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Factors Determining Foreign Direct Investments in Albania

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Abstract:

The foreign direct investments (FDIs) have taken a very great extent in the last decades in both developing and developed countries, having a positive impact on economic growth. This is mainly due to trade liberalization, as well as other advantages such as higher returns on investments, potential resource seeking, new market seeking, or cheap labor force. In developing countries investors face many risks that go beyond market risks such as corruption, unsustainable legal system, lack of proper definition of property rights, or high bureaucratic rules for businesses.

The aim of this paper is to analyze the behavior of Foreign Direct Investments in Albania compared to other countries in the Western Balkans. The study focuses on the trend of Inward and Outward FDIs in Albania and the region for the period 1992-2011, as well as an analysis of the factors influencing FDI flows. The main result is that Albania stands on a very good position regarding FDI flows compared to other countries. This is mainly due to massive privatizations taken after the fall of communism and due to efforts by the Government for creating a business friendly environment.

Key words: FDI inflow & outflow, determining factors, business environment, Albania, Western Balkan countries

1. Introduction

Nowadays the issue of FDIs has been given much attention both at national and international level due to their advantages to economic development. By definition Foreign Direct Investment is the "process where residents of one country (source country) acquire ownership of assets for the purpose of controlling the production, distribution and other activities of a firm in another country known as host country" (Moosa 2002, 1). Many are the theories and empirical evidences that justify and explain FDI dynamics (inflow and outflow) especially in developing countries where FDIs reap advantages, due to the needs these countries have mainly for capital and new technology. Meanwhile, what is more challenging in these countries is creating a more friendly business environment by deregulation and privatization that would allow foreign firms to enter with lesser barriers. From the point of view of foreign investors investment decisions in developing countries are influenced by economic and political risk. But these factors not always are positively correlated with the FDIs. Hence, some countries receive high flows of FDIs despite their moderate to high political risk.

In developing countries one of the ways for attracting FDIs has been through ***privatizations and concession contracts.*** After 1990s privatizations took a great importance especially in former centralized economies and constituted a great part of foreign direct investments. After finalization of privatization process these countries where Albania is included started to introduce concession contracts in telecommunication, roads, energy etc.

The aim of this paper is to analyze the factors influencing FDIs in Albania by analyzing the trend for the period 1992-2011 and factors influencing FDIs. Our study is structured as follow: in Section 2 we provide a literature review dealing with theories and determinant factors that justify FDIs, as well as positive and negative effects for the economy. In Section 3 we analyze the trend of FDIs in Albania for the period 1992-2011 and factors influencing them. The data for 2012 are not available from the UNCTAD Statistics and therefore are not included in our analysis. Later in this section we conclude with a comparative analysis of FDIs in other countries in Western Balkans. In Section 4 we draw the conclusions of our analysis.

2. Literature Review

Given the increasing importance of FDIs worldwide many theories have been adopted to explain the reasons why some countries agree to invest abroad and others to receive FDIs. Main theories that justify FDIs are the following (Moosa 2002: 23-50):

1. Assumed perfect markets
2. Assumed imperfect markets
3. Other theories
4. Theories based on other variables

Under the perfect markets theory the main assumptions relate to: (i) the differentiated rate of return assuming risk neutrality. The first effort to explain FDI belongs to the theory of Ricardo, based on comparative advantage. However, this theory cannot explain fully FDI because it takes into consideration two countries, two products and a perfect mobility of factors and exclude the risk factor or barrier to capital movement; (ii) the portfolio diversification assuming that risk exists and (iii) market size that explains that size matters. Many empirical studies have proven that in reality it is impossible to comply with this hypothesis, because the ex-ante data do not fit to the actual ones.

Under the imperfect markets theory, when a firm invests in another country, it has the disadvantage of competing with local firms in many ways and this is explained by the location hypothesis developed by Dunning in 1973, 1980 and 1988. This hypothesis is based on the argument that a firm decides to indulge in FDIs due to economic, political and social advantages. Economic benefits relate to those of factors of production such as cheap labor, natural resources, market size etc. Political benefits include specific government policies that affect FDIs, while social advantages include cultural diversity, attitude toward strangers etc.

But the main assumption for the decision to expand by investing in FDI is based on the complementary advantages deriving from: imperfect competition in product differentiation, imperfect competition in access to patent, managerial and operational skills, and imperfect competition in economies of scale and government intervention (Nonenberg et al. 2004, 2-4).

Imperfect market theory develops the hypothesis of internalization, which is based on the argument that high transaction market costs such as transportation cost or buyer uncertainty, could be replaced by FDIs which lower these costs through internal transaction (marketing costs, know how etc). The theory of internalization was developed by Buckley and Casson (1976), then by Hennart (1982) and Casson (1983). Hymer (1976) identified 2 major determinants of FDI. Hymer demonstrates that FDI takes place only if the benefits of exploiting firm specific advantages outweigh the relative costs of the operations abroad.

Another theory relates to the effect of the exchange rate on the FDI decision. According to this theory a country with strong currency will tend to invest in other countries, while countries with weak currency tend to be host countries, or recipient of FDIs. Theories based on other variables explain the relationship between political risk, country risk, tax policies, trade barriers, government regulation and FDIs. For example lack of political stability discourages inflows of FDI. Also many restrictions on profit repatriation, dividends to the parent firm, devaluation of currency cause political risk and have negative effects on FDIs decisions.

There are many empirical studies dealing with factors influencing FDIs. The study conducted by Campos and Kinoshita (2008, 3-13) finds a strong empirical relationship from reforms to FDI in particular from financial liberalization and privatizations using a panel data for 19 Latin America countries and 25 transition economies from 1989 to 2004. Both regions undertook massive structural reforms since 1990s. In many countries financial markets were liberalized, state-owned enterprises were privatized and trade barriers were gradually been removed. From the point of view of foreign investors, investment decisions in emerging markets are influenced by economic and political risks. According to this study, it was concluded that financial reforms are more important to FDIs than privatizations and trade liberalization. According to Prasad et al. (2007, 3-25), it is concluded that foreign capital inflows, including FDIs, can boost growth only when the recipient countries' financial systems are developed enough to channel foreign capital efficiently to finance productive investment.

According to Bevan and Estrin (2000, 20-27), it is argued that greater macroeconomic and political stability of the host country could attract more foreign investments. According to Caves (1992) and Singh and Jun (1996, 67-105), FDI and trade openness can be positively related as FDI flows can be considered complementary to trade flows.

According to Gelos and Wei (2005, 29-87), institutions matter on FDI decisions. The study finds out that when the indicator on "autonomy from political pressure, quality of bureaucracy" is rated high, it shows that there is a low non-economic cost for investors to invest, because there is less likely that the government will get corrupted. The study concluded that higher scores for rule of law indicates better legal system and as a result may attract more FDIs.

All the above mentioned theories and empirical studies help us conclude the determinant factors that explain the existence of FDIs. It is important to mention that all the variables of said theories reflect the economic, political and social characteristics of the host country, which are all important factors whenever the trend of FDIs is evaluated. Therefore, the magnitude and pattern of foreign firms will depend on the challenges and opportunities offered by different types of countries. For developed countries, the theory that explains FDIs is efficiency seeking and size of the market, while for developing countries, theories are based on the ground of new market seeking, such as cheap cost of labor etc.

In light of the above mentioned theories, the reasons of FDI flows to Albania could be explained by imperfect market theory on the ground of economic benefits related to cheap labor, potential new market seeking and natural resources, which is being considered a determining factor in the last years.

2.1 Positive and Negative Effects of FDIs

The reason why we explain the effects of FDIs is because we consider it important to analyze the positive and negative effects from the home country and host country perspectives, the differences between countries addressing culture, language, legal system, economic development, or geographical position. We base our conclusions on the theories explained above and the experienced reality.

The positive effects of FDIs are as follow (Moosa 2002, 68-77):

1. The capital provision is more stable and there is a long term commitment because of the access the home country firms have in international capital markets. Therefore, the host country has more capital opportunities from FDIs.
2. Advanced and modernized technology (know-how) transferred from home country to host country, which helps transform scientific knowledge into commercial one.
3. Access to raw materials is easier because FDI firms control the whole process from production to the final delivery of the product and therefore have a large network with many suppliers.
4. High managerial and operational skills, which are transferred in the host country.
5. Employment increase: FDIs contribute directly to employment opportunities either through new plant facilities or distribution.
6. Positive and negative effects on balance of payment. Home country firms that involve in FDIs have net positive effects of FDIs in their balance of payment, while host countries (ex. developing countries) have negative effects in the balance of payment.

The negative effects of FDIs are as follow:

1. Crowding out of local firms. FDI firm, due to the advantages it brings to host country, may damage the activities of local firms, causing a worsening on their performance.
2. Environmental damage. Host country governments, in an effort to attract FDIs, compromise with host country firms that are not environmentally business friendly. This is especially true in developing countries where standards and rules in environment are not strong.
3. Wage inequality. FDIs offer more attractive wages to the staff and this affects local firms through using their skilled labor.

3. Foreign Direct Investments in Albania- a comparative analysis with Western Balkan Countries

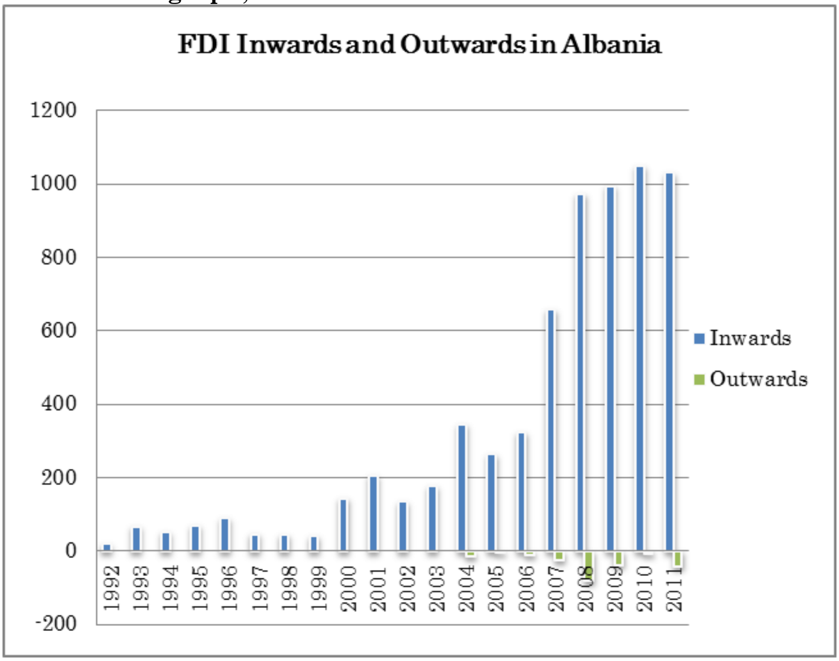
Albania has many comparative advantages, which are conditions that stimulate FDIs: (i) geographical position - a long coastline and the vicinity with Greece and Italy; (ii) improved infrastructure; (iii) abundant natural resources, such as minerals and water resources. In order to stimulate FDIs, the Government has undertaken many reforms to facilitate business environment such as:

1. Adoption of the legal framework that allows foreign investors to enter the market: the law on Foreign Investment 2.11.1993;
2. Albania "1 Euro" initiative that facilities foreign investors to enter the market for a very low rent;
3. One stop shop initiative that facilitate the licensing process of businesses;
4. Reduction of Corporate Tax from 20% to 10%, adopted in 2008;
5. New law on concessions and public procurement.

As shown in Figure 1 below, after 1990s until 2004, Albania had low levels of FDI flows. Even though the transformation process from centralized to market economy called for many privatizations of state owned enterprises, these were made by local businesses and therefore the foreign investments were very low.

Figure 1: Trend of FDIs in Albania in millions USD

Source: Own graph, UNCTAD Statistics

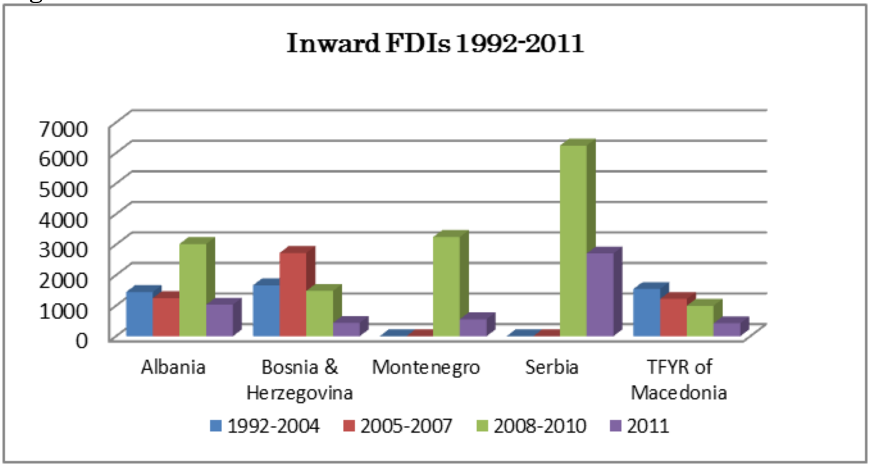


It is important to mention that from 1997 till 1999 FDI flows were at very low levels and decreased in comparison with previous years. To this contributes the pyramid schemes collapse in 1997 and the war in Kosovo in 1999, which had affected the investors' decisions to come and invest in Albania. Then we observe a rising trend from 1999 to 2004, the period in which there took place many important strategic privatizations, such as Savings Bank, Alb Telecom Company, ARMO. After 2005 FDI were on an increasing trend and what is evident is that the flows were high in absolute terms and at sustainable levels especially between 2008 and 2010. During this period FDIs were concentrated in industry and energy mainly in the form of concession contracts for hydropower plants and transmission lines. What is positive in the case of Albania is that although the financial crisis of 2007 affected many countries on a global level, the FDI flows to Albania were at high levels. This is explained by the fact that Albania has not been affected by the crisis at the same level as other countries.

In 2011 FDIs were decreased due to the economic crisis in Greece and Italy, which are main source countries for FDIs in Albania (Greece with 54% of FDI, followed by Italy 12% of FDI and also Austria 10% (Bank of Albania 2011, 67-70).

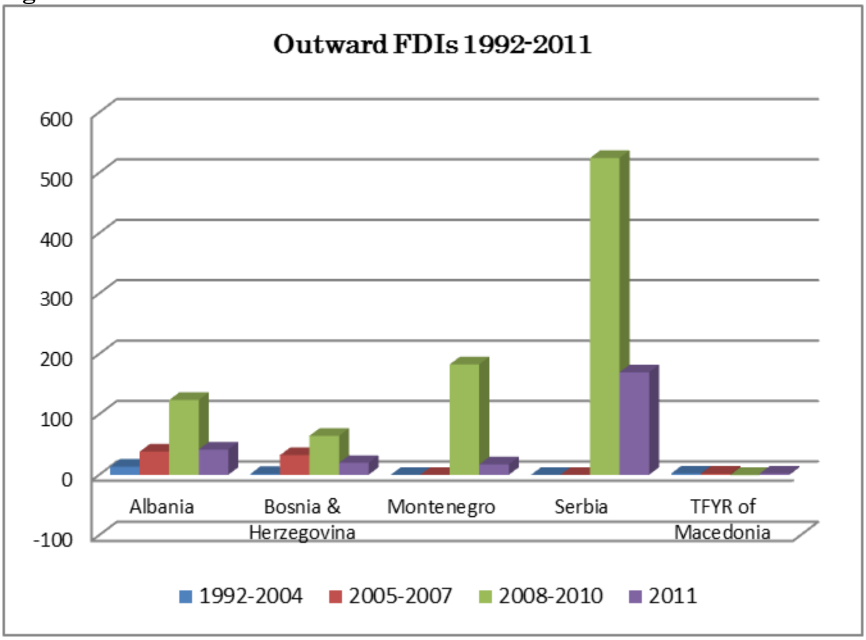
The following section gives a comparative analysis of Albania with six countries in the region of Western Balkans such as: TFYR of Macedonia, Serbia, Montenegro, and Bosnia and Herzegovina. These countries have similar characteristics related to market structure, reforms undertaken, culture, history etc. The data show that FDI flows have had different tendencies in the region. This is mainly related to the period when important reforms were undertaken in form of privatizations.

Figure 2: Inward FDIs in millions USD



Source: Own graph, UNCTAD Statistics

Figure 3: Inward FDIs in millions USD



Source: Own graph, UNCTAD Statistics

Concretely:

1. After 1990s until 2004 all countries had low levels of FDI flows. This is explained by the economic transformation from central to market economy. Even though the transformation process called for many privatizations of state owned enterprises, these were made by local business and therefore the foreign investments were very low.
2. Starting from 2005 till 2011 almost all countries had high levels of FDIs, due to the many important strategic privatizations that took place.
3. The trend of FDIs is different for all countries in our analysis. Albania has an increasing trend, Bosnia and Herzegovina and Serbia decreasing trend and Macedonia increasing. The low levels of the countries in the region could be explained by the market maturity reached where strategic privatizations were been finished.
4. All countries have a similar trend of FDI outflow, which are at low levels because these countries are not

technologically developed to compete in international markets.

Even though earlier in this paper we have mentioned the factors favoring FDIs, for the developing countries the main factor is business environment. According to the World Bank report on Doing Business 2013, Albania is ranked very well as to the indicators of protecting investors, getting credit and doing business compared to the regional average indicators.

Table 1. Business Environment Indicators

Country	Ease of doing business	Dealing with Construction permits	Getting electricity	Getting credit	Protecting investors	Paying Taxes	Enforcing contracts
Albania	85	185	154	23	17	160	85
Macedonia	23	65	101	23	19	24	59
Bosnia & Herzegovina	126	163	158	70	100	128	120
Serbia	42	179	76	40	82	149	103
Montenegro	51	176	69	4	32	81	135
Regional average	**73**	**126**	**123**	**53**	**62**	**95**	**59**

Source: World Bank Doing Business, 2013, Global Competitiveness Report, 2011-2012

As mentioned earlier, the empirical evidence has tested that political stability influences FDI flows, but it is not the main factor for FDI inflows. According to the political risk rating by International Country Risk Guide for 2013, Albania and Macedonia have moderate ratings, Montenegro low political risk and Bosnia & Herzegovina together with Serbia have high political risk. This factor is not positively related to the levels of FDI inflows, as tested by theory. Even if political risk could be a threat to foreign investors, it can be managed through some operating strategies with the help of International Institutions such as World Bank, OECD, which give recommendations towards the reduction of political risk in developing countries as below:

- Improvement of investment policy in host country;

- Creation and setting up of a new multilateral insurance agency for political risk;
- Creation of an organization for arbitration and conciliation of investment disputes;
- Inclusion of the rules of the World Trade Organization to the international investment domain.

4. Conclusions

The foreign direct investments have extended largely during the last decades in both developing and developed countries, having a positive impact on economic growth. Many theories have been adopted to explain the reasons why some countries agree to invest abroad and others to receive FDIs. In this paper we have listed main theories such as: (i) assuming perfect markets (ii) assuming imperfect markets (iii) Other theories and (iv) based on other variables and many other empirical studies, analyzing factors influencing FDI flows.

The focus of our study was to analyze factors impacting FDI flows to Albania compared to Western Balkan countries. These countries have similar characteristics related to market structure, reforms undertaken, culture, or history. From our analysis it is evident that Albania received high flows of FDIs from 1992 to 2011, especially from 2005, a time when many important strategic privatizations took place. The highest levels of FDIs are registered during 2008-2010, which were concentrated in industry and energy mainly in the form of concession contracts for hydropower plants and transmission lines. FDI flows to the Western Balkan Countries have had a different trend than that of Albania due to political conflicts (wars in Kosovo and Bosnia and Herzegovina) and market maturity was reached where strategic privatizations were finished.

Even though Albania has many favorable conditions for attracting FDIs, the main factor influencing them is business environment. According to the World Bank report on Doing Business 2013, Albania is ranked high in terms of indicators of protecting investors, getting credit and doing business compared to the regional average indicators.

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