

# THE ROLE OF FOREIGN DIRECT INVESTMENTS (FDI) AS A PROMOTER OF GROWTH – ATTRACTIVENESS OF ALBANIA FOR FDI

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## Abstract

Foreign direct investments (FDI) are playing an important role in the economic background of the Transition Economies. They are a catalyst of the economic growth and of the technological development, when domestic savings cannot. Many countries have benefited from capital inflows in the form of FDI. Fighting the lack of capital that the closed markets used to suffer, they have helped the effective use of these sources and they have created a competitive environment, which provides the investors with ever-growing outputs. So, considering that foreign investments are a very important asset to transition economies, the aim of this paper is to provide a general view of the role and determinants of foreign direct investments, an overview of foreign direct investments in Albania and especially, providing some suggestions to attract foreign investors (the case of foreign investors in textile industry in Albania).

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**Keywords:** Foreign direct investments, determinants, textile industry, Albania

## Introduction

There is a common perception of FDI as an important factor in the transition process contributing to the restructuring of enterprises and the transfer of capital and know-how (IMF, et al. 1991). Transition is a process which aims to establish and develop an open market. It involves changing and creating new institutions.

The combination of lower wages with a skilled labor force, which was found in the Central and Eastern Europe (CEE) market, is believed to be the factors that have contributed to the attraction of foreign investment in these countries. (Koechlin, 1992)

The impact of foreign direct investments in the host countries vary widely. Some theories emphasize the direct effects of FDI, such as: employment, the salary (bonus), while other theories emphasize the indirect effects, such as: the transfer of technology and knowledge, changes in market structure and the level of competition in the host countries. However, the level of technology transfer from foreign investors depends on the strategy of local authorities and foreign investors. Large multinational companies decide to transfer different technologies in different markets, according to local characteristics.

Based on arguments from various authors, this paper aims to provide an overview of a) the role and determinants of foreign direct investments (FDIs); b) foreign direct investments in Albania, some reasons and barriers to invest in Albania. And, the end of the paper will provide an overview of facilitates and obstacles of foreign investors in textile industry in Albania.

### **The role and determinants of foreign direct investments (FDIs)**

Foreign Direct Investment (FDI) is seen as a catalyst for economic growth in developing countries and economies in transition. According to Well (1980), Chen & Wong (1990), the FDI are becoming an important factor for economic growth and employment. Also, FDI is regarded as crucial for the transfer of technology, managerial skills and the promotion of innovation (HYMER, 1976, Rugman, 1980, Dunning 1980; Mallampally & Sauvart 1999, Nunnenkamp 2002).

Foreign capital does not only supply modern technologies but also advanced management techniques. Positive effects especially come out through businesses that continuously train their employees in order to improve the expertise of human capital. Also FDI bring to the recipient country new technology and investment goods. This will improve the competitiveness of goods and services produced in the recipient country, leading to increased sales on the international markets.

Positive spillover effects for domestic companies and branches can be expected from the foreign investments when domestic firms profit from foreign investors' knowledge in the fields of marketing and technology. An example of these positive spillover effects is the case of the car industry in Eastern Europe. The cooperation of Volkswagen AG and Skoda provides hundreds of subcontractors with modern technology and a better technical standard. 70% of the components for the Skoda production come from Czech contractors. Suzuki and General Electric have decided to modernize subcontractor firms in the Czech Republic. (Protsenko, 1999) FDI can also have a positive impact on the economic growth. For example, a study of the polish economy shows that that FDI have been responsible for 39 % of the growth rate in Poland during the period of 1991 to 1995. (Kusic, 1997)

FDI facilitate access to new markets and contribute to increased export incomes in the recipient countries because new technologies and advanced management methods introduced by foreign investors can help to raise the competitiveness of the transition economies products. At present, many Hungarian firms produce exclusively for the export to the EU. For example, the Czech car producer Skoda, which belongs to the German Group of VW since the beginning of the nineties, exports the largest amount of its products to developed industrial countries.

Foreign investment flows will increase if they find attractive determinants in local markets, otherwise foreign investment flows will remain unchanged or to decline.

According to several studies conducted by Merlevede and Schoors (2004), Janicki and Wunnava (2004), Bevan and Estrie (2000) conclude that the main determinants of FDI flows in transition economies are: the market size of the host country; the risk of the host country, the cost of labor force and market openness.

According to UNCTAD (2000), there are three categories of factors that attract FDI in a host country: economic factors (market, resources, competition), government policies (macroeconomic policy, private sector, trade and industry) and strategies of MNEs<sup>28</sup> (FDI policies, risk perception, location of resources, integration).

The less developed a country, the greater the expectation that it will be based on FDI flows. But, on the other hand, investors are attracted by locations that offer a combination of advantages. For this reason, FDI flows in recent years have been directed towards a certain number of countries that have certain characteristics for attracting FDI. Globalization has made a necessity for MNEs to change their strategies to be more competitive in new markets. Thus, the MNE-transfer activities, such as: finance, research-development (R&D), production, etc. in subsidiaries where is better suited the realization of these activities (UNCTAD, 1994).

The boundaries between different types of FDI are becoming less visible and it is seen as part of MNEs strategy to become more competitive. MNEs would be attracted from countries that provide appropriate combinations of local factors, such as: efficient operating conditions, quality assets and resources, access to markets (Dunning, 1998).

As a result of the adoption by MNEs of complex global integration strategies, an important determinant of FDI in host countries is the presence of sophisticated assets in host countries. (Noorbakhsh et. al, 2001)

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<sup>28</sup> MNE stands for Multinational Enterprises

## **FDI in Albania**

### **The characteristics of foreign investors actually operating in Albania**

Based on INSTAT data, it appears that in Albania 2.4% of the total number of enterprises registered with legal identity operate with entirely foreign capital while 3.4% operate with joint capital (most of them are small enterprises with one to five employees and only 8% have ten employees). Foreign investments in Albania have the following characteristics:

- The majority of foreign investments in Albania are in the form of joint ventures, constituting 20% of total enterprises. The reason is that foreign investors are not confident enough to invest their capital in 100% ventures of their own. So, to decrease investment risk, they invest in joint ventures.

- Foreign investments are generally made in the commerce sector (60%) and less in the most crucial sectors, i.e. industry (17.6%) and in agriculture (0.9%), because the amount of investment required is lower compared to industry and agriculture, and because the returns are rapid and the investment risk low. Foreign investors do not prefer to invest in industry and agriculture in order to minimise the risk related to the unconsolidated business environment. Backwardness in attracting foreign investment in agriculture is also related to the absence of a law on agricultural land and the many problems of management in this sector

- Compared to other countries of Central and Eastern Europe, according to INSTAT data, it can be seen that the source of FDI is generally neighbouring countries, such as Italy and Greece. 48% comes from Italy, 43% from Greece, 2.2% from Macedonia and Turkey, and less than 7% from other countries of Europe and the United States. Foreign enterprises in the production sector are engaged in re-exporting finished or part-finished products: generally they produce clothes, shoes and leather items. The volume of their exports is about 87%, and that of imports about 48%, of the total volumes of exports and imports in the country. Italian investments are focused in the western part of the country, close to the Adriatic Sea. Generally, they are small and medium-sized enterprises and the major part of them is engaged in industry (29% – the production of clothes, shoes, leather items and foodstuff) and in construction (35%). Greek investments are focused mainly in the south and south-eastern part of the country, close to the Greek border. As distinct from Italian investments, the Greek investments are engaged mainly in commerce and less in industry (about 2%).

### **Benefits of Albania from FDI**

FDI inflows stimulate economic development and have helped developing countries such as Albania when faced with economic hardship previously. (Economy Watch 2009)

FDI in the tourism industry, energy sector, road construction and the service sector are going to generate increased employment.

FDI into Albania permits the transfer of technologies and assists in competition between producers within the local market. Gains in the economy include the development of skills, and human capital resources by Albanian employees of Energy, Construction and Engineering firms receiving training on the operations of a business. The creation of new jobs, and increases the salaries of workers leads to lifestyle enhancement. (Economy Watch 2009)

Previously, Albanian professionals would immigrate to other nations. “Brain drain” is used to describe the phenomenon of emigration of highly qualified professionals from Albania to other EU nations. FDI in Albania contributes to positive economic growth, and professionals are a source of capital for developing countries such as Albania. Reversing the brain drain has had positive effects on education, income distribution and economic welfare. (Centre for Social and Economic Studies, 2006)

#### **Some barriers for FDI in Albania**

The financial system in our country is relatively underdeveloped by western standards, even though progress has been made. Even though many banks have expanded their services, the use of credit cards is still not widely used. Although credit offered by banks is available, it is expensive and difficult to obtain without large collateral security. Albania’s capital markets are already inexistent. Government has separated the Tirana Stock Exchange from the Bank of Albania, but the stock market remains inactive.

Feasibility of the client company entering the Albanian markets in a Greenfield capacity is varied. Despite some recent improvement, Albania’s business freedom remains constrained by a burdensome regulatory environment. Even though starting a business is relatively quick, obtaining a business license requires 24 additional procedures and almost 100 more days than the world average of 225 days. (The Heritage Foundation, 2009)

Corruption in Albania remains in high levels. Corruption is evident in all the sectors and levels of government. Albania is still considered a transit country for the traffic of arms, contraband and human beings. The economy remains vulnerable on several fronts due to tax evasion and the lack of anti-money laundering laws.

The resolution of the property problem in Albania is obstructing foreign investors. The process of the denationalisation of land and national buildings, medium- and large-sized national enterprises in industrial sectors with intensive capital, and strategic sectors like energy, water and transport, has been slow.

### **Some reasons to invest in Albania**

Investors choosing Albania find that they benefit from ‘the Albanian advantage’ which comes from investing in a politically stable, fast-growing, low cost, European economy that is today’s gateway for European manufacturers into Southern Europe. Some reasons to invest in Albania, according to ALBINVEST are:

#### *Macroeconomic stability*

Economic developments after year 2000 indicate that the Albanian economy has entered an irreversible process of reform, which has consequently had a positive effect on the main macroeconomic indicators and macroeconomic policy.

Albania is building a consistent track record of economic expansion built on export growth, a low and stable inflation rate, and increasing per capita income. Our GDP and export growth rates were the fastest growing in South East Europe from 1997 to 2008.

Albania is an excellent FDI opportunity that may provide substantial profitability to foreign investors. Real GDP in Albania has averaged 6% in previous years due to a surge in public investment. A 2007 World Bank report highlighted Albania’s high GDP growth and a dramatic decrease in poverty. Albania has received significant investment from international bodies such as International Bank for Reconstruction and Development. (Hirst, T, 2008). A country’s balance of Payments accounts calculates its payments to and receipts from other countries. If the FDI in Albania is a substitute for goods and services, the effect can positively improve the current account of the host countries balance of payments. (Hill CW, 2009). According to a UN report, inward FDI by foreign multinationals has been a major driver of export led economic growth, which can be utilized by Albania.

#### *Low inflation rate*

Businesses prefer a predictable environment in which to operate. Consistent low annual inflation rates in recent years have shown that Albania provides the economic stability that gives investors the confidence to invest. Consumer price inflation is under the 4 per cent upper limit of the central bank’s informal target. The Albanian LEK will continue to be supported in 2009 by large foreign-currency remittances from Albanians living abroad as well as relatively high interest rates.

#### *Established trading with the EU*

Almost 90% of Albania’s exports are designated for EU markets, and this export pattern is an important predictor of future growth. Exports should grow relatively strongly in 2009 and forecasted current account deficits averaging around 11% of GDP. (Business Eastern Europe, 2008)

#### *Gateway to the Balkans Free Trade Area*

Albania benefits from many Free Trade Area agreements with Balkan nations to the east of Albania. Western Balkan countries have liberalized their trade regimes significantly by concluding a network of bilateral free trade agreements that shall shortly be transformed in a multilateral one. Furthermore, substantial progress has been made in improving the investment climate, creating a common energy market and developing regional infrastructure strategies. The recent level of intra-regional integration can be illustrated by the level of intra-regional trade. The actual intra-regional trade in the Western Balkans is mainly characterized by the revitalization of traditional trade links. Investors can manufacture in Albania for export to the 50 million-strong Balkan market as well as throughout the European Union.

*Site availability from production facilities to high quality office space*

Various sites are currently available under the Albania “One Euro” initiative. These range from basic production facilities throughout the country to high quality serviced office space in all of our main cities. Industrial sites are better priced in Albania than in Eastern European or other Balkan countries. Electricity and water costs are also at or below those of other countries. Factory units are available for refurbishment, which, in many cases, are government owned and are offered along with attractive leasing arrangements based upon the number of jobs created.

*Total labor costs are lower than comparable countries*

Gross wage costs are a fraction of our competitors’ levels within the region, including Romania and Bulgaria, while social security ‘on costs’ in Albania amount to just 30.7% of gross wages. Competitive salaries are another favourable incentive. In the actual circumstances of an undeveloped economy, real salaries in Albania are low. Based on INSTAT data 2008, the minimum salary is 16 000 Lek per month (about EU130 per month).

*Adaptable and flexible skilled labor force*

Albania’s working population of slightly fewer than two million has a median age that is young by European standards, just 29 years compared to 40 years in Italy. A high proportion of under-40s speak two languages, many of them after returning from studying and/or working abroad. The current unemployment rate of approximately 15% shows that there is no complacency in the job market while the number of students in social sciences, business, and law accounts for more than one-third of all those in higher education. While some members of the labor force are highly skilled, many work in inefficient industries with outdated technology. Via foreign firms investing in Albania, the skill sets and technological capabilities of the Albania’s young work force is enhanced. (Macro-Accessibility 2007) Albania’s are rapidly learning market economic practices and often display

impressive entrepreneurship. (Macro-Accessibility 2007) There are definitely significant opportunities for the host country Albania through FDI.

*Extensive language skills*

Most Albanians learn either Italian or Greek from childhood, and are well able to perform customer-relation positions in these near-mother tongues. The younger generations learn English, which is rapidly becoming the primary foreign language taught in schools and universities.

*Administrative & business regulations are being simplified*

Albania is working hard to improve its administrative procedures. Starting a business, Albania ranks 68th in 2009 and set to move to 46th in 2010. The average time in days for starting a business is 5 days as compared to 13 days for the overall OECD Average. This demonstrates that the Albanian government is moving in a positive direction to attract foreign investment. (The World Bank Group, 2009). Foreign and domestic firms are treated equally under the law, and nearly all sectors are open to foreign investment. Agricultural land may not be purchased by foreign investors but may be leased for up to 99 years. The Albanian state can expropriate an investment or asset for the purpose of public interest, but there are no legal provisions for compensation. (The Albanian law on FDI) Investing in Albania offers the best tax system in Europe with a 10 percent flat tax. (NEWEUROPE 2009)

*Investment opportunities through privatization*

The government is reviewing its privatization strategy, because the privatization will represent an important source of investment as well as an opportunity to transform some key strategic sectors of the Albanian economy. A new law on concessions has recently been passed with support from the World Bank and is designed to stimulate the development of key sections of the country's infrastructure and public services. The feasibility of the client company to enter the Albanian market is positive. The Albanian government encourages foreign investment, thus in an ongoing effort to privatize public enterprises, the government is seeking qualified foreign investors in key sectors, including telecommunications, energy, oil and gas, finance, and construction. (Foreign Investment Climate, 2008)

**Attractive investments in Albania**

*The energy sector*

The business ventures that are attractive for FDI are focused on construction infrastructure and energy. Based on a recent EU report, it is acknowledged that Albania had undertaken some important steps to restructure and liberalize the energy sector and from international institutions it will be provided financing for new power generation. Therefore, renewable energy is also an attractive foreign investment option. Hydroelectricity generation has always provided the majority of Albania's energy capacity



and continues to represent its main generation source. Here, it can be mentioned the Hydro Power Energy investment in Ashta (North Albania), an Austrian investment in energy sector. Through a lack of investment funds, only 35 per cent of potential capacity for development is currently being exploited. (GMB Publishing 2009)

#### *Tourism sector*

During the last two years, Albania had an impressive growth in tourism. According to the Ministry of Economy, there was a 42 percent increase in the number of tourists visiting the country. With new hotels, resorts, and restaurants, the Albanian private sector in tourism has been growing at an average rate of 30 percent during the last five years. The previous low level of foreign interest is largely due to the fact that Albania's international image is poor, but wrongly so. Albania's service sector, especially its restaurants and hotels, are traditional and attractive. It can be mentioned the hospitality as a characteristic of Albanians that attract foreigners. They are ready for an influx of tourists. Albania is also rich in natural resources, such as oil, gas, copper, chrome and hydroelectric potential. (Austin RC 2006)

#### **Foreign investments in textile sector in Albania**

Investments in the textile sector are increased considering the numerous advantages that Albania offers; starting from its location, its connection with other Balkan countries, as well as a high rate of unemployment.

The origin of most foreign investors that operate in textile sector is from Italy and Greece.

Investors who want to invest in Albania also benefit from cheap labor force which works with very low cost compared with other Balkan countries like Romania or Bulgaria. The main factors that have positively influenced the activity of these investors are:

- A new workforce (in age) and a qualified workforce
- Geographical position
- Market openness
- Infrastructure improvements
- Free trade with the European Union for almost all goods (within the Stabilization and Association Process)

Initially, all businesses claim that the main factors that attracted these investors were the high rate of unemployment and the low level of wages. Today, the factors that attract these investors are professional competences and qualification of the labor force. Some barriers for these investors are: unfair competition, corruption and global crisis. There are some changes to be undertaken, proposed from existing investors in textile industry, so that other investors will be encouraged to invest in our country:

- Provision of credit facilities for these businesses
- Development of vocational education for the preparation of a qualified workforce.
- Implementation of laws and not their misinterpretation in bureaucratic guidelines

### **Conclusion**

Based on different authors it has been argued that developing countries might enhance attractiveness as locations for FDI by pursuing policies that raise the level of local skills and build up human resource capabilities.

FDI is not only a source of finance and employment, but can also be a medium for acquiring skills, technology organizational and managerial practices and access to new markets.

FDI inflows stimulate economic development and are seen as a catalyst of developing countries such as Albania when faced with economic hardship previously. FDI in Albania are considered as one of the main contributors on the economic growth of the country.

Even though the level of FDI inflows has increased during the last years, there are still some barriers for foreign investors such as, the poor infrastructure, the still undeveloped financial system, the unresolved problems of property and the high level of corruption.

There are some reasons that attract foreign investors in Albania such as, the macroeconomic stability, cheap and qualified working force, simplified business regulations etc.

Actually the sectors of tourism and energy are seen as very attractive by foreign direct investors in Albania.

The process of EU integration and the membership in NATO are also considered as very favorable factors in the increased level of FDI in Albania. The subject of foreign direct investments is of a great importance for our country, so this paper provides an overview of the conditions, opportunities that foreign investors can find in Albania. Other researches in this area could be done in the future, in specific attractive industries or sectors for foreign investors.

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