

IMPACT OF FDI_s AND FREE TRADE IN ECONOMIC GROWTH: CASE OF ALBANIA

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Abstract

Is the relationship between openness and growth necessarily always positive? This is the question that this study tries to answer. This study will focus mainly on foreign direct investments, free trade and their impacts in economic growth, considering more the case of Albania. Importance will be given to the macroeconomic developments and dynamics in the course of transition years. In the second part of the study it will be presented the business climate, advantages and disadvantages of investing in Albania. Investments have played an important role in economic growth of the country. While entering market economy it was seen as crucial the need to attract Foreign Direct Investments and implement Free Trade Agreements in Albanian economy. Free Trade agreements have had a crucial role in the openness and growth of Albania economy. Positive and negative impacts have been observed on economic indicators such as inflation, unemployment rate and trade balance. Despite the inconveniences Albania shows also positives signs regarding FTAs, such as higher trade volume as a result of increasing exports and imports. This means that the country has forced its cooperation with partner countries. The goal of this study is to establish a relation between indicators such as: Foreign Direct Investments and GDP Growth for an interval of 18 years from 1994-2012.

Based on the results of the model it could not be obtained the expected result, so the FDI high rate flows do not necessarily affect positively the GDP Growth rate in case of Albania.

KEYWORDS: Albania, economic growth, FDI, Free Trade

JEL Classifications

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INTRODUCTION

Prior to money existence, all societies in the world used a unique business system, known as barter system¹, which originates as far back as the prehistoric times. The history of business

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organizations begins from the Assyrian merchants in the 19th century B.C to the current variety of multibillion dollar companies. Foreign Direct Investments (FDIs)² and trade liberalization (membership in WTO) have had their huge contribute to the developing world of business. Before the Second World War, Albania was an undeveloped, largely rural based society and just after the war, it became part of the communist bloc³. All private enterprises were shut down and nationalized and all private initiatives were blocked out of economic life, prices and the investments were decided by the authorities. Lack of macroeconomic data during communist regime is justified with the fact that few economic statistics were being published. Western scholars found that those few data made available were often neither accurate nor consistent. Specialists in the Albanian economy have confirmed that the communist government released data only when performance results were positive and that data on aggregate economic growth were not published when they were close to or below the population growth rate.

After 45 years, when the communist system broke down, in the early 1990s Albania entered democracy and market economy. Like most of the transition economies in the region, it focused on liberalizing its economy and encouraging private sector growth. Albania, a previously closed and central planned state, has faced several difficulties in its transition steps towards a modern and open-market economy. Despite of all economic reforms undertaken, Albania still remains one of the poorest countries in Europe. The economic situation in the early 1990s was in the state of a collapse. The overall infrastructure and industries, in general, were old and inefficient. The early 1990s were characterized by high inflation, reduced output and an increasing budget deficit. Policymakers implemented the reforms in a fast and radical way aiming at deregulation, decentralization and liberalization in order to transfer the power of resource allocation to the emerging markets.

In the following years, the economy and ALL stabilized, and led by the agricultural sector, real GDP grew. The speed of private entrepreneurial response to Albania's opening and liberalizing was better than expected but the collapse of the infamous Ponzi schemes⁴ in 1997 and the economic, political and social instability that followed were a tremendous setback, from which Albania's economy still continues to recover. Even though, the cumulative growth since 1990 is among the highest of all transition economies Albania got an extreme number of black points in the annual report of the International Monetary Fund (IMF)⁵ on business climate conditions. The rate of risk for investments has decreased over years but still there is a high level of corruption.

¹ The act of trading goods and services between two or more parties without the use of money also enables those who are lacking hard currency to obtain goods and services.

² Investments in capital abroad, usually where the company being invested is controlled by the foreign corporation.

³ The former Soviet Union and the countries of Eastern Europe which had Communist governments and were under Soviet influence, especially between the end of World War II and about 1990.

⁴ A fraudulent investing scam promising high rates of return with little risk to investors. The Ponzi scheme generates returns for older investors by acquiring new investors.

⁵ The IMF plays three major roles in the global monetary system. The Fund surveys and monitors economic and financial developments, lends funds to countries with balance-of-payment difficulties, and provides technical assistance and training for countries requesting it.

Privatization together with liberalization, stabilization and institutional reforms are other issues considered as basic supporters in market transformation. Albania is of the transition countries that has made significant progress in this area. Nevertheless, reports conducted by international institutions show that the environment for creating and sustaining a business in Albania remains underdeveloped and unsecured. Despite the last global economic crisis, Albania enjoyed an increased percentage of FDIs. FDIs in Albania reached the level of 1,109 Million USD by 2010, which is the highest level of FDI flows in Albania in 19-years⁶.

Albania joined the World Trade Organization (WTO)⁷ by end of 2000 and all this time has been working on bringing its policies in line with those widely used in international trade. WTO membership has served as a guarantee for the foreign investors that they will be subject to the conditions, rules and norms standard in international trade. In this paper we consider a special aspect of economic growth like trade liberalization in the form of World Trade Organization (WTO) membership.

Many improvements are needed in the general business environment, the complexity, delays and costs, the extensive number of prepaid taxes, etc. Reforming and improving the environment for entrepreneurship remains a priority for the Albanian government.

LITERATURE REVIEW

A study made by Dorina KRIPA and Edlira LUCI, (2008) take the argument a step further and argues that private investments based on the enterprise structure survey conducted by them indicates an increasing positive trend of their volume and effectiveness. Allocation of private investments has been the main factor, leading to intensive changes of the sector structure of the economy during transition.

Drini IMAMI, Endrit LAMI and Holger KÄCHELEIN (2002), in their study confirmed that transition countries are characterized by massive privatizations of the public assets during the first decade(s) of the transition. Privatization, in addition of enabling the improvement of efficiency of different formerly publicly owned economic units, may serve as a source of income for the economy. Thus, it may be assumed that when income is needed by the actual government, to finance certain public expenditures, than there is a stronger incentive to engage in privatization. Typical case when public investments and other types of public expenditures increase is elections. As predicted by Political Business Cycle (PBC) theory, government may engage in fiscal expansion before elections, to increase likelihood of reelections, which has been found true for Albania in their research.

⁶ Information source: open.data.al

⁷ An international organization dealing with the global rules of trade between nations. Its main function is to ensure that trade flows as smoothly, predictably, and freely as possible.

Consequently, job creation became the main issue in political platforms of parties and out-migration evolved to be the inevitable. As a result, more than one-fifth of the Albanian population is thought to have moved to live abroad, mainly to Greece and Italy. This issue was justified by government as a means of exporting unemployment and importing wealth. "Results show that intention to emigrate is correlated positively with males, education and certain occupations, and negatively with age. There is little relation between emigration and income. Those who support the introduction of a free market in Albania are also more likely to emigrate than those who do not." (Harry Papapanagos and Peter Sanfey, *Intention to emigrate in transition countries: the case of Albania*, 2000).

Hanson(2001) argues that FDI's generate weak positive effects for host countries. Gorg and Greenwood(2002) conclude that the FDI effects are mostly negative. While Lipsey (2002) takes a more favorable view from reviewing the micro literature arguing that there is evidence of positive effects. He further argues that there is need for more consideration of the different circumstances that obstruct or promote spillovers.

The work by Borensztein et al. (1998), Xu (2000), and Alfaro et al. (2003) suggests that educational level, development of local financial markets, and other local conditions play an important role in allowing the positive effects of FDI to materialize.

World Investment Report (2001) for instance, argues, "In the primary sector, the scope for linkages between foreign affiliates and local suppliers is often limited. The manufacturing sector has a broad variation of linkage intensive activities. In the tertiary sector the scope for dividing production into discrete stages and subcontracting out large parts to independent domestic firms is also limited."Considering all these arguments I will try to analyze if FDI do have positive or negative effects on economic growth of Albania.

Driffield & Girma (2002) and Griffith & Sjöholm (2004) conclude in their studies that foreign companies also have effects on the resource market. These studies are focused on the effects of foreign companies in the labor market, which is considered as a spillover of foreign companies, since they first offer a higher salary and lower unemployment, given that FDI's are introduced in those sectors of the economy that cannot be offered by local companies.

There is a considerable literature concerning the relationship between export and GDP,

Krueger (1978) is pioneer on this subject, which takes a measure of trade Liberalization and studies its effects on export and GDP. Sebastian Edwards (1993) believe that there is not a theory which relates trade policy to growth, and in the neoclassical framework it can be only seen the effects of policies on the output level, not on the growth rate. Sachs and Warner (1995) provide an index of trade openness and Using Summers and Heston's data, Showthe Positive relationship between open trade policy and economic growth for1970-89 in 117 countries. It is interesting to test the political and Institutional infrastructure of negatively impacted countries from accession

to GATT and WTO, and find that whether weaknesses in these two areas lead to these results or the international Institutional or political weakness deliver such a results. We have not any position regarding this question, only report results. With respect to international institution Hoekman and Saggi (2004) Suggest a model which explores the incentives of a developing country to offer increased market access (by way of a tariff reduction) in exchange for a ban on foreign export cartels by its developed country trading partner. They show that such a bargain is feasible and can generate a globally welfare-maximizing outcome. J.Salcedo Cain; Rana Hasan; Devashish Mitra (2010) on their study on trade liberalization and poverty reduction concluded that states, and regions within states, that were more exposed to trade liberalization on account of their employment structures did not experience a slower reduction in poverty; but on contrary, the evidence points to faster poverty reduction in states and regions experiencing greater increases in exposure to trade. Moreover, this relationship is typically stronger in states with more flexible labor regulations, better quality transportation infrastructure, and more developed financial systems. Salamat Ali (2012) in his study finds out that export performance of an economy is highly associated with the performance of imports; however, there is no evidence that the reduced tariffs encourage increased imports of the industrial raw materials and capital goods required for expansion of the industrial base. The results are robust to time varying trends and industry fixed effects. The study suggests that in addition to tariff reduction, other complementary policy measures are necessary for increasing the share of manufactured goods in the country's exports and to materialize the gains associated from the trade openness.

Model analysis.

This paper is an attempt forward to analyze the causal relationship between Foreign Direct Investments and economic growth in Albania and tries to analyze and estimate the effect of FDIs on economic growth in Albania, using data for the period, 1994 to 2012.

In the host economy the effects of FDIs are usually believed to effect positively the employment, swell the productivity, boost in exports and transfer of technology. It facilitates the utilization and exploitation of local raw materials, introduces modern techniques of marketing as well as management, eases the access to new and latest technologies and also increases human capital via the job training.

In order to see how much openness and growth of a country are related to each other it could be worthy to build up a relation based on factors such as FDIs and GDP Growth, so that we measure this relationship in Albania. While working on impact of FDIs and Free trade in economic growth there were expectations to have a strong relationship between FDI flows GDP Growth. While evaluating the regression analysis FDI change was considered as independent variable while GDP Growth was considered as the dependent variable.

Table 1: Statement showing FDI flow changes and GDP Growth in Albania

YEAR	FDI change	GDP GROWTH
1994	-0.20588	8.3
1995	0.296296	13.3
1996	0.271429	9.1
1997	-0.47191	-10.2
1998	-0.04255	12.7
1999	-0.08889	8
2000	2.487805	7.5
2001	0.454545	7
2002	-0.35096	5
2003	0.318519	7
2004	0.820225	5.6
2005	-0.20679	5.5
2006	0.22179	5
2007	1.06051	6

2008	0.372488	6.1
2009	0.060811	3.3
2010	0.177282	3.5
2011	-0.10821	2
2012	-0.14055	0.5

From the simple regression model that is used it could not be obtained a very strong relationship between these factors. This is backed by the R square result which is approximately 10% meaning that the independent variable FDI in our case explains just 10% the dependent variable GDP Growth.. R Square to be 0.1 shows that that GDP Growth does not depend to much on FDI flow rates, meaning that in the years when FDI flows were relatively high there has not been any boom of GDP Growth. For example in 2010 FDIs in Albania reached their peek value of 1,109 Million USD from 1994, but it was not reflected in a GDP Growth rate, GDP Growth rate in 2010 was just 3.5%.

There are data available just for 19 years, so that the observed sample is not large enough.

After building the regression model using the annual data from 1994 till 2012 for the two above mentioned variables multiple R was found to be 0.31 which in fact does not show a strong relationship. The adjusted R square is more conservative as it explains also the accuracy of regression equation:

The Significance F of 0.19, which is relatively low shows that there is just a 19% chance that regression happened by chance. Some factors must be considered here:

-19 observations, which is currently not enough in order to determine the true relationship between the variables.

-FDI Flows is the not the main indicator that contribute in GDP growth, other factor that contribute to GDP Growth are:

- *General policy factors* including here political stability and privatizations.

- *Specific FDI policies* like incentives, performance requirements, investment promotions, international trade and different investment treaties.

- *Macro economic factors* such as, inflation rates and exchange rates.
- *Firm specific factors* such as information and communications technology developments that have had a high impact on the way that companies structure their international activities.
- *Land factors* such as natural resource endowments – in case a country is rich on diamonds or oil it helps!
- *Labour skills and abilities = education and training.* The more of these, the better for growth but it should be of the right kind..
- *Labour enthusiasm or motivation .*
- *Capital factors* -more machinery and equipment = higher growth rate.
- *Higher rates of investment* = it means more machines and new technologies will be available.
- *Higher rates of saving* = good for growth because the country can invest more (in the short term it could harm output if it means that consumers are suddenly not spending as much, but it is generally good for the long term).
- *Technical progress* - is the main source of growth in rich developed countries.

CONCLUSIONS

It was expected to obtain a very strong relationship between high FDI flows high GDP Growth But from the model above it was found R Square to be 0.1 which does not fulfill our expectations. That can be explained under the other factors despite macroeconomic ones that affect the GDP Growth in Albania. Thus, FDI Flows are not the main contributors to the GDP Growth in case of Albania.

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