composition; Albania

1. Introduction

The Asian currency crisis (1997) and 10 years later the global financial crises renewed among other the significance of prudent management of foreign capital flows in countries where domestic financial markets are not yet fully developed. The crisis poses many challenges including how to best supervise financial institutions, how to efficiently manage foreign exchange reserves, and how to prudentially manage foreign debt and investments³. The Asian crisis was a consequence of overinvestment, some or much of it misallocated (Stiglitz, 1997).

From the viewpoint of foreign resource mobilization, the crisis highlights the urgent need to re-examine the optimal combination of foreign capital i.e., proper composition of concessional public

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loans, commercial loans, portfolio investment, and FDI. To change the structure of capital inflows in order to increase the share of foreign direct investment and long-term loans within total capital flows, and above all to decrease the share of short-term and potentially reversible flows, by discouraging the latter. The lower level of short-term flows makes the country less vulnerable to currency crises. In the crisis context, volatile movements of portfolio investment caused the Asian crisis, reinforced by panic withdrawals of short-term commercial loans, while, FDI was a relatively stable source of foreign capital. Moreover, multinational enterprises affiliates were instrumental in ameliorating the severity of economic collapse and facilitating the recovery process (Athukorala, 2003).

FDI is a significant long-term commitment and a part of the host economy itself. FDI brings scarce capital needed in developing countries, new technology and managerial knowhow to enhance growth and productivity (Mody, 2004). FDI is also believed to be the most stable form of financial flows (IMF, 2010).

FDI produces a positive effect on economic growth in host countries. One convincing argument for that is that FDI consists of a package of capital, technology management, and market access. FDI tends to be directed at those manufacturing sectors and key infrastructures that enjoy actual and potential comparative advantage. In those sectors with comparative advantage, FDI would create economies of scale and linkage effects and raise productivity. For FDI, repayment is required only if investors make profit and when they make profit, they tend to reinvest their profit rather than remit abroad. Another benefit of FDI is a confidence building effect. While the local economic environment determines the overall degree of investment confidence in a country, inflows of FDI could reinforce the confidence, contributing to the creation of a virtuous cycle that affects not only local and foreign investment but also foreign trade and production. However, some empirical literature reveals contrary findings for an exogenous positive effect of FDI on economic growth due to the institutional limitations of a country’s capacity to take advantage of FDI externalities such as a lack of financial markets. Borensztein et al. showed that FDI is an important vehicle for the transfer of technology, contributing relatively more to growth than domestic investment. However, the higher productivity of FDI holds only when the host country has a minimum threshold stock of human capital. Thus, FDI contributes to economic growth only when a sufficient absorptive capability of the advanced technologies is available in the host economy. In fact, Alfaro et al. (2004) provide further evidence that only countries with well-developed financial markets gain significantly from FDI in terms of their growth rates.

Albania is committed to maintaining an open environment for investment but the size of financial market is small and foreign exchange and debt position is precarious. During the last decade almost half of current account deficit is covered by FDI flows. However, the sustainability of external sector can be a concern with the increase of gross external debt from 23.6% in 2004 in 38.2 % of GDP in 2009, as well as with a reduced coverage of the reserves from short-term debt, from 520% to 165% over the same period (Vika, 2011).

Albania has been making efforts to attract FDI and such efforts have been intensified with the advent of deregulation, privatization, and liberalization policies initiated at the beginning of ‘90s. The success of FDI policies can be judged by the size of the inflows of capital. Table 1 documents the size of the inflow of foreign investment in Albania during the last years. With the beginning of the overall liberalization program (1992/1993 onwards) the inflow of foreign investment grew at the compound growth rate of 30 percent. However, the collapse of the infamous pyramid schemes in 1997 and the instability that followed were a tremendous setback. FDI inflows to Albania remain relatively low and grew slowly before 2006. Since that FDI increase substantially, maintaining a positive rate even
during 2009, year with serious setbacks in most European countries FDI flows, in the wake of financial crises. In 2010, for the first time ever Albania saw its FDI rise to more than $1 billion, making it the second largest FDI recipient country in the SEE, after Serbia (UNCTAD, 2011).

Table 1. FDI inflows and stock in Albania 2003-2013

<table>
<thead>
<tr>
<th>Year</th>
<th>FDI inflows</th>
<th>FDI stock</th>
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<tbody>
<tr>
<td>2003</td>
<td>156.90</td>
<td>382.33</td>
</tr>
<tr>
<td>2004</td>
<td>278.29</td>
<td>614.22</td>
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<tr>
<td>2005</td>
<td>212.56</td>
<td>287.23</td>
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<tr>
<td>2006</td>
<td>258.61</td>
<td>355.20</td>
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<tr>
<td>2007</td>
<td>481.13</td>
<td>616.02</td>
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<tr>
<td>2008</td>
<td>665.15</td>
<td>699.33</td>
</tr>
<tr>
<td>2009</td>
<td>716.15</td>
<td>772.48</td>
</tr>
<tr>
<td>2010</td>
<td>793.33</td>
<td>896.23</td>
</tr>
<tr>
<td>2011</td>
<td>630.35</td>
<td>1,170.45</td>
</tr>
<tr>
<td>2012</td>
<td>665.78</td>
<td>1,124.45</td>
</tr>
<tr>
<td>2013</td>
<td>933.15</td>
<td>985.10</td>
</tr>
</tbody>
</table>

Source: FDI – Bank of Albania; GDP and population – INSTAT

FDI flows in Albania have also grown relatively to the size of the economy. The ratio of FDI to Gross Domestic Product (GDP) increased from 3 to 9% over the 2003-2010 period. When FDI/GDP ratios are compared to trade/GDP ratios the former are lower. Export/GDP ratio has been around 5 percentage points bigger than FDI/GDP, although this difference has diminished during the last 2 years. This suggests that trade has played a more significant role than FDI in the Albanian economy over the period under review.

The impacts of FDI flows on trade specialization patterns depend on the mode and the motive for investment, i.e. whether it is market-seeking or export-oriented type FDI. The former is undertaken mainly to provide goods and services to the local market while the latter aims to exploit particular and specific resources at relatively cheap cost and export the output back to the home country and/or other markets. In Albania, the bulk of the FDI have been directed to the services sector (85% of the FDI stock), especially telecommunication and financial sectors - which accounted for around 60% of FDI stock at the end of 2008 (Bank of Albania). Apart from FDI directed to the services sector, which were motivated by market access due to the relative non-tradability of services, the remaining share of resource and efficiency seeking FDI projects is very low, with the manufacturing sector (efficiency seeking) of 16% and very insignificant position of primary sector (like mining, agriculture etc.), even if Albania is a resource-rich country. Recently Albania has experienced remarkable growth in investment in the natural gas sector. Manufacturing FDI in Albania is concentrated in capital and labor-intensive affiliates and not in skill intensive industries. It seems that most of the investment projects are local market-oriented, coping much easier with higher investment risk and higher transaction costs than export-oriented projects.

However, they still have high significance in the Albanian economy in terms of value added, production, employment and investment activity (UNCTAD, 2010). The degree of foreign participation in the economy is similar to that in the Central European countries which have the highest indicators of FDI participation in Europe (UNCTAD, 2010).

The foreign investors played an important role in economic development, contributing to the substantial growth of permanent capital as well as to the modernization of the capital assets of the
companies bought. Albanian FDI inflows as a percentage of gross fixed capital formation (GFCF)\(^1\) increased from less than 10% in 2005 to over 19% in 2008 and nearly 23% in 2009. Among countries of the region, only Montenegro has attracted much more FDI relative to GFCF, both due to relatively higher amounts of FDI inflows and to lower amounts spent on fixed capital formation. In Albania, the ratio of GFCF to GDP was 41% in 2008, much higher than in other countries of the region. Having such a high investment rate is supportive to economic growth especially as much of the investments have gone into infrastructure facilitating business investments including FDI (UNCTAD, 2010).

2. Albania in the Global and Regional Trends of FDI

Although the Albanian FDIs are significant in absolute terms, they compare low relative to more buoyant economies of the region and globally. The share of FDI inflows to Albania in the world total remains marginal, at 0.1% in 2010, even though its share grew four times in 2006. The country’s weight in the South-East European region has, however, grown remarkably from 3% in 2006 to 26% in 2010. The pace of growth continued especially since 2007 when inflows to the South-East Europe decreased while flows to Albania kept increasing. (UNCTAD 2011).

During the last decade, Southeast European (SEE) countries experienced significant economic integration into the world economy through international capital flows and especially FDI. The region become an increasingly popular destination for FDI by EU member countries and overseas multinationals, and benefited from the worldwide surge in investment flows that characterized the period 2003-07. Underpinning this growth in FDI to the region has been the policy of liberalization and deregulation, which have been embraced by virtually all the countries. Moreover, a general expectation that the more advanced countries in the region will join the EU, affected positively the FDI developments. It is believed that the prospect of EU membership and the Stabilization and Association Agreements in force or being negotiated for most countries in the region contributed significantly to the considerable increase in inward FDI in recent years since foreign investors anticipate completion of reforms in a more stable political and economic environment (Bevan et al., 2001). During the most recent worldwide economic expansion (2003-07) the average growth rate of FDI inflows to SEE was 50%, much higher than the rise experienced by the developing (25%) and developed countries (30%) (UNCTAD 2010). In addition to the adoption of liberal policies, the strategies of transnational companies have been critical in influencing the type of FDI flows to the countries of the SEE. With respect to the strategies of transnational companies, the two major motives that have influenced FDI into the region have been the desire to have access to strategic resources as well as the need to reduce production cost in order to gain competitiveness in an increasingly globalizing world economy. It is, therefore, not surprising that the bulk of FDI inflows into the SEE has been directed to those countries that are deemed to have these advantages: real estate in Croatia and Montenegro, gas and energy in Serbia and Croatia, etc.

However, Albania is not very prominent into this picture of FDI development in the region. The largest recipients of inward FDI in the Western Balkans\(^2\) have been Croatia, Serbia and Montenegro accounting for 77% of total investments, in the 2003–07. Over this period, Bosnia-Herzegovina attracted 13% of FDI inflows and the remaining 10% was shared equally by Macedonia and Albania.

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\(^1\) FDI inflows as a percentage of gross fixed capital formation (GFCF) provides a rough indicator of the size of FDI inflows relative to total investment in the economy.

\(^2\) Throughout the paper we use SEE and the Western Balkans alternatively. Western Balkans includes Albania, Bosnia-Herzegovina, Croatia, Macedonia, Serbia and Montenegro.
The position of Croatia, Serbia and Montenegro was still comparatively smaller than the roles of other main SEE countries - namely Romania and Bulgaria. FDI cumulative inflows in these latter countries were twice those received by Croatia and Serbia and Montenegro.

This four years growth cycle of FDI in SEE, was broken up by the global financial crisis 1 with a deterioration of the investment situation starting in 2008. The current global financial crisis is probably the most severe since the Great Depression in 1929. It has gone far beyond the financial sector and has seriously affected the real economy, with negative impacts on FDI (UNCTAD, 2009). On one hand, tighter credit conditions and lower corporate profits have weakened companies’ capability to finance their overseas projects. On the other hand, the looming global economic recession and a heightened appreciation of risk have eroded business confidence and therefore companies’ propensity to expand internationally. As a result, many large transnational corporations (TNCs) have revised their global expansion plans, and a large number of greenfield and cross-border merger and acquisition projects are being cancelled or suspended. The trend is widespread, hitting many sectors ranging from extractive industries to manufacturing and services. For policymakers, major concerns are how long the downturn will last and how deep it will go (UNCTAD, 2009).

Largely dependent on the completion of the privatization process, the fall in FDI inflows in the SEE countries was less pronounced. In fact, during 2008-2009 FDI inflows into SEE decreased by 20%, while FDI to the developed economies decreased by 37% (UNCTAD data).

FDI inflows to Albania have developed independently of global and regional trends during the global financial crisis, showing a continuous increase in 2009 and 2010. Major privatization deals in 2009 (the sale of 12.6% of shares in mobile telecommunication company AMC to the Greek telecommunications group COSMOTE, for €48.2 million; the sale of 76% of shares in the energy distributor (OSSh) to the Czech company CEZ, for €102 million; investments in the cement industry by Italian companies and the sale of the fourth mobile telephony license to the Post-Telecommunication of Kosovo, for €7.5 million) contributed to maintain the upward trend of FDI. In 2010, Albania ranked the second largest FDI recipient country in the region after Serbia when its FDI rose to more than $1 billion for the first time ever.

However, Albania has the lowest FDI stock relative to GDP (22% in 2008) among the countries of South-East Europe. Comparing Albania sectoral composition, financial intermediation is the only sector in which Albania’s FDI share exceeds that of other SEE countries. Albania’s share is much lower across all other sectors of the economy, particularly manufacturing and network industries such as energy.

3. Review of FDI Policy in Albania

The factors driving investment decisions by multinational corporations are changing. When seeking business opportunities, companies are now more concerned about financial and political risks, with a focus on stable and predictable business environments. In response, governments everywhere recognize that their chances of attracting more foreign investment depend on making their investment climates more competitive (World Bank, 2010).

Albania has improved policies that directly encourage FDI, in order to provide an encouraging environment for FDI. The regulation of Foreign Exchange granted freedom to both inward and

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1 For more details on the impact of the global financial crisis in the Balkan countries, see Cutrini et al. (2010).
outward FDI now. There are no restrictions on the legal status of foreign residents. The legal framework to encourage investment is already in place. Law 7764 “On Foreign Investment,” dated November 2, 1993, was designed to create a favourable investment climate for foreign investors in the country. However, in other respects the policy environment has not always been an instrumental in channelling investment flows toward sectors considered to be of particular importance to the country’s development. Although Albania’s governments recognised FDI be an important bridge to developing and opened an export oriented economy, there has been never developed a consistent policy framework to bring it about.

Increasing FDI is a top priority for the Albanian government. The government decided to be more active in attractive FDI flows through: opening the privatization of state owned assets to strategic investors; providing competitive regime of corporate taxation - including a 10 percent flat corporate and income tax; taking measures to improve the business climate by streamlining business procedures through e-government reforms; setting up an institution responsible for attracting FDI, with a clear mandate. These improvements along with NATO membership and progress toward EU integration have contributed to the increase in investor interest during the last couple of years.

Policies to directly encourage FDI are a part of overall strategy to attract FDI. Foreign investors are usually attracted by three principal factors: the expected profitability of individual projects; the easy with which subsidiaries can be integrated with global strategies, and the overall quality of the enabling environment that affect the risks and expected payoff to firm considering FDI. Because countries cannot influence local market size and geography its essential they focus on improving the quality of enabling environment. Key ingredient of a good enabling environment are (Blonigen, 2005; OECD, 2002): integration with foreign market and opening to trade and investment; sound macroeconomic policies and institutions to encourage strong growth while minimizing volatility, maintain fiscal discipline and contain inflationary pressures; transparent e efficient legal and political institutions to keep business environment stable; reduce information cost and reduce resources devoted to rent seeking and corruptions; an efficient and internationally competitive corporate tax regime; flexible labour market institutions; high quality educations institutions; well-functioning capital and intermediation markets; minimise the cost of setting up and doing business; competition policy and sectoral regulatory and supervisory bodies for domestic and foreign investors; corporate governance policies that encourage sound management and accountability in private and state owned enterprises; ownership policies that encourage the participation of private and foreign investors when anticipated efficiency gain from privatisation are large.

A perception survey of 80 foreign owned firm undertaken by UNDP Albania (2010) found that the Albanian business environment had features that both attracted and deterred foreign investment. On the positive side, a relatively stable political and macroeconomic environment, flat tax, social security system and low related costs for employers. On the negative side, incentives to doing business in Albania include the implementation of laws, tax collection, VAT reimbursement, land property, skill labour force and bureaucracy in general.

The ranking of Albania has improved significantly this year (2011) in the Global Competitiveness Index of the World Economic Forum. After taking 88th position last year, Albania jumped 10 places upwards, ranking as 78th. Albania's competitiveness is being surpassed only by Montenegro and Croatia. Amongst weakest sides Albania still has to improve the general government debt, market size and financial market development.
The qualitative assessment of policies and institutions, that critically affect the environment for direct investment, Investment Reform Index (IRI) of OECD, states the Albanian position over the period 2006-2010.

**Investment and promotion policy.** Based on this indicators Albania ranks on the average. The legal framework to encourage investment is already in place. Law 7764 “On Foreign Investment,” dated November 2, 1993, was designed to create a favorable investment climate for foreign investors in the country. Since 2006 Albania has adopted a new investment promotion strategy covering 2007-2013. Yet, in supporting investment (with a very low rate on this indicator, with 2.5 points), Albania must focus on the improvement of the services for investors since the beginning of the activity.

Easily accessible and reliable information, and efficient and predictable actions by public institutions help create a business environment conducive to investment. For instance, studies have shown that 70% of countries miss out on foreign investment due to deficiencies of investment promotion institutions in providing potential investors with accurate and up-to-date information (World Bank, 2010).

**Human capital.** A technically trained, educated, and disciplined labor force along with a country’s labor laws are critical factors in attracting foreign investors. Here, Albania ranks below region average. Albania has an acute shortage of technically trained and educated labor, especially in middle managerial positions and in engineering, which may have discouraged foreign investors. In particular, Albania is at a more serious, disadvantaged position in terms of education and health compared with other developing countries that have attracted FDI at much higher level.

**Trade policies and facilities.** This is the only indicator where Albania ranks above the region’s average. Since 2006, important progress has been made in the standards and conformity assessment. In 2008, Albania adopted the law on Standardization and Product Safety and of the Conformity Assessment, in full compliance with EU directives. In 2008, Albania adopted a new law on accreditation in order to bring its legislation in line with EU requirements on accreditation and market surveillance. Few steps are taken to apply European and international standards with regards to food safety, animal diseases and protection of plants. Albania should make sure to take public’s opinion on issues of trade policies a permanent practice.

**Access to Finance.** Even here, Albania ranks below the average. Although there have been attempts to improve the access to financing means, Albania is among those countries in SEE where business access to external financing is very hard. In 2009, BEEP survey (World Bank) showed that 75% of companies use internal resources to finance new investments, compared to 56% of the region’s average. However, the same survey shows that in Albania, information on microcredit is particularly well developed. A large number of microcredit institutions are covering most of the territory. Bank of Albania (BoA) is the authority to license microcredit institutions and to supervise the deposit taking ones. In order to further facilitate access to financing, in 2008, BoA introduced the credit registry.

Nevertheless, further improvements are needed in relation to agreements on loan guarantee, and collateral registry and real estate registry. Apart from donors programs, Albania does not have a scheme for credit guarantees. While there is a real estate registry which can be used for collecting information on collateral, the collateral on tangible assets is only partly covered by legislation. The system of registering tangible assets is not fully functional. This situation is very unfavorable for SMEs which in their large part lack fixed assets collaterals.

**The role of parliaments in economic reforms.** Here, again Albania ranks below the average. The main weaknesses are in transparency and dialogue. Important progress has been made in reforming
our legislation framework in the recent years. The main objective has been to simplify our legislation and regulations. This strategy has been successful in regulations on business registration and licensing, but further work is needed to simplify other areas.

Since 2006, little progress has been made in the area of regulatory impact assessment, (RIA). The implementation of RIA in draft legislative instruments has not been formalized in the law. RIA can be a very effective instrument to optimize the efficiency and effectiveness of legislative instruments to ensure that the main objectives are achieved at minimum costs.

**Taxing policy analysis** Albania ranks below average of the region with regards to tax policies. The country faces problems with taxes on investments and employment as well as taxes on SMEs and multinationals. In the last years Albania has improved considerably in developing and implementing an efficient tax system. At present, the Ministry of Finance (MoF) uses a model to forecast main revenues from taxes. The model takes into consideration not only the GDP growth and inflation but also the impact of new fiscal policies. MoF is also currently developing a macroeconomic model which will be used to forecast tax collection more efficiently. The process of tax collection and public expenditures is reviewed periodically, while tax revenues are monitored on daily basis. The MoF has implemented the Medium Term Budget Plan which is based on national priorities and objectives, in order to design public expenditures.

**Investments infrastructure.** Albania ranks lowest in the region with regard to internet broadband access – only one person in 100 (OECD 2010). This picture is highly correlated with the situation of land line communication. The situation might improve in case providers of wireless communication will offer this service (OECD 2010).

The same situation is with land lines access, where Albania ranks one before the last country in the region. Land line penetration falls far behind mobile penetration, which as grown rapidly in the last years. This is typical for countries that development of telecommunication happened during the age of mobile communication. The time needed to install a land line is short (7 days) while the service quality (measured by interruptions and other problems for 100 main lines) is among the lowest in the region (OECD, 2010).

Albania ranks second in the region with regards to road density. This is comparable with Germany. Albania is the first in the region to spend most on road construction per year. The situation is quite opposite when talking about railway infrastructure. Albania has the lowest railway density in the region. It also ranks lowest for the level of expenditures on road maintenance. Air transportation costs are above the region’s average (OECD 2010).
4. Conclusions

So far FDI inflows to Albania have increased despite global financial crisis, showing a continuous increase in 2009 and 2010. Privatization has been the main contributor to maintain the upward trend of FDI. In 2010, Albania ranked the second largest FDI recipient country in the region after Serbia when its FDI rose to more than $1 billion for the first time ever. With privatization option exhausted a further global slowdown and the prolonged uncertainties around the Euro zone crisis is expected to influence Albania’s economy through foreign direct investment.

In spite of privatizations, Albania has a relatively low transnationalisation index (FDI/GDP ratio) compare to other countries in the region. FDI has not facilitated much dynamic structural change into high value added production and trade. In terms of sectoral composition of FDI stock, the most salient trend has been the high concentration in services sector (mainly telecommunication and financial services) and a low FDI presence in production.

For a more sustainable path of external balance Albania needs to shift FDI from nontradable sectors received before the crisis towards the tradable sector. In the short run, this requires a further progress toward greater trade integration. In the medium term, Albania also needs to upgrade human capital and address remaining bottlenecks in infrastructure and further improve its business climate in general (in particular property rights).

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Performance and Risks in the European Economy


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