Foreign Direct Investment Determinants in the Western Balkan: Insights and Implications for Albania

DITJONA KULE[1], OGERTA ELEZAJ[2],
[1]Faculty of Economy,
University of Tirana,
Tirana,
ALBANIA

[2]Birmingham City University,
UNITED KINGDOM

Abstract: - Foreign Direct Investment (FDI) remains a crucial driver of economic transformation in the Western Balkans, where structural reforms, market integration, and political stability shape investment attractiveness. This study examines the determinants of FDI inflows in five Western Balkan economies: Albania, Serbia, Montenegro, North Macedonia, and Bosnia and Herzegovina. Using World Bank World Development Indicators, pooled Ordinary Least Squares and fixed-effects (LSDV) panel regressions are applied to assess the impact of macroeconomic, demographic, and governance-related factors on FDI. The results indicate that market size, inflation, population, and political stability significantly influence FDI inflows, while government effectiveness emerges as a key institutional determinant at the regional level. To provide a country-specific perspective, Albania is further examined using time-series analysis, including unit root, Johansen cointegration, and Granger causality tests. The findings reveal a long-run cointegrated relationship between FDI and GDP, with unidirectional causality from FDI to economic growth, highlighting the importance of governance reforms and macroeconomic stability.

Key-Words: - Foreign Direct Investment, Western Balkans, Economic Growth, Institutional Quality, Market Size, Governance, Panel Data Analysis, Albania.

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1 Introduction

Foreign direct investment (FDI) is defined by the Organization for Economic Co-operation and Development [1] as a crucial component of an open and efficient international economic system, acting as a significant driver of development. FDI, along with Multinational Enterprises (MNEs), has experienced rapid growth since 1990, surpassing both world GDP and world trade [2].

FDI is a core element of the globalised economy that characterises the 21st century. It is a prominent component of technology transfers between countries and a growth engine for many developed and developing countries. The premise of FDI is rather straightforward. An investor (institutional or individual) scouts for profit-making opportunities and chooses the country (host country) best suited to their requirements. A widespread and accepted theoretical framework of FDI has been that of the Ownership–Location–Internalization (OLI) paradigm [3], which sets clear motives behind FDI. Those being market seeking, resource seeking, efficiency-seeking, and strategic resource seeking. This was based on his previous OLI-model [4]. The OLI model sets forward the Ownership (O), Location (L), and Internationalization (I) framework for analysing the foreign activities of multinational enterprises (MNEs) and the determinants of international production. The OLI factors set forward preconditions for MNEs to make a profit.

However, the benefits of FDI aren't the same for every country. They depend on the rules and policies set by each country. By examining Albania's experience with attracting and leveraging FDI and identifying the main factors impacting the FDI flow, we aim to shed light on the broader implications of FDI for emerging economies.

Given the countries small size and a relatively new presence on the international stage, the study considers the wider region of Western Balkan countries. The literature is also richer for Western Balkan countries rather than specific Balkan countries. The study focuses on five countries in the Western Balkans: Albania, Bosnia & Herzegovina,

Montenegro, North Macedonia, and Serbia. These countries, while close in geography, have both similarities and differences. They were previously transition economies and are now developing economies. All these countries aspire to become members of the European Union and have embraced policies that are conducive to attracting and fostering FDI. Previously, under socialist governance, these countries faced similar social and economic issues. This is an important factor when analysing the context in which FDI developed in these countries. The transition countries followed a similar route. Initially, liberalisation of prices allowed market forces to determine market demand and supply. Macroeconomic stabilisation through monetary and fiscal policies to control inflation. Restructuring and privatisation are the main channels of transferring ownership from state-owned enterprises to private agents. In addition to that, privatisation was the most popular method of FDI for the Western Balkan region.

This research is dedicated to studying the determinants of foreign direct investment in the Western Balkans region. The study shall pivot towards the Republic of Albania upon explaining the literature review and the findings through this research. Western Balkan countries exhibit similar behaviour in terms of social and economic structure. The countries under consideration have interacted with one another during their historical span and are known to have a great many deals of controversies during said historical span. However, the region is of great importance to all kinds of stakeholders. Studying this region presents difficulties due to the scarcity of data, and different geopolitical events have caused said scarcity to make data optimisation even harder. The countries in the Western Balkans gained independence on different dates, starting from 1912 (Albania), all the way to 2006 (Montenegro). Hence, the data is limited. All the governments of the Western Balkan nations wish to join the EU. Through the EU's enlargement schemes, the Western Balkan countries have seen major shifts in their public policy and political pursuits. The accession programs have been open for the 4 countries (Albania, Montenegro, North Macedonia, Serbia), and a potential candidate status has been given to Bosnia and Herzegovina. The 2003 Thessaloniki European Council summit was the most important starting point of negotiations between the Balkan countries and the EU.

The structure of the paper is as follows: Section two delves into the literature review and provides the background information concerning FDI inflows and their determinants. Section three presents the methodology. In section four, the authors present the empirical findings of the OLS and LSDV models applied to the relevant determinants. Finally, in section five, conclusions and policy recommendations are presented.

2 Literature Review

Understanding the determinants of FDI is crucial when comparing different industrial sectors, countries, and larger geographical regions. These determinants can be broadly categorized into two groups: micro determinants, which are specific to individual companies and primarily affect the supply side of FDI, and macro determinants, which are specific to countries and primarily influence the demand side of FDI. The author [5] presented several significant findings based on a sample study encompassing 30 transition economies from 2005 to 2011. The study showed the great and grave importance of institutional quality and governance on the maintenance of a business-friendly environment. Such an environment is a necessity for both domestic and foreign investments. The study found that transition economies face regulatory hurdles that are significant obstacles to building and maintaining proper institutions. The important takeaway from the study is that institutional reform/legislative reform means little when there is no proper implementation and enforcement of the reform. This is in line with other studies' findings on the robustness of FDI determinants in the Western Balkans, where the only statistically significant determinants were those which fell under the category of quality of institutions and governance, i.e., paying taxes, starting a business, etc [6]. A gravity model was employed by authors [7] to investigate the variations in FDI determinants across the Western Balkan countries from 1990 to 2011. The primary factors considered in the analysis included the size of the host economy, the size of the source economy, and the distance between the two economies. The premise is that FDI ought to be driven by the same factors as the countries are of similar characteristics. The study lays out that there is but one difference in FDI drivers for Western Balkan countries. Namely, that is the "closeness" to the EU core. The further a country is from the EU core, the lower the FDI inflow [8]. The determinants the study found to be significant were: unit labour cost, market size, and proximity to trading partners. These alone are one of the most important determinants of FDI [9], [10]. The study found that announcements on EU membership positively affected FDI inflow to the country starting accession

procedures. This is an important factor because the EU only allows states to join the bloc if the institutions are good and well-maintained. The estimation equation included the GDP, wages, resources, institutions, and EU membership of host and recipient countries. By using data from the IMF and EBRD, the study found a negative correlation between the independent variables of resources, privatization, property rights, and freedom. The negative factor of Western Balkans influencing FDI was tested to be significant, and it can be explained by the existence of weak institutional arrangements and a lack of attractive assets in the area. The study summarises that key factors for the Western Balkans are: - Size of the domestic economy - Distance from investing economy - Institutional quality. The last factor is closely related to the shared target of Western Balkan countries of joining the EU, but the causal effect is inconclusive. Meaning that it is inconclusive whether better institutions lead to EU membership or whether EU membership leads to better institutions. However, the literature is ambiguous in terms of what is a determinant for FDI. Lower wages, therefore, cheap labour, cannot be the main selling point as FDI in the Western Balkans region is not concentrated in the manufacturing sector [11]. However, authors in [12] found that high labour cost countries tend to invest in countries with low labour costs. The attractiveness of low labour cost for FDI is supported by different studies, [13], [14]. The study in [15] focuses on investigating the flow of FDI in the face of changes in the relative competitiveness of countries. The results of the neoclassical investment function used to explain domestic investment expenditures found that FDI flows are determined by changes in real levels of demand and the countries relative competitiveness. In the literature, it is evident that a great deal of focus is given to market size as an important economic determinant [14], [15], [16]. The economic theory leads us to believe that larger markets attract larger investments. Due to the nature of the 21st century, a large market can no longer be bound by simply geographical size or population number. It needs to take into consideration market growth, trade openness, consumer confidence, etc. The authors in [17] argue that a large market size is necessary for effective employment of resources for various economic uses. In this case, FDI requires a significant market size to effectively take off. They employ the market size and export-led growth hypothesis. This hypothesis claims that inward FDI is an increasing function of the market size of the country. The bigger the market, the larger the FDI. The proxy for the larger market size is usually the value of GDP. This is seen across most studies that take market size as a determinant of FDI [17]. However, authors in [18], [19] found no statistical significance of GDP size on FDI inflow because the FDI might not have taken place to serve the domestic market, but used the domestic market to better access other regional markets. This is the market-seeking motive of FDI. The market size hypothesis is supported by [20]. The study uses real GDP/capita as a proxy for market size. Using 4 different models, each tested by multiple regression with 54 country data, the study concludes that the politico-economic model, which included determinants from the first two models, models which were purely economic and political respectively, performed much better when testing goodness of fit and forecasting FDI. The study concludes that FDI is determined better by a combination of economic and political factors rather than by one cluster of determinants only. It found that determinants such as GNP growth and workers' skill level were of the least importance. The important message from it was that the higher the "per capita income", combined with a lower balance of payments deficit, the more FDI would follow. This economic conclusion is supported by the (ELG) Export-led growth hypothesis. A balance of payments deficit signals that a country imports goods and services at a higher value than it exports. A reduced balance of payments deficit means a lower rate of borrowing from other countries to pay for imports. The ELG hypothesis predicts that export-led growth will have a positive impact on economic growth. The authors in [21] analysed the causal relationship between exports, foreign output shock, and output growth for Turkey during 1986-2006 to find that changes in real exports precede changes in real GDP. This is an important finding as the Turkish government set an example of policy reforms towards foreign trade liberalisation and financial liberalisation. The same path was followed by Western Balkan countries after the shift from a centralised economy. A larger market, a more robust consumption, and a higher per capita income are all positive factors of FDI. Under no circumstances would a positive high value of these variables result in lower FDI for the host country. However, it is important to distinguish the results of FDI from GDP as an indicator and income per capita as an indicator. The author in [10] argued that absolute GDP is not a satisfactory indicator for the true market size. The same study further argued that GDP reflects population size more than it does income per capita. This is a useful difference when

wishing to determine whether specific goods/services would be purchased in the new market that the foreign company enters, as income per capita is a better indicator of consumer confidence and consumption rate. Moreover, [13] through a non-linear simultaneous equation utilising pooled aggregate data of 62 countries from 1975-1978 found that higher GDP per capita is indicative of higher FDI inflow. This finding is supported by [22]. However, many of the findings on studies like [22] cannot be used to determine FDI determinants for Western Balkan countries. FDI in already industrialised countries, like the UK in the case analysed in [22], is different from FDI in Western Balkans, and GDP may play many different roles in the two cases. The motives of FDI are different, and the effect that FDI plays on the economy is very different. Inward FDI for the UK in 2019 was 2%, for Albania it was 7.8% [23]. The difference doesn't stop at just the disproportionate relative percentage, but also at the FDI penetration. The UK is a major M&A hub, whereas FDI in the Western Balkans is focused more on tourism rejuvenation and infrastructure. However, the study in [22] brings population as a variable and population density as a proxy for concentrated consumer hotspots and attractive destinations for FDI. Authors in [24] used average data from 1980 to 2000 and applied cross-sectional OLS, making FDI the dependent variable and using data from the World Bank to generate a regression model using infrastructure, import, manufacturing, human capital, and income as independent variables. One of the models that the author implements discriminates between age groups. Groups of 0 to 14, 14 to 56, and 65 & above years of age were included from the population size. The regression found that a high 14-56 cohort size has a positive and significant correlation with FDI. This means that a largely middle-aged population tends to consume more; however, the model does not take into account the purchasing power of the fourteen, fifteen, sixteen, and seventeen-year-old sample specimens. An interesting aspect of this study was that high population growth and density are not determinants of FDI, contrary to [22] findings on population density. Moreover, the export-focused domestic firms' exposure to international competition increases the level of discipline, innovation, and efficiency yielded by the firms' management. Greater discipline, innovation, and efficiency are textbook implications for organisational profitability. If foreign investors were interested in penetrating a foreign market through mergers & acquisitions, the markets exhibiting better discipline would be more welcoming to these investors. Hence, export-led policy spills over to private agents who, in turn, can boost FDI attractiveness [25]. Another important study, [16] represents the most important study of the market size indicator for FDI inflow in the Western Balkans region. The study covers Albania, Bosnia & Herzegovina, Croatia, North Macedonia, Montenegro, and Serbia. The dependent variable FDI is accompanied by the independent variables of GDP per capita (a proxy for market size), GDP growth rate (a proxy for market growth), trade openness, and population size. The reason why the study chose to include two major proxies for market size, namely GDP per capita and population size, is that population size determines the purchasing capacity and the scale of the domestic market itself. A multiple regression model is applied, initially checking for bivariate correlation between the dependent variables to check for multicollinearity. The study finds no multicollinearity. An OLS method is applied to estimate the regression parameters to find that Population has the largest impact. GDP per capita and GDP growth were found to be statistically significant for FDI inflow. Trade openness had the smallest relative influence on FDI, and with a negative beta coefficient, it indicates an inverse relationship with FDI. The trade openness parameter has no statistical significance. The study concludes that market size is a large influencer of FDI inflow for the Western Balkans. This study supports the findings of previous literature on the importance of market size. So far, we have treated market size as one of the major determinants of FDI. Literature supports this, and we are comfortable with treating market size as one of the key factors for future FDI for the Western Balkans, and specifically Albania. The question we then pose tries to tackle this obstacle. Can the market size increase for Albania and bring in more FDI? The technical question is one of how to increase GDP per capita and, consequently, the purchasing power of the population, given that the population of the Western Balkan nations is highly concentrated in the capital cities of the above-mentioned nations. The other major "school of thought" for FDI determinants falls under the specification of financial development. It constitutes improvement and development of information regarding investment and capital allocation. It involves the establishment and further development of institutions, financial instruments, and financial markets that support investment and further growth. This part of dynamic interaction is not covered "en masse" in the literature. It treats the institutional aspect as a political factor in the scope of

corruption, institutional effectiveness, and political stability. A significant and considerable study that considers the relationship between FDI and financial development is presented in [26].

More recent evidence highlights the importance of institutional quality and regulatory effectiveness as key predictors of FDI, particularly in transition economies [27]. In the Western Balkans, geopolitical risk and EU integration prospects continue to play a decisive role in investment decisions [28]. Methodologically, fixed-effects and LSDV models remain widely used to evaluate regional FDI determinants [29], while country-level studies often rely on cointegration and causality analysis to assess long-term growth effects [30].

The study aims to study the Financial Development and FDI relationship through the lens of Institutional Quality (IQ). The financial system is a by-product of the transparency, reliability, and contract enforcement of the institutions forming the financial system. A system with an established rule of law, property right protection, and minimised corruption set a precedent for investor confidence (both domestic and foreign) [31].

3 Methodology

To uncover and test the factors affecting FDI in the Western Balkan region, we applied multiple linear regression models. We chose to use the multiple linear regression model for the following reasons. A multiple linear regression model will allow us to determine the strengths of the predictors, forecast an effect, and allow us to trend forecast as well. Using the obtained results, we focus on analyzing the significance of the determinants included in the data analysis and explaining their overall significance in FDI inflows. In this study, we also apply the Least Squares Dummy Variable method (LSDV). This helps in identifying some determinants that are supposed to influence the structure of foreign direct investment, known as a fixed-effects model in panel data analysis.

3.1 Fixed Effect Models

This model used Least Squares Dummy Variables (LSDV). This model is commonly used when dealing with panel data or when there is a need to control unobserved heterogeneity at the group level. This is done by including dummy variables in the model for each of the groups, as per the function below:

$$y_{it}=\beta_0+\beta_1 x_{1it}+\beta_2 x_{2it}+\ldots+\beta_k x_{kit}+\alpha_i+u_{it} \quad (1)$$

where:

- Y_{it} is the dependent variable for observation i in group t.
- x_{1it}, x_{2it}, …, x_{kit} are the independent variables.
- α_i represents the fixed effect for each category of the categorical variable i.
- u_{it} is the error term.

In this study, we then compare the results obtained by OLS and LSDV to determine the best model used to represent the data.

3.2 Data Source and Setting of Variables

Based on the vast information of the empirical literature, we have identified the determinants affecting FDI and used a combination of economic and political factors. The literature is set on the importance and significance of both macroeconomic factors and softer-power/political-based factors, i.e., political stability/corruption index. The determinants chosen to encapsulate the structural characteristics of the economies under investigation (i.e., GDP growth/unemployment/inflation), the economic policy and friendliness towards FDI (i.e., Official Development Assistance (ODA)), and the political environment (Government effectiveness, Corruption index). The considered variables in this study are listed in Table 1.

Table 1. List of Variables

Variables	Countries
FDI Inflow	Albania Serbia Montenegro North Macedonia Bosnia and Herzegovina
GDP growth	
Unemployment	
Inflation	
ODA	
Government Effectiveness	
Population	
Corruption index	
Political Stability	

Source: created by the authors

The data is downloaded from the World Bank dataset of World Development Indicators. The number of observations collected from the data source available belongs to the 5 countries of interest, and for the period 2001-2021.

We chose GDP growth as a proxy variable for market growth, and given its significance, it holds as a determinant in the literature. Unemployment is chosen as a proxy variable for the labour market pool. Inflation is chosen as a proxy for macroeconomic stability and its general

characteristic of being a good indicator for the separation of power between government and macroeconomic institutions, i.e., the central bank. The population is chosen as a proxy variable for market size, with literature being supportive of the population as a determinant of FDI. Government effectiveness, corruption index, and political stability have been chosen as independent variables to quantify the political risks associated with the Western Balkan countries.

ODA refers to Official Development Assistance. The OECD defines ODA as the resource flows to developing countries. This is a measure of foreign aid from the OECD Development Assistance Committee (DAC) that is intended for developing countries to develop and further enhance their institutions and projects that require financing. This is an important aspect of soft power as it indicates further integration of developing countries in trading blocks, i.e. EU. For the countries we have a vested interest in, this foreign aid would, hypothetically, be in great quantity from EU countries. High assistance from the EU is likely to be an indicator of positive/negative trajectory of Western Balkan countries towards integration in the European Union.

4 Results

4.1 FDI Inflows

As shown in Figure 1, Albania's FDI inflows exhibited fluctuations over the years but remained relatively stable, with a notable increase in 2009 and 2010 followed by a slight decrease in subsequent years; nevertheless, the country maintained a moderate level of FDI inflows throughout the period. Bosnia and Herzegovina saw a big rise in FDI in 2007, followed by a drop in later years. FDI remained low from 2009 to 2015 before slightly picking up again. Overall, FDI levels in Bosnia and Herzegovina have been unstable, showing fluctuations over time. FDI inflows in North Macedonia have varied over time, experiencing notable increases in 2007, 2010, and 2017. However, there was a considerable decline in FDI in 2019, followed by a recovery in 2020 and 2021. Despite these fluctuations, North Macedonia has consistently attracted varying levels of FDI over the period. Montenegro witnessed a significant surge in FDI inflows in 2007 and 2008, which was followed by a decline in the ensuing years. FDI levels remained relatively stable from 2009 to 2016 before showing a slight uptick in later years. Serbia experienced significant spikes in FDI inflows in 2007 and 2011, with fluctuations observed in the following years. FDI levels remained relatively steady from 2012 to 2018 before a slight rise in later years. It is evident that Montenegro stands out for attracting the highest FDI levels, followed by Albania and Serbia. Bosnia and Herzegovina and North Macedonia experienced more fluctuations in FDI levels, with Bosnia and Herzegovina showing the most volatile pattern.

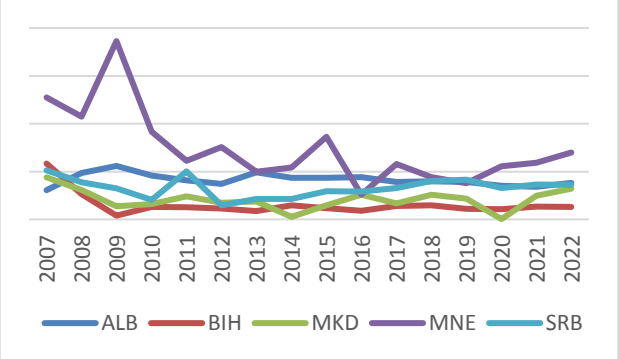

Fig. 1: FDI inflows
Source: created by the authors

4.2 Descriptive Statistics

Based on the descriptive statistics presented in Table 2 (Appendix), it is evident that FDI inflows vary from the maximum and minimum of 37.27 and -0,105 ($m inflow/outflow), respectively, with an average of 6.34 and a standard deviation of 5.3. We want to explore whether the independent variables exhibit correlation with the independent variable FDI inflow (denoted as “y” on the correlation matrix).

As presented in Table 3 (Appendix), some of the variables reported positive relations, while others had a negative relationship. Only 6 out of the 8 reported significant correlations (Unemployment, Population, NetODA, Inflation, Government Effectiveness, and Political Stability). This leaves out GDP growth and Corruption. These results are reassuring for the effectiveness and reliability of our model, as variables such as corruption have been found to report insignificant negative association [32], [33], [34]. We then move on to compare the results between the OLS and LSDV models.

4.3 Regression Results

Table 4 presents the results obtained by the two regressions (OLS and LSDV). The robust standard errors are in parentheses. *, **, *** indicates that the coefficients are significant at the 1%, 0.01%, 0% level of significance.

The primary findings from the Ordinary Least Squares (OLS) analysis indicate that several

variables, including GDP growth, Population, Political stability, and Inflation, exhibit statistical significance at the 0.01 level, consistent with prior research. With an R-squared value of 0.59, approximately 59% of the data aligns with the model, elucidating that 59% of the variation in Foreign Direct Investment (FDI) inflows can be attributed to the selected determinants. Furthermore, the calculated F-statistic of 12.25 confirms the overall significance of the OLS model.

The findings from the Least Squares Dummy Variables (LSDV) analysis reveal additional variables, including Government effectiveness, attaining statistical significance at the 0.01 level, alongside those identified in the OLS model. With an R-squared value of 0.87, approximately 87% of the data aligns with the LSDV model, demonstrating that 87% of the variation in FDI inflows can be explained by the selected determinants. The F-statistic for the LSDV model is recorded at 5.62416. Each component of the factor variable (country) captures specific effects, illustrating the nuanced differences across countries.

Table 2. Regressions Results

Variable	OLS	LSDV (OLS_DUM)
Intercept	46.90 **	–
	(−15.03)	
GDP Growth	−0.59 **	−0.43 **
	(−0.20)	(−0.20)
Unemployment	0.01	−0.04
	(−0.10)	(−0.14)
Log(Population)	−2.98 **	−105.81 **
	(−0.81)	(−36.49)
Log(Net ODA)	0.63	−0.15
	(−1.18)	(−1.22)
Corruption	−3.01	−1.87
	(−4.57)	(−4.69)
Political Stability	8.03 **	6.59 **
	(−1.94)	(−2.07)
Government Effectiveness	−3.92	−9.37 **
	(−4.41)	(−4.67)
Inflation	0.90 **	0.80 **
	(−0.22)	(−0.22)
Country Dummy: Albania	–	1580.61 **
		(−544.06)
Country Dummy: Montenegro	–	1424.65 **
		(−487.54)
Country Dummy: North Macedonia	–	1545.53 **
		(−531.37)
Country Dummy: Serbia	–	1675.20 **
		(−576.59)
R^2	0.64	0.9
Adjusted R^2	0.59	0.87

Source: created by the authors

Notably, while Government Effectiveness was insignificant in the OLS model, its significance in the LSDV model underscores the importance of considering country-specific factors. This highlights the inherent disparities in government effectiveness and practices among Western Balkan countries and emphasizes the need to control for such variations. The intercept of Bosnia and Herzegovina serves as a comparative country measure, further emphasizing the importance of the country factor.

The substantial increase in variation explanation from the R-squared value in the LSDV model compared to the OLS model underscores the added value of incorporating the country factor, ultimately enriching the model's explanatory power.

In summary, the LSDV model, with its incorporation of country-specific dummy variables, provides a more comprehensive understanding of the determinants of FDI inflows, accentuating the significance of country-level factors in shaping investment decisions.

4.4 Empirical Evidence of the FDI-GDP Relationship for Albania

This section examines how Foreign Direct Investment (FDI) affects Albania's economic growth. The analysis is based on various studies conducted over the years, which have attempted to determine if there's a connection between FDI and a country's GDP. However, the results of these studies are still mixed, and there's no clear agreement on whether FDI contributes positively to a country's economic growth. This discrepancy may be due to different factors considered, such as sample size, time period, or specific characteristics of the country being analyzed.

Different authors [35] have found a positive impact of FDI on economic growth. However, they all conclude that this impact depends on the macroeconomic policies of the host country. On the other hand, other authors [36] have concluded that FDI inflows don't influence economic growth significantly because they don't lead to spillover effects in the host country's firms.

4.4.1 Unit Root Test

This study looks at the relationship between Foreign Direct Investment (FDI) and Gross Domestic Product (GDP) in Albania. It examines both short- and long-term effects. The data used comes from the World Bank and covers the years 1992 to 2022.

Before analyzing the relationship, it is important to check if the data is stable over time. When data changes a lot and shows trends, it is called non-stationary. When it stays consistent, it is called stationary. If the data is not stable, statistical results may not be reliable. To check this, the study uses

two common tests, the Augmented Dickey-Fuller (ADF) test and the Phillips–Perron (PP) test. These tests help decide the right method for further analysis.

The results of the unit root test are presented in Table 5.

Table 3. Unit Root Test

Series	PP t statistics	PP at 1%	PP at 5%	ADF t-statistics	P value	ADf at 5%
GDP	0.95157	-3.653	-2.957	-0.2067	0.9377	-2.998
ΔGDP	-5.128	-3.661	-2.960	-3.610	0.005	-2.998
FDI	-1.4498	-3.669	-2.964	-1.5330	0.5170	-2.964
ΔFDI	-5.1679	-3.679	-2.967	-5.0612	0.6763	-2.967

Source: created by the authors

The null hypothesis gets discarded when, at time "t", both the ADF and PP statistics are more negative than the critical values set at 1% and 5% significance levels. In Table 5, both the ADF and PP statistics surpass the critical values at both significant levels. Consequently, based on both the Phillips-Perron and Augmented Dickey-Fuller tests, the given data present compelling evidence of non-stationarity. Therefore, in both scenarios, we do not reject the null hypothesis of a unit root. Hence, concerning Albania, both GDP and FDI inflows are deemed non-stationary variables at the base level.
It is possible to conduct valid regressions using non-stationary data if the variables are co-integrated, suggesting a long-term relationship despite individual non-stationarity. As evidenced by the earlier tests, although GDP and FDI data for Albania are non-stationary at the base level, they exhibit stationarity at the first difference. This indicates the potential existence of a long-term association between GDP and FDI inflows in Albania.

4.4.2 Johansen Co-Integration test

We use the Johansen Test to check if GDP and FDI inflows are connected in the long term. This test gives us two kinds of numbers: the Trace statistic and the maximum Eigenvalue statistic. They help us see how many relationships exist between the variables and if they have a stable, long-term connection [37].

$$LNGDP_t=\alpha 0+\alpha 1LNGDP_{t-1}+\alpha 2LNGDP_{t-2}+\cdots+\alpha k\ LNGDP_{t-k}+\beta 1FDI_{t-1}+\beta 2FDI_{t-2}+\cdots+\beta kFDI_{t-k}+\varepsilon t \quad (2)$$

$$FDIt=\alpha 0+\alpha 1FDIt-1+\alpha 2FDIt-2+\cdots+\alpha kFDIt-k+\beta 1\ LNGDPt-1+\beta 2LNGDPt-2+\cdots+\beta kLNGDPt-k+\varepsilon t \quad (3)$$

In the equations provided, the parameter k represents the lag length. The null hypothesis being tested states that the past values of FDI do not significantly predict current values of LNGDP, and vice versa, in a Granger causality sense. This hypothesis is symbolized by setting all coefficients (β1, β2, ..., βk) associated with the lagged values of one variable in the regression equation for the other variable to zero.

By applying the Johansen Test, we aim to test whether GDP and FDI inflows in Albania are co-integrated, implying a stable long-run relationship between these two variables. The presence of co-integration would support the notion that changes in GDP and FDI inflows are jointly determined by their long-term equilibrium relationship, which has significant implications for economic policymaking and forecasting in Albania.

Table 4. Causuality test

Null Hypothesis	F-statistic	Prob.
GDP does not Granger-cause FDI	0.144	0.706
FDI does not Granger-cause GDP	3.526	0.071

Source: created by the authors

In the context of Albania, the Granger causality test results reported in Table 6 provide insights into the potential causal relationship between GDP and FDI. With a p-value of 0.7069 and an F-statistic of 0.1444, we fail to reject the null hypothesis that GDP does not Granger-cause FDI in Albania. This suggests that changes in Albania's GDP do not have a statistically significant impact on FDI inflows into the country. In other words, fluctuations in Albania's economic output, as measured by GDP, do not lead to corresponding changes in foreign direct investment levels. This could imply that factors other than domestic economic performance influence foreign investment decisions in Albania. Conversely, with a p-value of 0.0712 and an F-statistic of 3.5268, we reject the null hypothesis that FDI does not Granger-cause GDP in Albania. This indicates that changes in FDI levels have a statistically significant impact on Albania's GDP. When there is an increase or decrease in foreign direct investment in Albania, it tends to lead to corresponding changes in the country's economic output. This suggests that FDI plays a significant role in driving economic growth and development in Albania.

Overall, these findings suggest a unidirectional causality between FDI and GDP in Albania, indicating that changes in foreign investment levels have a significant impact on economic output, but

the reverse causality is not evident. This underscores the importance of foreign investment in driving economic growth and development in Albania.

5 Economy profile of Albania

Given the importance that the Albanian governments through the years have given to FDI, we want to see what actions the different administrations have enabled, and especially what the current administration has done. This is of importance because the current government is the first to secure three back-to-back mandates to govern the country. With a more spread-out position of control, major investment projects and legislative agendas are easier to implement. We are aiming to provide a practical and pragmatic coverage of Albania. Given the abundance of literature, we want to see how this has translated into day-to-day policymaking. To do this, we refer to the Albanian Investment Development Agency (AIDA). Established in 2010 to enhance competitiveness in the private sector and boost the exporting potential of the country, AIDA acts as the first point of communication between foreign investors/parties of interest and the government of Albania. As the primary point of contact for FDI, AIDA lists the following reasons as the main attraction points for foreign investors: 1. Liberal Investment Climate 2. Competitive labour cost 3. Young & well-educated population 4. Competitive taxation and incentives 5. Optimal geographical location 6. Strong growth potential 7. Free access to large markets 8. Macroeconomic stability. In our literature review scope, we can say that AIDA and the Albanian Government policy and direction are in line with the literature. The 6th argument is an ambiguous one. However, according to the IMF, the Albanian economy is set to grow by 5% in 2024. The 1990 "On Foreign Investments" law allows 100% full foreign ownership. Article 9 of this Act protects investors from coercive and strong-arming techniques that government entities could hypothetically take to damage the foreign investor. The article also includes the necessity of compensation should public interest deem nationalisation/expropriation of said foreign business necessary. The 2015 Law on Strategic Investments paved the way for a strategic relationship with key stakeholders on incentivising and fast-tracking administrative procedures to enable investments in industries of public interest to take place faster. Strategic and public interest sectors are considered: electronic communication infrastructure, urban waste management, mining and energy, transportation and logistics, agriculture, and fisheries. With almost 50% of the population under the age of 35, the Albanian government can only incentivise young people to engage in matrimony and infant support care as a boost for child policies. A young population does not require the welfare system to take care of them, and allows for greater tax revenue year on year. This unfreezes a considerable amount of tax revenue to be put into otherwise more revenue-intensive projects. Literature is quite clear and set on the FDI motive of market-seeking. Albania's geographical location and soft-power location allow investors many free trading areas. The most notable FTA agreements are with the European Union, Turkey, CEFTA, and EFTA. Apart from the 27 member states of the EU, Albania's FTA agreements allow for ease of trade and business with Turkey, North Macedonia, Bosnia and Herzegovina, Moldova, Montenegro, Kosovo, Serbia, Iceland, Liechtenstein, Norway, and Switzerland. The country has signed 45 bilateral agreements with the intent of promoting and protecting investments. At the same time, Albania is the beneficiary of the Generalised System of Preference (GSP) with the USA, Australia, Japan, New Zealand, the Russian Federation, Belarus, and Kazakhstan. This can explain why most of the foreign investments are not export-oriented but engaged in a business that is more motivated to benefit from the market-access possibilities of Albania. In the banking sector, the largest banks are all foreign-owned, i.e., Alpha Bank (Greek), BKT (Turkey), First Investment Bank (Bulgaria), Intesa SanPaolo Bank (Italy), Raiffeisen Bank (Austria). The only significant Albanian-capital competitor is Credins Bank. However, following the literature, the Albanian government has taken several steps to incentivise foreign investment in export-oriented businesses. These are manufacturing, tourism, and agriculture. Thresholds of investments are set to grant special status to those foreign investments that pass that threshold. Benefits include exemption from property taxes, profit taxes, VAT on machinery and goods/services. These benefits are not only for absolute investment value projects but also for domestic/foreign investors who create job opportunities for the local community. Incentives and subsidies are offered across agriculture, tourism, and manufacturing businesses.

Figure 2 enables a visual understanding of where the Albanian government's current export focus is.

Figure 2 bundles the products Albania exports, and 41.15% of the total exports in 2019 belonged to travel and tourism. 50% of 2019 exports were

Travel/Tourism and ICT. These data further underline the importance of services for the Albanian economy and its exporting capacity. In 2019, almost 45% of exports went towards a single EU member, Italy. Albania is a service economy that, soon after the change of regime, found itself prone to large privatisation projects and a lack of manufacturing infrastructure development. This is an important distinction between Albania and the Western Balkan region.

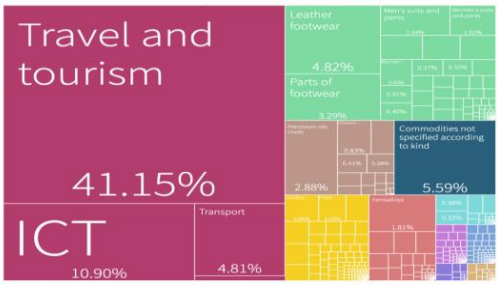

Fig. 2: Exports
Source: [38]

It's not only Albania that has an abundance of FDI focused on the service industry of the country. The transition of the Western Balkans allowed for these 2 events to occur:

The initial reform against an informal economy that the current government pledged in their first term must remain at the forefront of any initiative regarding finance and the economy. A transparent economy is imperative for any form of sustainable and significant growth. The flagship project against informality and lack of transparency across the facets of government has been e-Albania. This was the launch of online public services, rendering more mundane in-person administrative tasks (i.e, filing tax forms for approval) obsolete. Apart from creating a "lean organisation" in public administration, this tool also prohibits "informal" activities to take place, i.e., bribing. The strategic focus of Albania's government should be on promoting further investment in manufacturing and heavy industry infrastructure. Being in a special position with 100% of electricity being sourced from renewable sources, Albania can greatly benefit from exporting any surplus of electricity. The biggest source is Hydro energy, and when investigated closely, only 35.4% of the hydro energy potential has been used so far. At the same time, with an average of 240-300 days of sunshine, the Albanian government is set to ripe the benefits of energy produced by solar plants with lower tariffs. The incentives the government has put in place have clearly been functional, as foreign investments in the energy sector have grown. Some flagship FDI projects have been the Trans-Atlantic Pipeline (TAP), Devolli Hydropower Plant, Ashta Hydropower Plant, and Pocem Hydropower Plant.

As shown in Figure 3, the green line shows the optimistic scenario, whereas the red and blue the intermediate and pessimistic scenarios, respectively. This is due to lower birth rates and, more importantly, large numbers of migrants. To maintain a positive market size, the Albanian economy should maintain its population while maintaining its consumer purchasing power and investor confidence.

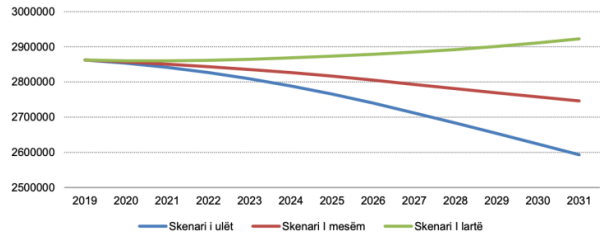

Fig. 3: Population forecast
Source: [39]

At the same time, an important takeaway from the literature is the development of institutional quality as a mediator of financial development for further Foreign Direct Investment. The government needs to take further action in adopting and promoting the flow of financial resources for both foreign and domestic investments in Albania. This is done through a developed money and banking system. The banking system is largely foreign-owned, with Turkish BKT occupying almost 27% of the market share. In order to support capital formation, the Albanian Securities Exchange (ALSE) was formed. In its inception, the ALSE was a privately owned stock exchange. Almost 90% is owned by Credins Bank and American Bank of Investment. Its creation is an innovation in Albanian financing and funding solutions. Further improvement in its structure and capital formation is a positive step towards better financial development. However, the quality of the institutions being set up is more important than the institutions themselves. This is a testament to what happened to the very first stock exchange of Albania, namely the Tirana Stock Exchange. Virtually inexistent in the financial history of Albania, TSE was created by the Bank of Albania, and it traded government bonds on its behalf. After seemingly big inefficiencies, the stock exchange stopped functioning in 2014. Relating to what was said before regarding promoting domestic Albanian products, it is important to understand that the majority of today's export/import dynamics

between countries is intra-industry trade. For Albania, this means that the small number of products that it can export needs to be at such a level to be internationally competitive. This domestic boost in productivity, profitability, and production capabilities would be in line with literature predicting greater FDI inflow. The textile and footwear industry has been an important part of the Albanian economy. As of 2019, it approximately accounted for 40% of the total exports [40] and employed over 40% of the labour force in the processing industry. Apart from finished products, Albanian enterprises exported machinery for manufacturing purposes. This industry is of high importance to Albania's future. The government ought to continue its programs of VAT reimbursement, VAT exemption, 5% Corporate Income tax rate, job training financing, customs procedure facilitation, etc. These examples were part of the Textile and Footwear Industry Package 2014. These examples fall in line with literature preaching lower taxes, skilled labour, and less bureaucracy in terms of "Doing Business". For agriculture, on the other hand, the Albanian government has its utmost focus on the future. It employs over 40% of the total labour pool. Agriculture and the textile and footwear industry together employ roughly 80% of the workforce in Albania. Agriculture makes up almost 20% of the GDP [40], and the government aims to transform the slogan "Made in Albania" into a trusted international partner. Agriculture products tested for exports in the year 2019 have been: Cardboard packing containers (12.42%), Plants used in perfumery and pharmacy (9.96%), tomatoes (7.35%), prepared or preserved fish (6.91%), cucumbers (2.42%), etc. The percentages above are breakdowns of 2019 Agriculture exports, sourced from the Harvard Atlas of Economic Complexity [38]. To support this already powerful sector, the Albanian government presented the National Scheme 2020, which allocates a fund of 7bnALL ALL ($67m) to aid farmers in Albania. The aid would come in the form of subsidizing electricity costs, the price of plastic, lower transportation costs through subsidies, fuel prices, etc. It also presented a reduced VAT of 6% for entities in the agrotourism industry. Although infrastructure is not statistically significant in terms of FDI determinants, Albania has benefited from upgrading its road infrastructure. This has been both a boost for domestic transportation companies and also an indication for foreign investors not to be worried about the necessities for their future endeavours. Currently, the two major projects under construction are Corridor VIII, which is an infrastructure project connecting the Adriatic Sea port of Durres to the naval port of Varna on the Black Sea, Bulgaria. Another international road transport is the Blue Corridor Road, which links the Adriatic-Ionian Riviera route, spanning all the way from Croatia to Greece. An industry that is completely left behind is railway transportation. Different administrations since the 1990s have tried to get the network up and running, but both nationalisation and privatisation have found the task of maintaining normal profits in the railway industry very difficult. Infrastructure can amplify the market size, and given Albania's strategic position in the Adriatic Sea, a method of amplifying the benefits of the market size variable has been the port of Durres and the port of Vlora. The former, the port of Durres, is currently under negotiation between the government of Albania and the famous multinational company Emaar. This highly esteemed FDI is set to rejuvenate the port of Durres and transform it into a regional powerhouse. The same company was responsible for the construction of the Burj Khalifa and Marina Bay in Dubai. The port of Durres is an important determinant of logistics as it covers over 90% of freight shipping and nearly 82% of the country's total shipping needs. At the same time, the Albanian government has licensed the second international airport in the north of Albania in the city of Kukes. Since 2004, the only commercial airport has been that of Tirana. In 2021, a private-public partnership was established between the government of Albania and the government of the UAE. In terms of infrastructure investment, the Albanian government has proved to attract foreign investors in its key assets. The aviation industry is set to face the licensing of a further 2 commercial airports in the south of the country. Albania is a small nation with unparalleled opportunities and plentiful resources to maintain and improve its position. Its long history with central planning should act as a guideline for its people and current/future governments to avoid interventionist practices and maintain a relaxed approach to private capital formation and foreign investment. It has a positive trend, and the effective governance during the pandemic sets Albania in a position to be the prime actor of the Western Balkans region.

6 Conclusion

The Western Balkan region presents an unmatched opportunity for drawing comparisons. The countries are divergent in culture and inherent values, yet they exhibit similar economic behaviour in both

individual and social aspects. In our regression model, we could see that the main difference was controlling for Government Effectiveness in the region. The ambiguity of the FDI effect on economic growth and the ambiguity of FDI determinants leave room for further research to be conducted. With more data being harnessed, it will be easier to draw comparisons and implement such findings in better policymaking for all Western Balkan countries. An important conclusive remark should be that more rigorous integration within the Western Balkan region is necessary. In 2021, the Open Balkan project was launched as a joint initiative between Albania, North Macedonia, and Serbia. This agreement entailed three member states with improved bilateral relations and an economic and political zone. This Balkan integration is seen as an initiative to boost trade and the political capital of the Western Balkan countries towards joining the EU. The agreement set in place is set to create an FTA with completely open borders for citizens and products to move in and out without restrictions in 2023. By removing any visa-related and customs-related procedures, the free flow of goods, capital, and people is indefinitely a positive determinant for more FDI in the region. Spill-over effects and regional hubs are important determinants for future and sustainable FDI growth. The region is not without its controversial aspects. This FTA has been seen as undermining Kosovo's independence, whereas the historical disputes between Bulgaria and North Macedonia saw the latter change its official name to its current form from the older version of Macedonia. Further political integration will surely reduce any potential political risk and maintain both macroeconomic and political stability. These two alone have been shown time and time again to be the best determinants for longevity in the foreign direct investment projects that take place.

Limitations of this study include the limited availability of long-term and consistent macroeconomic data for all Western Balkan countries, which may affect the robustness of some estimations. The analysis focuses on broad national indicators and does not capture sector-specific FDI trends or firm-level dynamics. In addition, external shocks such as the COVID-19 pandemic and geopolitical tensions may influence FDI patterns in ways that are difficult to fully isolate in the models used. Future research could address these gaps by using disaggregated data or alternative econometric approaches.

Declaration of Generative AI and AI-assisted Technologies in the Writing Process

During the preparation of this work, the author(s) utilized artificial intelligence (AI) technologies solely for the purpose of linguistic refinement and grammatical correction. Following the application of these tools, the author(s) comprehensively reviewed, verified, and edited the resulting text. The author(s) maintain full accountability and responsibility for the accuracy, integrity, and final content of the publication.

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Contribution of Individual Authors to the Creation of a Scientific Article (Ghostwriting Policy)

The authors equally contributed in the present research, at all stages from the formulation of the problem to the final findings and solution.

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Conflict of Interest

The authors have no conflicts of interest to declare that are relevant to the content of this article.

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APPENDIX

Table 5. Descriptive Statistics

	Minimum	Maximum	Mean	Standard Deviation
FDI Inflow	0,105	37,272	6,341	5,325
GDPgrowth	-7,323	9,028	3,129	2,838
Unemployment	6,619	37,250	19,565	7,358
Population	607389	7503433	3458424	2068823
NetODA	6,283	278,080	115,951	53,168
Inflation	-2,757	86,826	4,496	8,658
Corruption	-1,177	0,2914	-,305	0,284
GovernmentEffectiveness	-0,960	0,706	-0,104	0,413
PoliticalStability	-1,642	0,816	-0,0859	0,511

Source: created by the authors

Table 6. Correlations

		y	GDPgrowth	Unemployment	Population	NetODA	Inflation	Corruption	GovernmentEffectiveness	PoliticalStability
y	Pearson Correlation	1	-,082	-,266*	-,307**	,234*	,282**	,189	,294**	,587**
	Sig. (2-tailed)		,463	,019	,005	,033	,010	,087	,007	,000

Source: created by the authors