The Foreign Direct Investment and Economic Growth - Case Study for Kosovo

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Abstract

This research paper will explain the impact and relationship between the Foreign Direct Investment (FDI) and economic growth, Kosovo case. The used data in research are secondary data and cover a period of time between 2008 and 2013. By using STATA program for calculation and by various regression analyses (descriptive statistics, linear regression and correlation) relationships have been identified between involved variables in research, where economic growth is defined as dependent variable, whereas FDI, interest rate and real effective and exchange rate (REER) are defined as independent variables. The main results in this research paper indicate that FDI has a positive relation (0.011) but non-significant effect (T<2) on economic growth while the interest rate has a positive relation (0.076) and a significant effect (T>2) on economic growth in Kosovo. The real effective exchange rate has a negative (-0.347) and non-significant relation (T<2) with economic growth. The main activities of FDI in overall Kosovo's economy are: real estate, transport and telecommunication, financial and manufacture services, construction, etc. The main conclusion is that the Kosovo institutions should create a favorable environment, such as: political stability, enforcement of justice, reduction of trade barriers, Kosovo should also create appropriate policy for protection of foreign investors, investment security, fair

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competition and institutional support. This will impact the drastic improvement and increase of FDI. In 2013 Kosovo had an FDI percentage of 5% of GDP while in 2007 it was over 13% of Kosovo's GDP.

Key Words: Foreign Direct Investments, Economic Growth, Kosovo, Correlation, Inflation Rate, OLS method, REER, STATA analysis

1. Introduction

Over the last few decades, especially in countries that are in developing process, FDI has a special importance in the overall economy, by exerting a positive impact and having a multidimensional effect on many economic areas, such as: the development of the credit market, increasing export, improving competitiveness, transfer of technology and knowledge, social and human capital development, etc; (Badivuku and Berisha, 2008). So economic growth is defined as an increase of quantity of goods and services within a period of time in one place, (Dzambazka, 2013). Therefore FDI has an important role in economic growth, particularly for these countries with difficult transition processes (such as Kosovo). Different authors, (Suliman and Elian, 2014); (Don et al, 2011); (Inekwe, 2013) have argued that there is a positive correlation between FDI and economic growth across many different countries. The recent studies also suggest that FDI has a beneficial impact on developing host countries (Loungani and Razin 2001). This comes as a result of the great need that these countries have for FDI and their attempt to use them efficiently in the most important strategic sectors of their economy. As conclusion, in order to attract FDI, SEE and Western Balkan countries shall undertake following measures: reduction of political risk and transaction costs, increase the knowledge and education in workforce, privatization process, fight the corruption, institutional support and promotion of FDI in the relevant countries (Hunya, 2000).

In most of the Balkan countries (including Kosovo), FDI are very important for sustainability and economic growth, particularly after global financial crisis. In 2009 FDI have participated over 10% of GDP; what is very crucial for small economies such is Kosovo’s (OECD 2013). According to different reports, CBK Report (2013), (OECD 2013) Kosovo is an example, where the main sectors of economy absorb large parts of FDI, such as: real estate market, financial markets, construction and

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telecommunications. According to the World Bank Report (2014) in Kosovo, FDI and export are still not reaching the sufficient level of stability. Government institutions in Kosovo have always attempted to protect foreign investors through the Law on Foreign Investments (World Bank 2013). The law has not been implemented because of various factors (such as: bureaucracy costs, long administrative procedures, bribery and favors) and all of them have created discouraging environment for foreign investors. However, in order to reach a greater attraction of FDI, Kosovo needs a systematic improvement of political stability, progress of economic growth, fight against corruption, defining the right of property, strengthening the judicial system, etc; (RiInvest, 2002).

2. A Review of Selected Literature

This part of the paper will present the selected research sources by various authors that deal with the association between FDI and economic growth in many countries in the world. According to (Bagli and Adhikary, 2014), five (5) most developed Asian countries have reported a positive impact of FDI on economic growth and it is as a result of opening their economies and improving the environment for investment of foreign investors (FDI). Then in many Arab countries sectoral composition of FDI (as financial development, trade openness, human capital and quality of infrastructure) has played a critical role in the growth of FDI, which may be a necessary prerequisite for FDI to promote economic growth in these countries, (El-Wassal and Amal, 2012). If we analyze FDI in developed countries (like USA), we can understand that the main determinant in economic growth, whether in short or long term, is a perfect relationship between FDI and US exports (Stylianou, 2014).

If we analyze FDI, in the countries of the region "SEE - 6", only from 2008 to 2010, we can see that we have a reduction of FDI level for over 3.2 times (from 12,657 in 3976). Regardless of this, the common interest of these countries is the increase of FDI because these investments have helped the reduction of unemployment and social problems and they have greatly facilitated the economic restructuring. But the main condition to increase the FDI, remains the strengthening of government and other relevant institutions in SEE countries, (Estrin and Uvalic, 2013). If we examine the impact of FDI in Kosovo, we can see that in 2007 FDI has increased its participation in GDP over 13%. According to CBK Report (2012) the effect

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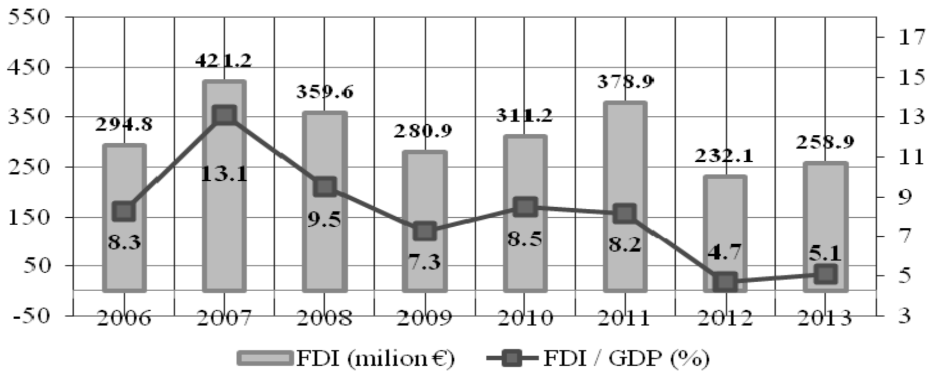
of the recent global financial crisis have affected FDI immediately in 2008, when it constituted 9.5% while continuing to fall to 7.3% in 2009 and in 2012 these investments reached the lowest possible limit, with only 4.7% participating in GDP. According to CBK Report (2013) in 2013 we had an annual growth of 5.1% of FDI, as a result of the development of the economy in the Euro zone. It is known that from there comes the main part of FDI in Kosovo, namely from western European countries. The figure below shows how the FDI has moved from 2006 - 2013:

Figure 1: The performance of FDI in Kosovo 2006 - 2013



Source: CBK Reports 2006, 2009, 2013,

After reconstruction phase in 1999 (as a result of the consequences of the war) and the period of intensive construction of road infrastructure (mostly through government investment), FDI are concentrated in bringing new technologies, modern experience in different fields and improving competition in the overall market, (Kida, 2013). According to CBK Report (2013) two basic elements that Kosovo institutions should focus during this period are: the first is the increase in export which constitutes only 5% of GDP, while region countries have 25% higher export than Kosovo and the second is the FDI which also constitute 5% of GDP and the percentage of FDI is quite low if compared with other countries in the region. Taken as a whole the main challenges for Kosovo's economy after all the difficulties from the financial crisis, are: a) increase of savings and investments, both of these in modern economy create convenience to increase consumption but

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this consumption should be directed towards products from domestic market, this will affect employment growth in national level; b) increase of foreign investments through cooperation with Western Balkan counties and wider, it will create greater opportunities to overcome the consequences of the recent financial crisis (Berdo, 2010).

Kosovo hasn't had environment for attracting FDI, due to political instability (rapid change of governments) and economic problems (high unemployment rate), high level of corruption, non-qualified workforce, and the effect of financial crisis in 2008, which reduced the participation of FDI in GDP from 13% in 2007 to 5% in 2013. The effect of FDI was significantly large, particularly in productivity growth (such as: development of the human capital, technology and improvement of domestic businesses) (Riinvest 2011). According to MTI Report (2013), opened markets for foreign capital have created an immediate effect on the whole Kosovo’s economy. In last three (3) years as foreign investment (FDI) Kosovo has received over 1 billion euro. FDI has stimulated and supported domestic demands in different markets, as proved IMF Report (2013).

In general, there are four (4) types of investors (FDI): investors that completely aim to receive domestic market (particularly in service market), investors that aim high efficiency through reduction in the cost of raw material (i.e. low cost of human capital in technology services), investors that aim natural resources (investments in natural resources of different minerals, such as: coal) and strategic investors, whose focus is to receive natural resource in any country that they have invested and with those resource they plan to keep in control either regional or global markets, (Barolli *et al*, 2009). Three main categories that can affect the level of economy in the Balkan countries are as following: the efficiency of government institutions (by providing suitable environment for foreign investors), the domestic economic market size, and the distance from countries where FDI come from; (Estrin and Uvalic, 2013). If structurally presented, the forms of FDI in economic sectors that are invested in Kosovo during 2014, will be seen that the real estate sector constitutes the largest part of FDI with over 41.6% then transport and telecommunication sector with 13.2%, the financial sector with 11.5%, the construction sector by 9.5%, etc; as argued in CBK Report (2014) and (Fabris, 2014). In the figure below, is presented the allocation of FDI in different sectors of Kosovo's economy in 2013.

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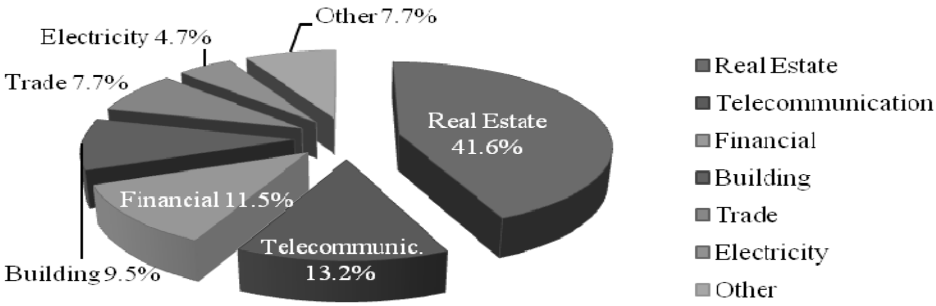
Figure 2: Structure of FDI in the main sectors of Kosovo's economy



Source: CBK, 2013

3. Methodology and Data Collection

The methodology will discuss the principles of the research paper: how are the data collected and analyzed and how this data has impact on FDI and economic growth in Kosovo during the period of time 2008 - 2013. The aim of this research paper is not just knowing the facts and understanding interactions between the phenomena in this field, but also how to operate and understand as much as possible about this field of research, that we had previously known (Bell, 2005). The used data in the methodology is secondary data that is collected during the period of time between 2008 - 2013, by official economic and financial institutions in Kosovo (CBK Reports and Statistical Agency of Kosovo) and international institutions (World Bank, etc). In this research is used regression analyse to find the relationship between the variables that are used, where as the dependent variable is the economic growth and as the independent variables are the following: FDI, inflation rate and the real effective and exchange rate (REER). All data that were used in this research are analyzed through quantitative research method which reflects also the data calculated through econometric program STATA. This program has provided very important results about FDI in Kosovo. Econometric model was used for data analysis with the following formula: $\text{Ln}(EGt) = \beta 0 + \beta 1\ln(FDIt) + \beta 2\ln(INFt) + \beta 3\ln(REERt) + \varepsilon t$. The main variables are as follows:

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- EG = Economic Growth
- FDI = Foreign Direct Investment
- INF = Inflation rate
- REER = Real Effective and Exchange Rate
- εt = Standard Error
- $\beta 0$, $\beta 1$, $\beta 2$, $\beta 3$, are included in the analysis parameters.

4. Empirical Results and Interpretations

This part of research paper will present the results achieved through econometric STATA program, in fact this constitutes the most important part of the research because here will be interpreted the implications of the parameters that are involved in research on different statistical and econometric methods. In Table 1 we have modeled the statistical description, which is a quantitative discipline that describes the main features of a quantitative description of the variables. The number of variables in this research are 6, including the period of time from 2008 to 2013, then variable "economic growth" has a minimum of 2.5% (mean annual growth, it implies a lower value growth during research time) and a maximum of 5.4% (implies a higher value growth during research time), with an average 3.7% (it means average growth during research time) and a standard deviation of 1.03 (meaning that variables are grouped very close to the average value). Then in this method, FDI have the highest level with 25.5 (%) but the minimum is lower with -41.2 (%), while the average is -5.3 (%) and the standard deviation is 24.9 (so we have a distribution of data in average value with (-5.33"). Two (2) last variables (inflation rate and REER) have obvious approximation at their minimums (with -2.41 and 102.2) and at their maximum (with 9.35 and 107.2), with an average value of 3.6 and 105.2 and with low standard deviations (4.1 and 1.7). For further detail see table (1) below:

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Table 1 Descriptive Statistic Analysis

Variables:	Obser-vations	Std. Deviation	Minimum	Average	Maxi-mum
Economic Growth	6	1.037	2.5	3.7	5.4
FDI	6	24.95	-41.2	-5.333	25.5
Inflation Rate	6	4.190	-2.41	3.666	9.35
REER	6	1.757	102.2	105.283	107.2

Source: Authors' own calculations

Table 2 presents the main results of the research paper; where through the coefficient OLS Method shows the level of positive / negative impact that FDI, inflation rate and exchange rate have (as independent variables) in economic growth (as the dependent variable). Considering the other variables unchanged (or constant), an increase of FDI for a unit will affect the economic growth rate by 0.0012 (positive impact), as well as an increase of the rate of inflation for a unit, when the other variables remain constant, it will also effect on economic growth by 0.239 (positive impact). However increasing the real effective and exchange rate (REER) for a unit will affect in economic growth in a different way, by -0.347 (negative impact). Through T-Statistics, we will understand the explanatory ability (or significance), positive (T>2) or negative (T<2), of independent variables on the dependent ones. Only the rate of inflation (with 3.13), has shown significant explanatory ability (T>2) on economic growth (inflation rate has affected economic growth) while FDI 0.11 (T<2) and REER with -1.91 (T<2) showed no significant explanatory ability on economic growth. For further details refer to the table (2) below:

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Table 2: Ordinary Least Squares (OLS) Method

Variables:	Coefficient	Std. Deviation	T-Statistic	T > |t|	R^2
Constant	39.43	19.08	2.07	0.17	0.84
FDI	0.001	0.011	0.11	0.92	
Inflation Rate	0.239	0.076	3.13	0.08	
REER	-0.347	0.182	-1.91	0.19	

Source: Authors' own calculations

If we analyze the R^2 indicator (which is known as coefficient of determination) in table 2, it tells us the scope of the relationship between independent variables and the dependent variables. According to the results that we achieved by this method, these independent variables (FDI, Inflation rate and REER) have a relationship of nearly 84% with dependent variable (economic growth) and 16% (100% - 84%) with other factors that are not included in this methods. In Table 3, if we analyze the independent variables to the dependent variable, based on the level of correlation method (or sensitivity), we will understand that the inflation rate has a correlation of "nearly perfect" positive by 0.74 to economic growth or a change of economic growth by 1% associated with increasing inflation rate by 0.74%. On the other hand FDI has a negative correlation (no sensitive effect) to economic growth (almost close to zero 0.096), so one possible change in economic growth doesn't have any "obvious" effect on FDI. Real effective and exchange rate variable has a negative correlation, because it has a negative numerical value of -0.205 (a positive change of economic growth, have negative correlation to REER variable).

Table 3 Correlation Method

Variables:	Economic Growth	FDI	Inflation Rate	REER
Economic Growth	1.000			
FDI	0.096	1.000		
Inflation Rate	0.740	0.147	1	
REER	-0.205	0.131	0.392	1

Source: Authors' own calculations

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5. Conclusion

This part of research paper will present the conclusion on the role of Foreign Direct Investment (FDI) in economic growth, Kosovo case. The data used in research are secondary data and cover a period of time between 2008 and 2013. The main variables are: Economic Growth, FDI, Inflation Rate, Real Effective and Exchange Rate (REER). Empirical Results in this research are made by STATA program (it is an econometric and statistical program that is very useful for this research area). Then the main analyses are made by: descriptive statistic method, Ordinary Least Squares (OLS) method and Correlation method. As the results from OLS method show, the FDI (0.011) and the inflation rate (0.076) have a positive impact on economic growth and the REER (-0.347) has negative impact on economic growth. The results of T-statistics (in OLS method) argue that only the interest rate (with 3.13) is significant (T>2) to economic growth whereas FDI (0.11) and REER (-1.91) were non-significant (T<2) to economic increase. The R^2 analysis, measures the relationship of the independent variables with the dependent ones and it is 84%, whereas 16% are other factors related to the dependent variable that are not included in this research. In correlation method, the results show that the Inflation Rate (0.74) has high correlation with economic growth whereas FDI has less but positive one (0.096) and only REER has a negative correlation to economic growth (-0.205). So, the main elements for improving the environment and increasing FDI in Kosovo are as follow: political stability, reduction of the economic and trade barriers, investment security and enforcement of justice, fair competition, institutional support and protection for foreign investors.

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Appendixes:

Table 1/A: The main data for analysis the FDI in Kosovo

Year	Economic Growth (%)	FDI (%)	Inflation Rate (%)	Exchange Rate (REER)
2008	5.4	-16.8	9.35	105.1
2009	3.5	-20.5	-2.41	102.2
2010	3.3	25.5	3.48	104.8
2011	4.4	7.9	7.34	105.8
2012	2.5	-41.2	2.48	106.6
2013	3.1	13.1	1.76	107.2

Source: Economic Growth and FDI - CBK Annual Report 2014; Inflation Rate - World Bank: World Indicators 2014; REER - CBK Financial Stability Report 2014;

Table1/B: Variable Definitions and Data Sources

Variables	Description	Source
GDP	Annual "real" growth rate of GDP in Kosovo and it is expressed by percentage (%)	Annual Report of CBK, 2014
FDI	FDI in Kosovo, based in annual rate of increased (or decreased)	Annual Report of CBK, 2014
Inflation Rate	Inflation Rate (CPI), that measures the level of price in good and service market within annual period (it is expressed in %)	World Bank: Global Indicators for Development
Real Effective and Exchange Rate(REER)	Weighted average of a country's currency expressed on an index of currencies of other countries	Financial Stability Report of CBK, 2014

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