

FDI Revisited: Empirical Evidence from Transition Economies — Case of Albania

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Abstract: Transition economies in the Central East European (CEE) and South East European (SEE) region have embraced the notion that FDI can act as a catalyst in their effort to reform their economies and as a result policies and measures have been put in place to attract FDI inflows. Indeed, foreign investors started moving capital into the region which caused FDI to increase markedly. The undertaken study draws on the idiosyncratic economic environment of Albania and attempts for the first time to provide empirical evidence on the short as well as the long-run relationship between FDI and a number of factors thought to play an instrumental role in attracting foreign capital.

Key words: Foreign Direct Investment, Albania, ARDL model, Cointegration

JEL Classification: B22; E12

Introduction

Several waves of globalisation in the history of the world economy led to a growing interdependence among countries through cross-border financial flows and increasing amounts of foreign trade. One of the most important features of the globalisation during the last decades was the rapid increase of foreign direct investment (FDI). Multinational enterprises (MNEs) have engaged in FDI in order to serve foreign markets or to take advantage of differences in production costs among countries.

As largest carriers of the world's advanced technology, multinational enterprises (MNEs) are believed to base their investment decisions according to Ownership, Location and Internalisation advantages (OLI framework) offered by prospective

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host countries (Dunning, 2000). Thus, many developing countries have been aggressive in their efforts to attract FDI. However, that pure vertical investment motivated only by factor-endowment differences is not a dominant model of FDI strategies. Rather, MNEs enter foreign markets horizontally by replicating their activities in many locations. Consequently, geographical diffusion of technology is a result of a decision to internalise the use of core technology, instead of transferring the technology beyond the boundaries of MNEs. However, MNE's technology may still leak to the surrounding economy through external effects or spillovers that raise the level of human capital in the host economy and increase productivity of local firms.

In a number of studies FDI inflows emerges as a crucial factor responsible for facilitating a successful transition process in CEE and SEE countries as well as a very significant component contributing to high levels of economic activity. Foreign Direct Investment is essential for transition economies not only because of the transfer of technology and know-how, but as a source of financing it also helps economies to cover the current fiscal deficit, supplementing insufficient domestic resources to invest both ownership change and capital formation.

Albania serving as a focal point of this study, has been recuperating from the deep political and economic crisis, making considerable strands towards political and economic stability. A new set of policies and regulations have been put in place to reform the obsolete economic framework, but the challenge of transforming the economy into a dynamic breathing apparatus for the region is still on. Despite the increasing FDI inflows into the country, potential investors are still awaiting to see the promised changes to materialise.

The rest of the paper is organised as follows. Section 2, very succinctly provides an overview of the macroeconomic performance of the CEE and SEE as well as touches on past empirical studies conducted on the determinants of FDI. In section 3, the economic profile of Albania serves as a basis on which a more extensive elaboration of the existing economic environment is pursued and the measures put forward to attract FDI, while sections 4 scrutinises key macroeconomic indicators in attempt to gauge the economic path that the Albanian economy, is balancing itself on. Section 5 through cointegration techniques attempts for the first time to empirically establish the impact of some key variables as factors that condition FDI inflows both in the short and the long run respectively. Finally, section 6 concludes.

Macroeconomic Performance in the CEE and SEE: An Overview

Over the last decade, former planned economies in the Central East Europe (CEE) and the South East Europe (SEE) have embraced rather keenly, the transition process

towards market economy¹. Cheap production opportunities have led a number of multinational enterprises to move into the emerging markets driving FDI flows to unprecedented level. Such a development had had a huge impact on the domestic economies contributing significantly to the long process of transition (Protensko, 2003).

Despite the fact that both the CEE and SEE countries set off from the same starting point there appears to be a rather different picture shaping up as to the economic trajectories that those regions are on. The SEE countries do share some common features whereas CEE countries are characterised by a more diverse denominators (Hunya, 2000).

The current economic environment in the SEE region is exposed to a number of political constraints that have hampered their process towards market economy. In spite of this, the overall image of the region appears to be improving as time progresses, making steps towards their objective, i.e. creating the appropriate economic conditions for future EU membership (Uvalic, 2003).

A close look at some economic indicators reveals the different economic performance that permeates the two regions. The CEE countries have achieved a higher level of development than the SEE mainly due to efficacy of the reforms adopted by the CEE countries as well as the political stability the region has enjoyed over the last decades. More specifically, GDP in the SEE is less than one third of the GDP in the CEE (see appendix). SEE's GDP per capita in 2002 was about two to three times lower than that in the CEE.

GDP growth in the CEE as this is exemplified by Hungary, Poland and Slovenia has been rather robust. In the SEE, on the other hand, it wasn't until after the war in Kosovo was over that some economies started exhibiting signs of recovery. But even then, the overall picture did not change dramatically mainly due to the crippling effects that the deep recession had had on output. Furthermore, high-sky inflation rates in countries such as FRY, Bosnia and Herzegovina and Romania add to the macroeconomic instability that characterises the entire region (see appendix).

On the employment front, in the SEE the picture is rather alarming. The social costs that the process of transition entails has not been matched by adequate job creation. Thereby, unemployment in countries such as FYROM, Bosnia and Herzegovina or Yugoslavia has reached unprecedented levels, adding to the already existing problem of social exclusion and poverty.

Despite the dismal macroeconomic performance that the entire SEE region has experienced, reports coming from economic institution such as the European Bank for Reconstruction and Development (EBRD), are rather optimistic as according to them key areas such as enterprises, infrastructure, financial institutions, have improved considerably, and therefore there are no large differences between the CEE and SEE (Zakharov and Kusic, 2003).

Nevertheless SEE countries face still a number of economic, political and social problems, the overall forecasts for the future of the SEE region are nowadays much brighter than some years before. The improvement of conditions for achieving more constant stabilisation and sustainable growth will make easier the integration of the SEE region into the EU (EBRD, 2004).

FDI in CEE and SEE Countries

The bulk of the existing academic literature concerning the impact of FDI in transition economies focuses on either the positive role of FDI in restructuring the economy at a micro level or the role of FDI as a key determinant of economic growth.

For the CEE and SEE countries it's not only the amount of FDI that plays an instrumental role as an enormous source of fresh capital for these countries, but the most important thing is its contribution to economic development.

Over the years, reams of academic papers have been written on the effects of FDI in CEE and SEE economies through the transfer of technology and managerial know how, modernisation of enterprises, increased competition, stimulation of growth and employment and access facilitation to Western markets (Zakharov and Kusic, 2003; Hecklinger, 2002; Kusic and Cvijanovic, 2002).

In particular, FDI can be thought of as a bridge between diffusion of technology and advanced management techniques, know how, improvement of the quality of the products produced in the host country etc. In the CEE and SEE countries however, little has been invested in R&D leaving these countries lagging in sophisticated technology. In addition, FDI has been regarded as key factor responsible for employment creation in some CEE and SEE countries. According to Mickiewicz, et al (2000), and Faggio (2001) FDI has been translated into more jobs as well as higher wages in Hungary, Poland, Bulgaria and Romania respectively. As a result, FDI and economic growth are closely associated as for instance in Poland FDI is thought to have contributed to approximately 39% of the GDP growth rate for the period 1991-1995. In another study Kusic and Cvijanovic, (2002) emphasise the importance of FDI as a key determinant of a sustainable economic growth in Croatia.

Attracting FDI in SEE Region: Incentives and Barriers

The inflow of FDI in the SEE region has been significantly lower than in the CEE countries (see relevant tables in appendix). Due to political and economic uncertainty in the SEE region FDI inflows were usually very low until 2000. In her article Uvalic (2003), states that:

‘During the first half of the 1990s (over the 1989-1996 period), the cumulative net inflows of FDI into six SEE countries (without Bosnia and Herzegovina, for which data are not available), have amounted to only \$2.8 billion-corresponding to 6.6 per cent of total inflows into all 27 transition economies. The situation has improved over the last five years. Since 1997, the annual FDI inflow into SEE has been at the level of around \$3 billion (therefore equal or even higher than during the entire period 1989-1996)’ (p.76).

According to the abovementioned statement it’s obvious that one of the challenges that SEE countries should face nowadays are the preparation of policies and incentives framework and the lowering of barriers in order to be able to increase the level of FDI inflows.

Potentially, the increase in the level of FDI inflows recently has been attributed to the new era that globalisation has ushered in. International trade barriers have been dismantled and a number of trade agreements have been signed around the globe. Nowadays, almost all countries have liberalised their FDI policies and offer different forms of investment incentives in order to attract FDI.

Privatisation in the SEE region has been looked upon as means to an end. Even though the economies are far from ready to fully adapt to the new economic conditions that the process toward privatisation entails, governments in the SEE are trying hard to raise the low levels of capital accumulation (Hunya, 2000). In doing so, new steps towards reforming the obsolete institutional framework conducive to attracting new investment has been put into place. The new framework, should be transparent reflecting the governments’ intentions in relation to taxation² and trade policies, corporate governance, public administration, etc.

Recently, an initiative to set up the institutional framework promoting FDI in the SEE region has resulted in what is known as the Investment Compact. According to this promoting private sector investment as well as improving the business environment for foreign investors have been set as the central objective. Furthermore, twelve detailed Guidelines that provide the ‘best practice’ framework for investment promotion have been envisaged (OECD and SEE, 2002).

The entire region has been suffering from rigid legislation, corruption³, political and economic instability. It is therefore imperative that FDI barriers in the SEE are lowered so as to facilitate the creation of an appropriate climate for doing business.

Determinants of FDI

Determining the factors that attract FDI and most importantly identifying the key characteristics of the host economy, are essential in comprehending the rationale behind FDI flows in a country or region.

On the empirical front, a number of different studies provide various results. More specifically, in a cross-section analysis, Balasubramanyam et. al. (1999) found that in the export-oriented countries, FDI is a more powerful driving force of growth than domestic investment. In addition to this nexus of exports, growth and FDI, the results suggest that the size of the domestic market (measured by real GDP per capita) and strength of local competition (the value added share of manufacturing) also have an impact on FDI. However, the most important finding of the study is the existence of a bi-directional relationship between FDI and human capital in the host country (as proxied by the manufacturing real wage)⁴.

In another study by Chakrabarti (2001) the market size is found to have a positive impact on the level of FDI while the growth rate and market openness are observed either as having positive or insignificant effect on FDI. Evidence on the influence of the remaining variables i.e. labour cost, trade barriers, taxes, trade deficit, exchange rate, is mixed as their correlation to FDI remains highly sensitive to small alterations in the information set.

Bajo-Rubio and Sosvilla-Rivero (1994) in their empirical investigation on the Spanish economy found that large gross FDI inflows in the period 1964-1989 were strongly correlated to the level of real GDP, macroeconomic stability as proxied by the rate of inflation, trade barriers and the lagged foreign capital stock. To the aforementioned findings De Mello (1997) adds institutional features of the recipient economy, namely political stability, the degree of government intervention, the existence of property rights legislation and bureaucracy. Moreover, international trade and investment arrangements, degree of monopolistic competition, inflation and monetary and fiscal policies, balance of payments constraints and financial incentives can also affect the volume and pattern of FDI.⁵ However, De Mello warns that 'beggar-thy-neighbour policies' tend to be of limited scope and duration (p.5).

Lim (1983) by specifically examining the role of fiscal incentives offered by governments of less developed countries to foreign investors identified three categories of incentives: pure tax holidays, modified tax holidays whose duration and value depends on the level of investment and the category of cost-lowering incentives such as the accelerated depreciation allowance, the investment allowance and the investment subsidy⁶.

Emerging evidence on the importance of both traditional (wage and infrastructure) and nontraditional (regime type, regime duration, property right's index) factors that condition FDI suggests that both the traditional and nontraditional

factors interact and jointly determine FDI (Biswas, 2002). In passing, the wage rate does appear to be a significant factor, while infrastructure quality (as proxied by per capita total net installed capacity of electric generating plants and the main telephone lines per 100 inhabitants) has a positive impact on foreign investment. In addition, regime type (as in democracy vs. autocracy), duration of the regime and the risk of expropriation of private investment (measured by the property right's index) are found as statistically significant factors in determining the level of FDI.

Based on the motivation of potential foreign investors to invest in host countries, we distinguish between three different types of investors: market-seeking, efficiency-seeking and resource-seeking. Countries that offer the best opportunities to penetrate domestic markets attract market-seeking investors, whereas efficiency-seeking investors set out to increase profit through the reduction of costs that arises by using resources in a more efficient way. Finally resource-seeking investors attempt to find resources, which are not available in their countries (Baniak et al, 2002).

According to Merlevede and Schoors (2004) the determinants of FDI in transition economies can be divided into two groups. The ones suggested by economic theory and the ones relating to the specific country in transition. Amidst a number of studies the ones conducted by Merlevede and Schoors (2004), Janicki and Wunnava (2004), Bevan and Estrin (2000) suggest that the main determinants of FDI flows in transition economies are centered on the following key areas: host country market size, host country risk, labor cost and openness to trade.

In particular, the prospect of new well organised markets that expected to grow fast in the near future could be a legitimate reason for market-seeking investors to penetrate those economies. Low labour cost is a feature pertaining to most of the CEE and SEE countries rendering the entire region a comparative advantage in terms of FDI flows (Resmini, 2000).

Another significant determinant that influences the investment inflows in emerging markets is the one associated with the country's risk, in terms of both macroeconomic and political stability, but also in terms of the transparency attached to the legal framework intended to promote transition reforms. (Baniak et al, 2002)

Openness to trade in conjunction with the undertaken privatisation process of state-owned companies, has added to the reliability of host countries as potential destinations of investors.

The transition process from socialism to capitalism for CEEs and SEEs countries coupled with the potential accession in the EU of some CEEs countries have attracted more efficiency-seeking FDI, boosting the confidence of investors (Bevan and Estrin, 2000). In particular, the first wave of EU candidate countries (namely, Czech Republic, Hungary, Poland, Slovenia and Estonia) received most of FDI in the region due to ongoing processes of privatisation at the time. Although the geographic

proximity of these countries to world markets, easy maritime access in case of Estonia and large market size of Poland, relative abundance of well-educated but low-cost labour (that is commonly shared characteristic by all transition economies) are also identified as major advantages in attracting FDI, the single most important determinant of FDI flows is seen in the privatisation of state assets. On the other hand, main factors that discourage FDI inflows into transition countries are slow economic reform and political climate, i.e. unfavourable attitude towards foreign investment, corruption, regional conflicts, periodic economic crisis, landlocked locations and greater distances from world markets as well as poor records of law enforcement.

Conversely, as one of the main motives behind government's efforts to attract FDI, Obwona (2001) identifies the need to increase the equity/debt ratio on foreign capital. Compared to equity, debt needs to be serviced regularly, and with private foreign investment the government is able to transfer the commercial and exchange rate risk to the investor. In a survey of foreign and local investors operating in Uganda, Obwona (2001) identifies liberalised exchange rate and a fully convertible currency, low inflation and constrained fiscal management as the most widely perceived strengths of Uganda as an investment location. However, the country's anti-FDI history, landlocked position, poor infrastructure and high tax on fuel that further increases transportation and communication cost present the main weaknesses of Uganda's market. Additionally, relatively small market size, low labour productivity, underdeveloped banking system and erratic macroeconomic policies concerning FDI also have a negative impact on the FDI flows to Uganda.

Hsiao and Shen (2003) argue that in addition to the standard factors affecting cost-benefit analysis of an investment projects, there are intangibles such as bureaucracy, degree of openness, stability of institutions and urbanisation equally important in attracting FDI. The evidence obtained suggests that economic growth has a positive impact on foreign capital inflows and also indicate the importance of predictable behaviour, trustworthiness and commitment from government institutions in attracting FDI. In addition, while the corporate tax rate has a disincentive effect on attracting FDI, the development of infrastructure plays in offering locational advantages.

Venkataramany (2003) questions the reasons behind low FDI inflows to India compared to China that ranked first among the top ten developing host countries of FDI in 2001. The results of panel data analysis covering the period 1992-1999 indicate that at 99% confidence level, FDI flows to India can be explained by the income growth, inflation rate, and interest rate on deposits that seem to be increasing foreign investment as opposed to interest on commercial loans, and level of imports. However, after-tax profits explanatory variable is not found as statistically significant even at the 90% level of confidence, except when the data set is broken according to FDI-source countries. One of the possible reasons behind low FDI

inflows to India is a relatively slow process of privatisation of state enterprises in the industrial sector, utilities, and the banking sector.

In contrast, Chakraborty and Basu (2000) find that in the short run FDI flows to India are largely explained by real GDP that defines the size of the domestic market. In the long run, however, two relationships exist; the one between FDI flows and existing market opportunities (proxied by real GDP) and market liberalisation (proxied by the proportion of import duties in total tax revenue). In addition, there is also a long-run relationship between real GDP and unit cost of labour that is independent of FDI flows and changes in the trade policy.

In the sketch of the above arguments, one can discern that attracting FDI is a task that is contingent upon a number of potential variables, the significance of which is heavily conditioned by the idiosyncratic economic and socio-political environment that permeates the host economies.

Albania: A Country in Transition - An Overview

The political regime in Albania was a socialist-communist one for about four decades and compared to other countries in Eastern Europe it has experience a more articulated socialised economic system. In the early 1990s Albania was one of the last of the SEE countries that accepted the political pluralism and also started the transition process toward a market economy.

During the years of transition to a market economy Albania faced strong political, economic and social changes. The way the country was run for all those decades caused a great degree of macroeconomic instability to be paramount in all sectors of the Economy. A deep recession at the beginning of the 1990s caused the GDP to decrease by approximately 40%, the unemployment rate to grow to 27.9% and the inflation rate to reach the 226% mark (KPMG, 2000).

After that a more promising picture emerged as with the assistance of international organisation the country experienced a real and strong growth with an increased annual rate of GDP of about 9% from 1993-1996. The ensuing year put paid to the short lived recovery as the collapse of fraudulent pyramid schemes in 1997 caused a social and economic crisis and a 7% GDP decline in real terms (Holzner, 2002).

In spite of the damaging effects of the 1997's crisis, the Albanian economy has emanated signs of recovery. Real GDP growth in 2003 reached considerably high levels, with the inflation pinned at 2,3%. Ever since 1999, enterprises in Albania are thought to be operating in a relatively stable macroeconomic environment. According to Izzo, (2004) a significant factor contributing to the country's growth has been the favorable environment for foreign investors

Furthermore positive developments in public finances through the increase of tax revenues and FDI inflows reduced the deficit from 12% of GDP in 1999 to approximately 5% in 2003. In addition to this a restrictive monetary policy maintained inflation under control and contributed to the stability of the exchange rate and the economy as a whole (EBRD, 2004).

Although Albania recently experienced improvements in its macroeconomic indicators such as GDP, inflation and employment, poverty is still fluctuating at alarming high levels with a very low GDP per capita. Measures are still needed to ensure sustainable economic growth and political stability. Some of these challenges may be: further development of private sector and the improvement of investment climate, realisation of strategic privatisations in some important sectors of the economy, reforming in this way the most vital sectors for further sustainability and growth of the economy.

Investing in Albania

Albania is continuing the process toward a liberal and open trade system, trying to fulfill the obligations as a member of WTO from September 2000 and preparing for future commitments in the framework of Stabilisation and Association Agreement (SAA). Furthermore, the general effort is directed towards the finishing touches of the Free Trade Agreements (FTA) with SEE countries as well as the implementation of efficient strategies intended to promote exports and FDI.

Due to the fact that FTAs reduce and liberalise customs and other trade barriers between the countries that have signed the agreement, not only is Albania contributing dynamically to the creation of FTAs network in the SEE region but has signed a number of bilateral agreements for the protection and promotion of foreign investment as well.

The legislative framework has been set up so as to promote private sector investment giving a special attention to the promotion of FDI. The most important law related to FDI is the Law 'On foreign investment' (No. 7764, dated 2.11.1993), which intends to provide a positive investment environment for foreign investors in Albania. It attempts to serve this purpose through treating the foreign investors in the same way as to Albanian counterparts providing at the same guaranties to foreign investors such as: protection against expropriation or nationalisation and more favorable treatment in accordance with international agreements (Mancellari, 2004).

It should be stressed however that despite the positive incentives to attract FDI, the level of FDI inflows is rather mediocre due in the main to the existence of some barriers relating to the slow progress of the transition process as well as to the overall political and economic reforms undertaken. The most serious administrative barriers

in Albania are centered on custom duties, tax administration, bureaucratic procedures that complicate the registration and functioning processes of economic entities and the unsettled conflicts relating to land and construction permits (Izzo, 2004).

General Features of FDI

The uncertain political and economic environment that has permeated Albania has caused FDI inflows to fluctuate considerably during the last decade. More specifically, during the period 1991-1996 FDI amounted to only USD 483 million. In 1997 the economic crises that crippled the country caused FDI to fall by about 50%. In the ensuing years however, FDI inflows started picking up again reaching USD 143 million in 2000 and USD 207 million in 2001 (EBRD, 2004; KPMG, 2000).

According to EBRD, (2002) and Hunya, (2002) the underlying progress was mainly due to the privatisation process. In particular, FDI contributed to more than a half of the capital inflow through the successful privatisation of different SMEs, mobile telecommunication companies and financial institutions.⁷ Obviously, there is still more things to be done to boost FDI inflows as the country has to offer many opportunities in high profit sectors such as mining, oil extraction, tourism, agriculture, manufacturing, energy sector, transports, etc (see appendix).

Measures to Attract FDI in Albania during 1993-2004

Being part of the SEE region Albania has taken a string of various measures not only to enhance its economic and political stability, but also to cooperate in different fields with other SEE and EU countries in key areas such as: trade liberalisation, implementation of joint investment projects etc. In an attempt to gain a better understanding of the policy expedients taken over the last decade it is imperative that we focus on the key elements that form the platform on which FDI can be based.

Trade Liberalisation

The 1990s found Albania an exhausted economy in terms of production technology, economic structure and institutions, which caused nearly total bankruptcy of the economy. In this context reforming the economy and more specifically the way trade was organised was deemed essential to stimulate economic growth (Dhimitri, 2004).

A significant step towards this end was when Albania in 2000 became a member of the WTO. Although the accession process was very intensive and difficult, it marked a profound institutional reform, including a legal package with 66 legal and

Governmental acts that appraised the Albanian trade legislation compatible with the WTO principles and with all international standards. All these measures provided a liberal and constructive trade regime for Albania making the country an amenable partner, ready to integrate with other member countries (Meksi, 2001).

Such an achievement was only the beginning as the government took further steps towards integrating with other countries within the south-east region. It was envisaged that regional trade cooperation's can create better conditions to attract domestic and foreign investors (The World Bank and IMF, 2001).

Nowadays the overall picture is undoubtedly much more positive than a few years ago with the main indicators directed in the right way. The prospects for trade within the SEE region and between this region and the EU have improved considerably over the recent years (Christie, 2004).

In June 2001, Albania and other SEE countries signed a Memorandum of Understanding (MOU) on Trade Liberalisation and Facilitation under the support of the Stability Pact for South Eastern Europe. The MOU provides the promotion of trade within the region under a wide-ranging agreement on a set of procedures. In this way the countries decided to negotiate free trade agreements between themselves by end-2002 based on the elimination of the most part of export and import duties. Moreover they agreed to harmonise and simplify custom procedures. In addition to these they also approved to implement WTO rules on free trade agreements and on their protection measures (Sundstrom, 2002; World Bank, 2001).

As it appears signing the MOU on Trade Liberalisation and Facilitation was of significant importance because not only it reflects Albania's dedication to promote peace stability and economic development in the region, but also afterwards the implementation of the signed Free Trade Agreements (FTAs), will bring increased trading volumes, and will rejuvenate the economy. It's evident that Albania can benefit from its comparative advantages in terms of market composition, geographical position, climate and many other resources.

Furthermore signing six FTAs with other SEE countries (Macedonia, Croatia, Bulgaria, Romania, Bosnia and Herzegovina, and Kosovo) means that Albania has established a network of fully operational FTAs, increasing in this manner trade liberalisation and moving ahead towards a free trade zone in the region (Mancellari, 2005).

The creation of bilateral agreements network was important not only to intensify the forms of trade cooperation and to resolve some problems that emerged especially after the military conflict in FRY in 1999 between SEE countries, but to influence FDI flows into these countries. According to Tobin and Ackerman (2005) investors in developing countries employ bilateral agreements as a mean to attract FDI. Furthermore. In their study they found that in general bilateral treaties have a positive

effect on the attraction of FDI if the country has a high level of political risk and instability.

Recognising that one of the main development strategies for Albania is the improvement of FDI environment, liberalising trade constitutes an essential feature of the new policy orientation towards a more sustainable economic performance.

FDI Legal Framework

The best strategy for Albania to attract FDI is to improve the business climate and this can be done first of all by reducing the administrative bureaucracy and establishing an appropriate legal framework on this matter.

In the field of foreign investment in Albania the most important law is the 'Law on Foreign Investment' (No. 7764, date 2.11.1993). This Law aims to ensure an encouraging investment climate for foreign investors in Albania. Under the Law, the investment conditions for foreigners are as favorable as for the domestic investors. The national treatment is provided in Article 2 of the Law, which stipulates: '...It (foreign investment) is permitted and treated based on conditions not less favorable than those that apply to domestic investments in similar circumstances, excluding ownership of land, which is regulated by a special law". Foreign investment in Albania, according to the Law (Article 2), is not subject to prior authorisation and no sector is closed to foreign investment (OECD, 2003).

Generally the Albanian Law on Foreign Investment is an instrument that creates highly constructive conditions for the promotion of foreign investment because on the one hand it clarifies the conditions for the promotion and protection of FDI and on the other hand it provides non-discriminatory treatment and a complete protection of foreign investments in Albania (Fida et al, 2004).

Furthermore specifically, foreign investments are protected from expropriation and nationalisation or other similar actions. Expropriations or limitations of a property rights according to Article 41 of the Constitution can only be carried out in cases involving public interests and against fair compensation. Such expropriations or limitations of property rights are based on law No. 8561 dated 22.12.1999 'On expropriation and taking for temporary use of private properties for public interest.' (ANIH, 2004).

According to the article 4 of the Law: 'Foreign investments will be expropriated neither directly nor indirectly and will not be subject to any measure or similar action, except for public purposes determined by law". Moreover, according to article 7 of the Law: 'foreign investors have the right to transfer out of the territory of the Republic of Albania all assets related to a foreign investment.' In addition to these the

Law also provides more favorable treatments to international agreements (OECD, 2003).

Although Albania has made solid progress in setting up an appropriate legal framework for the formation and functioning of foreign investments still there are only a few procedures in place in order to make these laws enforceable. As a result the efficacy of the existing legislation on FDI is undermined by gaps in implementation, which may give rise to discrimination between different types of investors and, in this manner, to corruption (Mancellari, 2005; IMF and World Bank, 2001)

SMEs Restructuring

The provision of efficient institutional support to small and medium-sized enterprises (SMEs), is generally recognised by all SEE countries as a top priority, because SMEs play an instrumental role in the transition process. Improving the business environment for SME development is essential of the policy framework in Albania, because SMEs by now make-up the vast majority of private businesses and are probably the main source of employment generation (Xhepa and Agolli, 2004; OECD and SEE, 2002).

Furthermore the SMEs role in the transformation process is rather substantial as they contribute to restructuring and development of the domestic market as well as to increasing competition of Albanian products in European markets. This may affect the enhancement of potential FDI inflows, which represent a potential market opportunity for local SME-s as suppliers of capital, technology and knowledge. In effect the building of supply capacity of domestic SMEs through training and other business support programmes is vital (Rembeci, 2003).

The Albanian economy is mostly dominated by SMEs and most enterprises are very small, micro or family organisations. Although a considerable number of employees continue still in state employment, SMEs reflect the sudden decline of large, state-owned industry⁸.

The key transition challenges for Albania are the investment climate and SME development. Despite some progress made in improving the business environment, SMEs development still encounter many barriers such as corruption, poor law enforcement, below standards infrastructure, etc. Corruption and bureaucratic obstacles are persistent and this has been the reason why many businesses try to avoid these obstacles by operating in the informal sector. Furthermore poor investment environment, in conjunction with weak corporate governance and lack of management skills are thought to have hampered FDI inflows (Muco et al, 2004; EBRD, 2002).

In dealing with the challenges facing the SME sector in February 2001 the Albanian government approved a strategy for the development of SMEs. This strategy is projected to cover gradually all the identified needs of the SME sector in Albania, ranging from institution building to entrepreneurs' training to providing appropriate finance to SME-s aiming in this way to increase production and employment. Thus the main objective of this strategy is to provide the platform on which existing businesses can expand, new ones can be formed, augmenting in effect the base on which SMEs can propagate (Rembeci, 2003; EBRD, 2001).

Xhepa and Agolli (2004), sustain that the government of Albania and Ministry of Economy (MoE) till now have done good work in the implementation process of new policies that support SMEs growth and development.

Privatisation Scheme

Privatisation is certainly and largely considered as the most important strategy of transition economies toward a market economy. Although the privatisation process for SEE countries over the past decade involved a fundamental transformation of the economy, the speed of privatisation in this region lagged behind that in the CEE countries. Even though the privatisation process in SEE countries has been of a great interest due to the fact that the main part of the society's assets were state owned, it suffered from a number of problems such as incoherent policy measures, as well as legislative and administrative deficiencies. (Muco, 1997).

As in other transition countries the implementation of the privatisation programs in Albania was considered to be one of the top priorities during the transition process. The transferring of the ownership from the government to the private sector creates a competitive economic environment in which firms make every effort to maximise the profits (Saving, 1998).

In low-income countries such as Albania, a proper implementation of privatisation programs is more than certain that will generate growth. However in achieving this goal is important to use the appropriate privatisation forms and especially the ones that can be efficient in economies with underdeveloped capital markets (Bennet et al, 2004).

Even though priorities for privatisation are usually specific for every country, the majority of those gave priority to SMEs. Albania began the privatisation process in 1991 with the Privatisation Law, which smoothed the way for rapid privatisation of SMEs⁹. The small-scale privatisation continued extensively till mid1990's.

It should be stressed that a lot of criticism was leveled at the first phase of the privatisation process with the hottest debate centered on land privatisation.¹⁰ In

addition, questionable practices were encountered during this stage rendering this phase of the process not very structured and properly designed.

The second phase of privatisation process began in 1995, when in order to privatise the large state owned enterprises the government decided to use a voucher or a mass privatisation scheme. This privatisation included all enterprises with an approximate value of US\$ 500.000 or 300 employees and foreign capital were invited to participate, as domestic funds were relatively limited (Austin, 2003; Muco, 1997).

Voucher or mass privatisation methods were considered to be appropriate at this stage by Albanian government, believing that it deal with problems encountered during the first privatisation phase. In addition, through this phase many state owned enterprises would be privatised at once and not on a case-by-case basis. This was considered to be especially important in a country like Albania where thousands of firms had to be privatised at the same time and as soon as that was possible (Castater, 2002).

However, although mass privatisation was considered the most appropriate privatisation process during these years, it had also its limitations such as: no single investor has the ability to supervise management, because it can generate a situation where an enormous number of investors hold only a number of shares. Furthermore voucher privatisation in conjunction with a low voucher value in the free market caused a number of problems to arise, instigating fraudulent activities. As a result by the end of 1997 only 5% of the state-owned enterprises were privatised (Austin, 2003; Saving, 1998; Muco, 1997).

In order to avoid all these limitations the government tried to alter the voucher strategy and to attract foreign investors. Thus, in 1998 launched the law for the privatisation of strategic sectors such as telecommunication, energy, water, mining, insurance and banking.

Obviously privatisation of these strategic sectors required the support of foreign capital. It should be noted that from 1998 onwards, FDI inflows have sharply increased, improving technology and managerial skills not only in the abovementioned sectors, but also in the whole economy. Foreign owned companies have contributed significantly to increased exports and employment through establishing new plants in the area (Sherif et al, 2000).

Political Risk

Political risk is potentially a factor that can have a bearing on the decisions of foreign investors in their effort to move capital into a particular country. Busse and Hefeker (2005) in an empirical study found that the absence of government stability,

basic democratic rights and the lack of law and order are significant deterrents of FDI inflows.

Furthermore in their paper Brada et al (2004) have demonstrated that not only internal conflicts, but also external conflicts and ethnic tensions are important determinants of foreign investment flows. In the case of Balkan countries international conflict and instability have reduced FDI inflows below the level where they should have been. As a result, the economic costs of instability in these countries have been rather substantial as political risk is highly related to investment decisions of multinationals. It should be stressed however, that recently the Balkan countries have made an all out effort to eliminate both internal and external conflicts and reap the economic benefits that peace can bring.

Probably the worst political instability that Albania experienced over the last decades was bound up with the pyramid scheme. Once the scheme collapsed about two-thirds of the Albanian population, who had invested in them lost their savings. The end result was rather chaotic. The government lost control, was forced to resign and a new interim coalition government was formed to address the socio-political unrest (Gomel, 2002; Jarvis, 2000).

After the collapse of the pyramid schemes the situation gradually improved ushering in a new era where a reform package for political stability and economic prosperity was put forward by the government in an attempt to regain the confidence needed to run the country.

Corruption

The extent and the depth of corruption in the Balkan region have been rather unprecedented. Arguably, socio-economic problems such as unemployment, poverty, illiteracy, low incomes etc. are considered to be the potential culprits responsible for the enormity of the problem.

In Albania a number of factors such as its geographical position, the level of education and dismal economic performance in conjunction with the privatisation of state-owned businesses, the political clans and the deficiencies in the administration of the country added to the problem significantly.

Apart from raising awareness as to what the costs of corruption are for the country, the government should ensure that the fight against corruption is matched by appropriate legislative and regulatory frameworks that are enforced stringently (IMF, 2003; SELDI, 2001; Sherif et al, 2000).

Corruption in Albania can be distinguished into what is known as petty corruption and state captures. Petty corruption is evident across all sections of the Albanian society, probably more pronounced in hospitals, customs and courts. This

phenomenon has been condoned by the citizens' tolerance toward corruption, which sometimes may be considered as a 'necessary evil' that solves practical problems.

State capture, can be detected in high administrative chambers. On the one hand potent businesses control politicians and influence legislative reforms, while on the other hand politicians own businesses and use the power of the state to their own benefit, establishing and sustaining monopolies (ACER, 2002).

Implementing anticorruption reforms in Albania has proved pretty tough as these are often opposed by senior bureaucrats, politicians and officials, who try to stamp their authority and pursue their vested interests. That's why fighting corruption calls for total commitment and political will simultaneously (EC, 2004; Kaufmann, 1998).

Although in its report GRECO (2004), concluded that Albania has implemented effectively half of the recommendations contained in the First Round Evaluation Report, Albania is still one of the countries with a high level of corruption in Europe. It's widely known that the problem of corruption is a significant restraint to FDI, because by increasing the cost of managing the businesses, corruption discourages foreign investors to invest. Therefore the fight against corruption is an issue of vital importance in Albania and is one of the main challenges that the country faces nowadays (Sherif et al, 2000).

Macroeconomic Performance (1993-2004)

As past experience in other CEE countries suggests, macroeconomic stability is essential when a country is in transition. In Albania the reform package put forward sought to address issues relating to macroeconomic management. Following a spell of high levels of inflation a policy mix of both monetary and fiscal policies served as means to deal with the ultimate objective i.e. the elimination of monetary deficit financing.

Several World Bank and IMF programmes supported the government's efforts towards stabilisation. The first IMF programme otherwise known as Enhanced Structural Adjustment Facility (ESAF), aimed at kick-starting the reforms through a number of measures to stabilise as well as liberalise the economy. Measures to decrease the budget deficit, reduce inflation, reduce the foreign debt, introduce a floating exchange regime, etc. were amongst the main objectives of the program.

The second ESAF programme which was signed with IMF in 1998 highlighted again the importance of maintaining macroeconomic stability as prerequisites to obtain growth and poverty reduction. Even though, the second program was in spirit along the same lines as the first one, special emphasis was put on the institutional reforms to be implemented. In the year 2000 IMF replaced the proposed ESAF programme with the Poverty Reduction and Growth Facility (PRGF) one, in an

attempt to set the framework through which foreign aid to poor countries is facilitated (Mancellari and Hida, 2005; Muco et al, 2001).

At this point it is deemed essential that a close look at some key macroeconomic variables is taken so that a more lucid picture of the Albanian economy emerges.

Foreign Direct Investment

With the exception of 1997, during the period 1996-2004, more than half of the capital account inflow is contributed by FDI. From 1993 to 1995 annual FDI inflows had fluctuated around EUR 50 million and reached the level of EUR 71 million or 3% of GDP in 1996. However in 1997 the financial crisis caused by the collapse of pyramid schemes, dried up again foreign investment (Schautzer, 2005).

A close look data on FDI (see appendix) suggests that from 2000 onwards Albania appears to have become more attractive to foreign investors. It was during that year that 85% stake of the state-owned mobile phone company Albanian Mobile Communications was sold for USD 96 million to a consortium comprising Norwegian Telenor and Greek Cosmote. Furthermore, in the same year the government sold the second largest bank in the country, to Turkish Kentbank (Schautzer, 2005; Hunya, 2002).

Moreover in 2001 FDI inflows reached the level of EUR 231 million or 5% of GDP with the privatisation of several state-owned companies contributing significantly to this upward trend¹¹.

Despite the fact that the value of FDI in 2002 was lower compared to 2001, it can however, be considered higher than FDI in 2001, if we subtract privatisation investment from FDI in 2001 (CoM, 2003).

In 2003 the share of privatisation decreased by 4.2%, which caused the total FDI inflows to decrease, but still they were at 3% level of GDP. Finally, the increase in FDI inflows in 2004 to EUR 278 million or 4.3% of GDP is mostly attributed to the privatisation of Albania's Savings Bank, which was sold to the Austrian banking group Raiffeisen Zentralbank (Schautzer, 2005; Hunya, 2004).

GDP Growth

The concept that 'progressive' economic growth in Albania is the main vehicle for poverty reduction is the explanation of why Albania is experiencing solid economic growth over the past decade. Stabilisation has caused the economy to grow by an average of 6 percent during this period (Phillips, 2005).

Albania ranks amongst the most successful transition economies having a cumulative real economic growth of about 40% during 1990-2004. After a disappointing spell in the period 1990-1992, the macroeconomic stabilisation process laid the foundations for a higher average growth rate of 9.3% in the subsequent period i.e. 1993-1996 (Khan, 2004; Schautzer, 2005).

Although in 1997 the financial crisis caused GDP to go down by 7% the economy's turnaround began in 1998. In 1999, Albania showed the real signs of economic recovery as GDP increased by 7.25% that year and the same growth was expected for 2000. A potential factor that contributed to that growth was the increased demand especially in the transportation and services sectors as a consequence of the Kosovo crisis (Steblez, 1999; Carlson and Betts, 2000; DFID, 2001).

From 1999-2004 the macroeconomic situation has been stable and GDP growth averaged about 7% during these years, expected to remain at around 6% over the medium term (IMF, 2005).

In 2002 economic growth was somewhat slower (3.4%) as mainly external factors such as bad weather conditions had a profound impact on the agricultural sector, probably one of the most domineering sectors of the Albanian economy. It is also worth stressing that the contribution of agriculture to GDP has fallen by about 27% during the last five years (DFID, 2001; Karaxho, 2004; Schautzer, 2005). As for the period 2003-2004 GDP growth went up by 6%, expected to fluctuate at the same level in 2005 as well¹².

Price Stability

In terms of GDP and inflation, Albania has been one of the most successful transition countries. Understanding the driving forces behind the behavior of the price level, Albania has succeeded in fighting inflation and this was mostly due to tight fiscal and monetary policies. Furthermore the restrictions of public sector wages and the lower import prices caused a downward pressure on domestic prices. The reduction of inflation was one of the main factors that contributed to the rapid growth of Albania (Rother, 2000; Lati and Sallaku, 2002).

According to official data, inflation has dwindled, from 237% at the end of 1992 to 31% by the end of 1993, 16% at the end of 1994, and 6% at the end of 1995, demonstrating one of the best performances of Albanian's economic reforms. The main objective of the Bank of Albania (BoA) during these years was to preserve a certain monthly inflation rate, which later was converted into maintaining a quarterly and then a yearly inflation rate (Muci et al, 2001; Kolasi, 2005).

After these first transition years the rise of the pyramid schemes through increasing the ‘supposed’ wealth of individuals gave rise to inflationary pressures. As a result inflation climbed to approximately 13% in 1996 and after the collapse of pyramid schemes in 1997, the average annual inflation was nearly 33% (Rother, 2000; Schautzer, 2005).

However the Albanian government reacted swiftly and through tight monetary policy succeeded to reduce inflation to around 20% in 1998. The following year up to now, the continuation of prudent monetary policy in Albania has been the key element in the fight against inflation (Rother, 2000; Economic Freedom, 2005).

On average, the annual inflation rate for the period 1998-2003 varies around 2.5 per cent, which is absolutely in accordance with the main objective of the BoA to maintain an annual inflation rate at the level between 2-4 per cent (Kolasi, 2005).

During 2003 and 2004 further advancements in structural reforms in conjunction with cautious monetary policy kept inflation in check. Although the process has been long with ups and downs, the general feeling is that of a successful attempt to contain inflation (Siniscalco, 2004; (Kolasi, 2005).

Labour Markets

The rapid development of new private enterprises in Albania was one of the main factors that reduced the level of unemployment from 36% in 1991 to 13% in 1996 (Gerxhani, 1999).

According to official data, in 1999, 18% of the working age population was unemployed. Furthermore in 1999, the number of those in employment was 1,065,104 out of which 19 percent worked in the state sector, 10% in the non-agricultural private sector and 71% in the private agricultural sector. (Muco et al, 2004; UNICEF, 2000).

One of the most significant features of the labor market in Albania is the shrinkage of the labour force from 1.3 million in 1993 to around 1.1 million in 2002, due to a mass emigration. As a result, the unemployment rate declined to 14.4% at the end of 2004 (Schautzer, 2005).

As it appears from the nationwide survey conducted by the AIIS (2004), it's obvious that poverty and unemployment are the primary concern for human security in Albania. This conclusion was supported by IMF (2005), which stated that the high unemployment in Albania is clearly correlated with poverty¹³.

3.4.6. Labour cost

While until 1990 the wage system was heavily regulated by the state, in 1991, a new differentiated wage system was introduced according to which payments depend on the quantity and quality of work (MoFA, 2004).

Moreover for the period 1990-1994, the average monthly wage for the public sector employees increased 8 times. From 1993 up to 1997 real wages of state employees have increased progressively. However in 1997 there was a decline in real wages of around 29.7% as a result of inflation (Freedom House, 2000).

Although before 1998 average wage increases had been modest, in order to attract and retain the most qualified staff in the civil service during 1998 the new wage structure provided an increase of 20% approximately of the average salary in the state sector. Hence, by the end of 1999, the real wage marked a 10% increase (MoFA, 2004).

According to Schautzer (2005) over the period 2001-2004 average gross wages increased at an annual rate of approximately 11%. Despite the fact that wages have increased since the beginning of the transition, Albania still remains one of the poorest countries in Europe (Carlson and Betts, 2000).

Empirical Investigation

Bearing in mind the barren empirical literature on any aspects of the Albanian economy, our effort seeks to instigate future research by providing empirical evidence on FDI both in the short and long-run. More specifically, given the idiosyncratic environment of Albania as an emerging economy that seeks to climb up the economic-growth ladder, we will attempt to gain an insight into what many empirical studies, identify as the factors responsible for attracting FDI. In so doing, an econometric model will expose the extent to which what is suggested by economic theory holds in transition countries such as Albania. In particular, FDI inflows in transition economies are supposed to be contingent upon a number of factors such as: the market size, risk, the wage level and the unemployment rate, etc. For the underlying investigation a data set was compiled consisting of quarterly time series data spanning from 1993-2004 for Albania (see Appendix for definition of variables). The main providers of our data were INSTAT (Albanian Statistical Office) and Albanian Central Bank (BoA)¹⁴.

Methodology

The underlying relationship of the key variables is envisaged to take the following form:

$$fdi = f(ms^+, r^-, lc^-, u^?) \quad (1)$$

where fdi stands for FDI inflows; ms stands for market size; r denotes risk; lc stands for labour cost; u denotes unemployment; small case letters denote logarithms; expected signs are also given¹⁵.

Expressing (1) as a multiple regression we get:

$$fdi_t = \beta_0 + \beta_1 ms_t + \beta_2 r_t + \beta_3 lc_t + \beta_4 u_t + \varepsilon_t \quad (2)$$

where ε_t is the error term satisfying the normal requirements.

Over the last couple of decades reams of academic papers have been produced proposing different methodologies on how to investigate long-run equilibrium between time-series variables. On the univariate front, cointegration techniques such as the ones by Engle and Granger (1987) and Phillips and Hansen's (1990) have been applied. As for multivariate cointegration, Johansen (1988) and Johansen and Juselius (1990) full information maximum likelihood procedures are extensively used in empirical studies. A relatively new procedure, the autoregressive distributed lags (ARDL), introduced originally by Pesaran and Shin (1999) and further extended by Pesaran et al. (2001) also deals with single cointegration. This method is thought to have certain econometric advantages over other single cointegration procedures. More specifically, endogeneity problems and inability to test hypotheses on the estimated coefficients in the long-run associated with the Engle-Granger method are avoided; the long and short-run parameters of the model are estimated simultaneously; all variables are assumed to be endogenous; it obviates the need to establish the order of integration amongst the variables i.e. the Pesaran et al. method could be implemented regardless of whether the underlying variables are I(0), I(1), or fractionally integrated.

To illustrate the ARDL modelling approach, (eq.2) can be formulated as follows:

$$\begin{aligned} \Delta fdi_t = & \beta_0 + \sum_{i=1}^p \beta_{1i} \Delta fdi_{t-i} + \sum_{i=1}^p \beta_{2i} \Delta ms_{t-i} + \sum_{i=1}^p \beta_{3i} \Delta r_{t-i} + \sum_{i=1}^p \beta_{4i} \Delta lc_{t-i} \\ & + \sum_{i=1}^p \beta_{5i} \Delta u_{t-i} + \beta_6 fdi_{t-1} + \beta_7 ms_{t-1} + \beta_8 r_{t-1} + \beta_9 lc_{t-1} + \beta_{10} u_{t-1} + \varepsilon_t \end{aligned} \quad (3)$$

The first part of equation (3) with $\beta_1, \beta_2, \beta_3, \beta_4,$ and β_5 represents the short run dynamics of the model whereas the second part with $\beta_6, \beta_7, \beta_8, \beta_9,$ and β_{10} represents the long run relationship. (The null hypothesis of non-existent long-run relationship to be tested is $H_0: \beta_6 = \beta_7 = \beta_8 = \beta_9 = \beta_{10} = 0$).

The ARDL method estimates a number of regressions in order to obtain optimal lag length for each variable. The model can be selected using the model selection

criteria like Schwartz-Bayesian Criteria (SBC) and Akaike's Information Criteria (AIC)¹⁶.

Once a long-run relationship is established, then the long-run and error correction estimates of the ARDL model can be obtained from Eq. (3)¹⁷.

The error correction representation can be formulated as follows:

$$\Delta fdi_t = \beta_0 + \sum_{i=1}^p \beta_{1i} \Delta fdi_{t-i} + \sum_{i=1}^p \beta_{2i} \Delta ms_{t-i} + \sum_{i=1}^p \beta_{3i} \Delta r_{t-i} + \sum_{i=1}^p \beta_{4i} \Delta lc_{t-i} + \sum_{i=1}^p \beta_{5i} \Delta u_{t-i} + \lambda EC_{t-1} + \varepsilon_t$$

where λ is the speed of adjustment; EC is the residuals obtained from the estimated model (3).

Finally, to establish the goodness of fit of the ARDL model, a number of diagnostic test in conjunction with a stability test are conducted. The CUSUM and CUSUMSQ tests are also employed to test for structural stability (see Appendix).

Estimation

The initial step in analyzing the time series data properties, is to test for unit roots by applying the Augmented Dickey-Fuller (ADF) (Dickey and Fuller, 1979 and 1981). The results of the ADF unit root tests for the variables are given in Appendix. All the series in Eq. (2) appear to contain a unit root in their levels, indicating that they are integrated at order one and thus they are difference stationary i.e. I(1).

In an attempt to find the optimal length of the level variables of the long-run coefficients of Eq. (3), lag selection criteria of AIC, and SBC were employed. The AIC based model is selected here as it has the lower prediction error than that of SBC based model.

Table 1: ARDL (1,1,1,and 0) Long Run Estimates (dependent variable is fdi)

Regressors	Coefficients	T-ratios
Constant	-2.11	0.739
ms	0.714	1.30
w	-1.59	4.54*
r	-0.41	2.72*
u	-0.20	2.51*

Notes: The absolute values of t-ratios are given; (*)significant 5% level.

The long run test statistics (Table 1) reveal that the labour cost appears to play an instrumental role in attracting FDI in Albania. The negative sign reinforces the argument that cheap labour is of paramount significance acting as a catalyst for the host country. Despite the fact that the coefficient of the market size bears the expected sign is found to be insignificant. This result is diametrically opposite to what other studies have established for other countries. As for the remaining variables, both risk and unemployment appear to condition FDI in a negative way.

Table 2: ARDL (1,1,1,0) ECM Results (dependent variable Δfdi)

Regressors	Coefficients	T-ratios
Constant	2.14	3.42
Dfdit-1	0.197	2.01*
Dmst	1.23	2.98*
Dmst-1	0.31	1.27
Dwt	-0.76	2.74*
Dwt-1	-0.12	1.42
Drt	-0.88	2.10*
Drt-1	-0.92	1.56
Dut	-1.65	1.95**
ECt-1	-0.03	3.08*
R2	0.64	
F-statistic	12.78	
DW	1.80	

Notes: The absolute values of t-ratios are given; (*)significant 5% level; (**)significant 10% level.

The short run dynamics of the model are illustrated in Table 2. More specifically, the coefficient of ms is not statistically significant, as opposed to the coefficient of Δms , which is statistically significant at the 10 per cent level. This implies that although there is no statistically significant long run relationship between FDI and market size, a change in the market size is closely bound up with a change in FDI in the short run. Similarly, the rest of the variables are all statistically significant reflecting the short term effect on FDI when any of these change.

As for the coefficient of EC_{t-1} this is found to be statistically significant and of a rather small magnitude which indeed confirms a long run relationship between the variables. In particular, the coefficient of ECM term is -0.03, suggesting a slow

adjustment process. About 3 per cent of the disequilibria of the previous quarter's shock adjust back to the long run equilibrium in the current quarter.

Conclusions

Transitions economies over the last decades have been swift to reform their economies and adopt policies to attract foreign direct investment. More specifically, countries in the CEE and SEE region, despite their socio-economic problems, have embraced this new challenge by tuning in their economies in an attempt to remove any market barriers that have deterred investors from moving capital into this region. As a result FDI has been flowing in creating the economic environment conducive to economic growth.

In Albania, FDI has increased significantly but there is still more to be done in terms of attracting foreign investment. Apart from the policies implemented to pursue macroeconomic stability, a lot of effort should be directed towards reforming the framework within which businesses operate.

It is beyond any shadow of a doubt that Albania during the years of transition to a market economy has faced strong political, economic and social challenges. Despite all problems encountered, signs of macroeconomic stability are evident, if one considers the GDP growth achieved as well as the low levels of inflation. Unemployment however, is still plaguing a great proportion of the population and appears to be rather immune to the policies undertaken by the government.

In addition, despite all efforts by the Albanian government to fight corruption, it is still a major concern for the Albanian society, affecting both the political system and the entire of the economy. The government is indeed moving in the right direction through reforming the legislative framework so that the country becomes more attractive to foreign capital. Implementation of the new framework is a time consuming process that requires years of hard work as well as a new cultural orientation.

On the empirical front, the emerging evidence indicates that at least in the short run FDI is conditioned by the variables under scrutiny, i.e. market size, labour cost, risk, and unemployment. In the long run however, the insignificant result of the market size is of some interest, since according to the bulk of the studies conducted for different countries this variable is of utmost importance for potential investors.

On the whole, given the absence of any econometric studies applied on the specific country, the contribution of the study is undoubtedly significant. The results generated from this piece of work should be considered in such a manner, so that further research takes place in the future.

NOTES

¹The countries belonging to both the Central and East European groups are as follows: CEE: (Czech Republic, Hungary, Poland, Slovakia, Slovenia) and SEE (Albania, Bosnia and Herzegovina, Bulgaria, Croatia, FR Yugoslavia, FRY Macedonia, Romania).

² It should be stressed that tax incentives has been looked upon as a measure that might cause macroeconomic instability and therefore low levels of FDI (Ranchev, 2003).

³ For more on this see a study by Hunya (2000) where the impact of the aforementioned barriers in Bulgaria, Romania and Croatia are estimated.

⁴ Although Balasubramanyam et.al. (1999) do not test for causality between any of the variables, it is argued that FDI requires a certain threshold level of human capital before the interaction begins to take effect. This is highly consistent with Blomström and Kokko (2003) and Barro's (1991) notion of the threshold level of human capital in developing countries.

⁵ Evidence provided by Lim (1983) suggests that, the presence of natural resources appears to be an important determinant of FDI inflows, the same as the level of economic development suggesting that investors are more concerned with economic performance over a long period of time, instead recent economic performance reflected in the rate of economic growth. Yet, government fiscal incentives are found as statistically insignificant in attracting FDI (Lim, 1983).

⁶ These categories are proxied by dummy variables and expected to positively affect the level of investment, as well as the presence of natural resources as proxied by the annual percentage of minerals in the total merchandise exports.

⁷ Some of the success stories of FDI in Albania are: KURUM International sh.p.k (limited liability), which operates in metallurgy industry, Albanian Mobile Communication Sh.a. (AMC), a telecommunication company in Albania since 1995, 'Tirana Beer' company, which produces and sells different types of beer, SEAMENT Albania sh.p.k, which is operating as an import trading company for European Cement and another telecommunication company Vodafone Albania as part of the world's largest telecommunication company.

⁸ In the years 2002 micro-enterprises alone accounted for 92 per cent of total active enterprises, while 54 per cent of total employment is offered by SMEs, which can be considered to be the driving force behind the growth trend of the whole national economy (Muco et al, 2004; Xhepa and Agolli, 2004).

⁹ At the time the National Agency of Privatization (NAP) was established, which was responsible in organizing and monitoring the privatization process.

¹⁰ The main reason for this was because individuals who owned land before the communist regime didn't obtain the restitution of their land.

¹¹ FDI acceleration in that year contributed to a new increase in foreign exchange reserves as well (Schautzer, 2005; EC, 2002; Hunya, 2002).

¹² According to INSTAT, (2003) it is the consolidation of the private sector that has contributed significantly to GDP growth in Albania.

¹³ Obviously, one might argue that the deflationary nature of the economic policies adopted over the last decade to stabilize the economy have added to the problem of unemployment. It should be stressed that amongst different groups of the economy it is predominantly the female population that have been affected the most (IMF, 2005; Schautzer, 2005).

¹⁴ It should be noted that collecting data for a number of variables that are perceived as the determinants of FDI was quite a task in the case of Albania, due in the main, to the unavailability of data for key economic indicators. Thus, we consider ourselves lucky to have compiled the data used in this analysis.

It should also be stressed that most of the data were obtained through direct contacts with Albanian officials. Thereby, most of the data may not be widely available.

¹⁵ The question mark above the unemployment variable suggests that unemployment can be perceived as either a potential market thriving with labour in which case it is expected to have a positive impact on FDI, or a sign of instability I which case it will act as a deterrent to FDI.

¹⁶ SBC is known as the parsimonious model: selecting the smallest possible lag length, whereas AIC is known for selecting the maximum relevant lag length.

¹⁷ The long run relationship amongst the variables of Eq. (3) is tested by means of bounds testing procedure of Pesaran et al. This procedure is based on the F or Wald-statistics and is the first stage of the ARDL cointegration method. A joint significance test that implies no cointegration, is also performed. The F test used for this procedure has a non-standard distribution. Thus, Pesaran et al. compute two sets of critical values for a given significance level. One set assumes that all variables are I(0) and the other set assumes they are all I(1). If the computed F-statistic exceeds the upper critical bounds value, then the null hypothesis is rejected. If the F-statistic falls into the bounds then the test becomes inconclusive. Lastly, if the F-statistic is below the lower critical bounds value, it implies no cointegration. It should be stressed that this approach is similar to the Johansen and Juselius multivariate cointegration procedure, which has five alternative cases for long-run testing too. At the second stage of the ARDL cointegration method, it is also possible to perform a parameter stability test for the appropriately selected ARDL representation of the error correction model.

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APPENDIX

Table 1: Basic indicators (year 2002)

	Population Persons mln	GDP EUR mln	GDP pc EUR	GDP pc USD at PPP	real GDP 1990 = 100
Albania	3.1	4,908	1,583	4,000	123.3
Bosnia & Herzegovina	3.8	5,574	1,467	6,400	-
Macedonia	2.0	3,916	1,958	6,520	87.3
Serbia & Montenegro	8.3	14,000	1,687	4,500	52.8
Western Balkans without Croatia	17.2	28,398	1,651	5,065	73.9
Croatia	4.4	23,820	5,414	10,030	92.9
Western Balkans (SEE-5)	21.6	52,218	2,418	6,076	83.6
Bulgaria	7.8	16,668	2,136	8,250	87.9
Romania	22.4	48,384	2,160	6,590	92.3
Eastern Balkans	30.2	65,052	2,154	7,019	91.2
SEE-7	51.8	117,270	2,263	6,626	88.0
Czech Republic	10.2	73,855	7,241	15,740	107.2
Hungary	10.2	65,852	6,456	13,550	115.6
Poland	38.6	199,549	5,170	10,510	146.5
Slovakia	5.4	25,144	4,656	12,820	111.6
Slovenia	2.0	22,367	11,184	18,530	127.4
CEE-5	66.4	386,767	5,825	12,210	130.4

Source: National bank of respective countries and IMF

Table 2: FDI stock (USD million)

	1990	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania	.	78	131	201	291	339	384	425	568	800
Bosnia and Herzegovina (1)	.	.	.	.	.	.	100	190	340	470
Bulgaria	4	141	247	337	446	951	1488	2307	3309	3997
Croatia	.	120	238	359	874	1425	2439	4075	5202	6703
Macedonia	.	.	19	28	40	55	173	205	381	824
Moldova	.	14	29	93	117	193	255	318	462	609
Romania	.	211	552	971	1234	2449	4480	5521	6561	7698
Yugoslavia	.	.	.	.	.	740	853	965	990	1155
SEEC-8 2)	4	565	1215	1989	3002	5412	9319	1304 1	1682 2	2110 0
Czech Republic	72	3423	4547	7350	8572	9234	1437 5	1755 2	2164 4	2676 4
Hungary	569	5585	7095	1192 6	1496 1	1608 6	1851 7	1929 9	1980 4	2356 2
Poland	109	2307	3789	7843	1146 3	1458 7	2247 9	2607 5	3360 3	3900 0
Slovakia	.	.	897	1297	2046	2083	2890	3188	4504	6000
Slovenia	.	954	1326	1763	1998	2207	2766	2657	2809	3400
CEEC-5 2)	750	1226 9	1765 4	3018 0	3904 0	4419 7	6102 7	6877 1	8236 3	9872 7

Notes: 1) Estimate. -2) Sum of available data.

Table 3: FDI inflow (USD million)

	1990	1993	1994	1995	1996	1997	1998	1999	2000	2001
Albania	.	58	53	70	90	48	45	41	143	200 1)
Bosnia and Herzegovina	.	.	.	.	.	.	100	90	150	130
Bulgaria	4	40	105	90	109	505	537	819	1002	689
Croatia	.	120	117	121	516	551	1014	1637	1126	1502
Macedonia	.	.	19	9	11	16	118	32	176	442
Moldova	.	14	12	67	24	79	76	40	143	149
Romania	.	94	341	419	263	1215	2031	1041	1040	1137
Yugoslavia	.	.	.	.	.	740	113	112	25	165
SEEC-8 2)	4	326	647	777	1013	3154	4034	3812	3805	4414
Czech Republic	72	654	869	2562	1428	1300	3718	6324	4986	4916
Hungary	311	2339	1147	4453	2275	2173	2036	1970	1649	2443

Poland	89	1715	1875	3659	4498	4908	6365	7270	9342	8000
Slovakia	.	179	273	258	358	220	684	390	2075. 2	1475. 3
Slovenia	4	113	128	177	194	375	248	181	175.5	441.8
CEEC-5 2)	476	4999	4292	11110	8753	8977	13051	1613 5	18228	17276

Notes: 1) Estimate. -2) Sum of available data.

Table 4. Foreign direct investment in Albania by sector (%) of total (2001)

Trade	27.2
Textiles and leather manufacturing	21.2
Food, beverages and tobacco	6.4
Construction	6.2
Manufacturing of non-metal products	5.3
Chemicals and plastic	4.8
Wood and furniture	4.6
Other	24.3

Notes: According to survey data on 445 enterprises

Table 5. Order of Integration

Variable	Level	k lag	Difference	k lag
lnfdi	-1.78	1	-4.93*	1
lnms	-1.89	1	-6.17*	1
lnlc	-1.56	1	-5.26*	1
lnr	-1.95	1	-3.47*	1
lnu	-2.02	2	-3.74*	2

Note: (*) denotes rejection of unit root hypothesis, according to McKinnon's critical value at 5 %; k stands for the lag level that maximises the AIC (Akaike Information Criteria) and SBC (Schwarz Bayesian Criteria)

Figure 1: CUSUM stability test

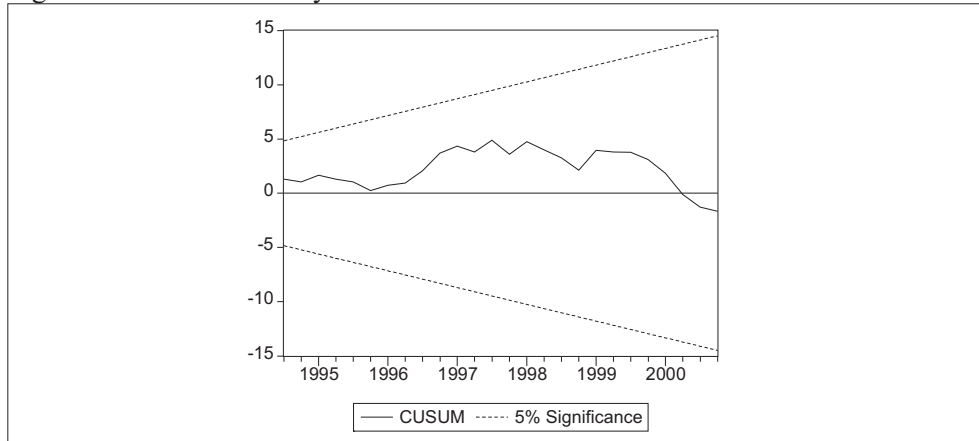


Figure 2: CUSUMSQR stability test

