

Impact of FDI in economic expansion: The Kosovo case

Assoc. Prof. Afrim Loku

MSc. Nadire Loku

MSc. Nora Vizdik

Abstract

The Republic of Kosovo declared independence from Serbia in 2008. Kosovo's neighbor to the north, Serbia does not recognize it as a sovereign state, but has begun to normalize relations in accordance with the Brussels Agreement of April 2013. With a population of 1.8 million and land area 6,765 square miles, landlocked Kosovo is considered Europe's poorest country, yet it does have some mineral and coal deposits.

Kosovo's official unemployment rate is 35.3 percent, although some estimates are as high as 45 percent. Unemployment levels for youth and first-time job seekers are considerably higher than the official rate. According to the World Bank, Kosovo's economy is characterized by: limited integration into the global economy; the success of its Diaspora in foreign labor markets resulting in a steady stream of remittances; pro-growth budgetary priorities; and continued international financial support. Political instability coupled with corruption -- practiced and perceived -- unreliable energy supply, a large informal economy estimated at 35 percent of GDP, and a lack of contract enforcement have created significant barriers to foreign investment.¹

Establishing appropriate policies regarding emigration and the status of the Kosovo Diaspora are of key importance for stimulating growth reducing macroeconomic imbalances in Kosovo. With appropriate policies and incentives, the Diaspora could contribute more effectively, both in terms of human capital and financial resources, to economic growth and job creation in Kosovo.²

Kosovo is at an early stage in developing a functioning market economy. Some progress was made, particularly on supporting export-oriented businesses, improving contract enforcement, especially within the financial sector, and access to finance. However, the fiscally unsustainable decisions related to war-veterans' benefits may have a negative effect on the macroeconomic stability of Kosovo and its relations with international financial institutions. The persistent trade deficit reflects a weak production base and poor international competitiveness. Reliance on remittances and the widespread informal economy additionally decrease employment incentives, resulting in low labour force participation, especially among women, and high unemployment rates, in particular among young and unskilled workers. Kosovo is at an early stage in building the capacity to cope with competitive pressures and market forces within the Union. No progress was made on improving the quality of education, which is a key driver for improving long-term growth and competitiveness.³

Foreign direct investment (FDI) is widely recognized for its positive impacts on economic

¹ U.S Embassy (2016). Kosovo Investment Climate Statement 2016, p.3.

² Riinvest Institute (2007). Diaspora and Migration policies, This study is prepared for Forum 2015 by Riinvest Institute based on the research conducted in Kosovo, Germany, Switzerland, Belgium, UK, Sweden, Austria and The USA, Pristina, p. 13.

³ European Commission – Fact Sheet (2016). "Key findings of the 2016 Report on Kosovo" (file:///C:/Users/Loku/Downloads/MEMO-16-3633_EN.pdf), Brussels.

growth and transformation (Amerasinghe & Modesto, 2012). FDI may facilitate rapid economic growth in developing countries by increasing savings and investment and by transferring experiences, technologies, and know-how from developed countries (Mottaleba, & Kalirajan, 2010). The impact of FDI on growth may also positively affect poverty levels in the host country by increasing employment opportunities and wages (Klein, Aaron and Hadjimichael, 2011). Kosovo is limited in its ability to attract foreign investment due to the lack of information distribution within global markets, poor international communication regarding its economic environment and opportunities for foreign investment, and the absence of a credit rating by a credible foreign rating agency. Foreign investment inflows have also been hindered by high degrees of corruption, slow and ineffective business environment reforms, lack of transparency, economic inactivity in many sectors, negative perception by foreign investors and diaspora populations, and the failure of institutions to implement and achieve their set objectives.⁴

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;⁵ This research paper will explain the impact of Foreign Direct Investment (FDI) on economic expansion, Kosovo case. The used data in research are secondary data and cover a period from 2013 and 2016.

Keywords: FDI, Economy, Kosovo, Growth.

Introduction

The purpose of this study is providing answers to research questions related to the impact of FDI, services sector and local investment on economic growth in Kosovo. This study aims the following objectives:

- To study the trends of FDI flow (descriptive analysis);
- To show the investment environment, and study the circumstances of how friendly is Kosovo in Foreign Direct Investments.

A review of selected literature

This paper is based on secondary sources for the period 2010-2016. The main sources of data are from Kosovo Agency of Statistics (KAS), Central Bank of Kosovo (CBK), and international organizations.

Before literature review discussion is started, a FDI definition should be given with the purpose that the audience to have a clear picture of its concept. "Foreign direct investment (FDI) refers to long term participation by country A into country B. It usually involves participation in management, joint-venture, transfer of technology

⁴ A POLICY REPORT BY GROUP FOR LEGAL AND POLITICAL STUDIES (2017). How 'friendly' is Kosovo for Foreign Direct Investments: A Policy Review of Gaps from a Regional Market Perspective, Pristina, p.6.

⁵ The Foreign Direct Investment and Economic Growth - Case Study for Kosovo: (PDF Download Available). Available from: <https://www.researchgate.net/publication/307820764> The Foreign Direct Investment and Economic Growth - Case Study for Kosovo [accessed Sep 20, 2017].

and expertise" (Agrawal, G., & Khan, M. A. 2011).

Literature offers no clear predictions about the FDI effects on economic growth and development. Providing conditions for FDI expectation by the host country must be one of the main activities as investment incentives, their promotion, etc. Through their control, foreign investors achieve the goals, but despite their interests for profit, FDIs in developing countries bring new managerial techniques, training, capital, create new jobs, higher salaries, improved employment conditions, and development of industrial sectors. Analysis of the theories of commercial activities with abroad on both macro and micro levels, and in particular the Dunning "OLI" theory have dealt and continue to deal with the issue of FDI (the most actual phenomenon of 20th century). Neoclassical theory predicts increasing the availability of capital per capita instead of maximizing the growth of FDI. Economic growth is associated with significant fluctuations of relative sizes of economy sectors. Authors and relevant institutions such as Chenery and Strout (1996), Dunning (1970), Todaro (1982), Kruger (1987) and World Bank (1993), prove that FDI continuously promote growth of GDP. Neoclassicists point out that savings, i.e. accumulation of capital is the main engine of economic growth. Supporters of this economic theory who have worked in that field like; Reuber (1973); Kojima (1978), Bergten, et al. (1978); Chu (1989); Antonelli (1991); Kennedy (1992); Lall (1993); Sornarajah (1994); Seid (2002), Narula (argued that FDI increase competition and improve productivity. This advantage of competition will lead to better resource allocation, better capital exploitation, efficient management and efficiency increase in the market. However, the empirical literature has left behind (there is not a consensus reached yet) and there were a lot of problems to identify advantages in practice.

Investment environment

Despite the challenges faced by other countries due to fluctuations in the global economy and particularly in Europe, Kosovo's economy has experienced positive growth during recent years. However, the economy of the country is characterized by a high reliance on the import of goods which negatively affects the growth rate and the current account balance Kosovo's economy was characterized with an increase of economic activity during 2016 compared to the previous year. Preliminary statistics, prepared by Kosovo Agency of Statistics, related to quarterly GDP, indicate that Kosovo's economy marked an average increase of 3.4 percent during the four quarters of 2016. The CBK projections for 2017 suggest that the real GDP growth rate will reach 3.7 percent. Economic growth in 2016 was supported by increased domestic demand, while net exports had a negative impact on the economic growth rate. During 2016 it was the increase of investment of 9.1 percent as well as the increase of consumption of 3.0 percent that contributed to the real economic growth in the country. According to the manufacturing approach, economic growth in 2016 was mainly a result of the increased value added activity in the agriculture, trade and financial activity. Whereas real decrease is marked with real estate business, processing industry and public administration.

The country's economy has continued to face imbalances against the external

sector. While added value from manufacturing sectors in the country remains low, the growth in internal demand has contributed to a further increase in import. The increase of consumption and investments in 2016 had an impact on the increase of imports, which is translated into increase of current account deficit. Also, during 2016, Kosovo's external sector has been characterized by a decline in exports, mainly as a result of the decrease of prices in international markets and the decline of nickel production in domestic economy. Also, the increase of deficit of current and capital account is attributed to the decline in the positive balance of the primary income account, whereas the positive balance of services and the secondary income account marked an increase. During 2016, the current and capital account deficit amounted to euro 534.6 million, compared to the deficit of euro 471.4 million (about 8.9 percent of GDP), an annual increase of 13.4 percent. Remittances received in Kosovo, which at the same time represent the largest category within the secondary income account, amounted to euro 691.0 million, thus representing an annual increase of 3.8 percent. With regards to financial account, FDI received in Kosovo were characterized by a decline to the amount of euro 215.9 million in 2016 from euro 308.8 million that were received in 2015.⁶

Table 1. Economic Data

	2010	2011	2012	2013	2014	2015	2016
GDP at market prices, EUR million	4,402	4,815	5,058	5,327	5,568	5,807	6052
Real GDP growth rate (%)	3.30	4.40	2.80	3.4	1.2	4.1	3.6
GDP per capita in EUR	2,480	2,672	2,799	2,935	3023	3159	3244
Inflation rate (%)	3.5	7.3	2.5	1.8	0.6	0.4	0.3
Currency account, EUR million	(658)	(658)	(380)	(339)	(438)	(541)	(594)

Source: IMF (2017). *IMF Country Report No. 17/68*. p. 23

The unemployment rate in Kosovo is estimated to be 27.5%, according to the latest available statistics from the Kosovo 2016 Labor Force Survey carried out by the Kosovo Agency of Statistics. Unemployment is higher among youth and women. The situation is not expected to improve quickly given that Kosovo has the youngest population in Europe and these individuals enter the labor market each year finding limited employment options. On the other hand, the labor market offers a work force with varied skills and levels of education and training. An important component of Kosovo life and the labor market is migration. Traditionally, migration has been very high, which in turn has alleviated some of the labor market pressures. Another positive influence from migration is the fact that returning migrants bring to the local market their experience and skills gained abroad.⁷

Kosovo's Legislative Framework on FDI

Kosovo's laws do not discriminate against foreign investors. The GoK – specifically the Prime Minister's Office, Ministry of Trade and Industry (MTI), Kosovo Investment and Enterprise Support Agency (KIESA), Ministry of Finance (MOF), and Ministry of

⁶ CBK (2017). Annual Report 2016. Pristina, p.21.

⁷ KPMG (2017). Investment in Kosovo 2017, Pristina, p.8-9.

Economic Development (MED) – actively promotes foreign investment and welcomes the expansion of the private sector. However, the lack of a single GoK organization empowered and responsible for coordinating all foreign investment opportunities is a hurdle to some projects. While the Kosovo economy continues to transition from socialism to capitalism, some public distrust of the private sector remains.⁸

The Foreign direct investment in Kosovo is primarily regulated by Kosovo Constitution exactly by the Law No. 04/L-220 on Foreign Investment, whose purpose is to promote, protect, and attract foreign investment in Kosovo, primarily by providing fundamental rights, protection measures and guarantees for foreign investors. The main aim of this law, which repealed the Law No. 02/L-33, is to improve the business climate and conditions in order to attract foreign investments and ensure fair treatment of investors in accordance with international standards.⁹ The law regulates all aspects of foreign investments, addressing non-discrimination, expropriation, compliance with obligations/standards and laws, and, among others, mechanisms for the resolution of investment disputes. The Law stipulates that foreign investments include but are not limited to:

- “movable and immovable property, including rights in and to such property such as a mortgage, lien, pledge, lease or servitude;
- intangible and intellectual property, including rights in such property, as well as goodwill, technical processes and knowledge;
- cash, securities, commercial paper, guarantees, shares of stock or other types of ownership interests in the Republic of Kosovo or foreign business organization; bonds, debentures, other debt instruments;
- claims or rights to money, goods, services, and performance under contract;
- concessions or licenses conferred by law, administrative act, or contract; and
- Returns yielded by an investment in the Republic of Kosovo or an investment elsewhere”.¹⁰

Foreign investors, in theory, enjoy treatment guaranteed by the law which gives them the same rights and responsibilities as domestic investors.¹¹ The law on foreign investment also provides assurance regarding the repatriation of capital and profit, and, contrary to the previous law, the definition of foreign investor includes also Kosovo citizens of diaspora.¹² It should be noted that foreign investors enjoy the right to settle investment disputes according to the requirements agreed upon between the foreign investors and the Republic of Kosovo. In the case that an agreement does not exist, foreign investors can request to settle the investment dispute through a court of competent jurisdiction in Kosovo or through local and/

⁸ U.S Embassy (2016). Kosovo Investment Climate Statement 2016, p.3.

⁹ A POLICY REPORT BY GROUP FOR LEGAL AND POLITICAL STUDIES (2017). How ‘friendly’ is Kosovo for Foreign Direct Investments: A Policy Review of Gaps from a Regional Market Perspective, Pristina, p.12.

¹⁰ Law No. 04/L-220 on Foreign Investment Article 2: Definitions, paragraph 1.4: Investment.

¹¹ Law No. 02/L-33 on Foreign Investment; The rights vested on this law are: constant protection and security, nondiscriminatory treatment, compensation in case of nationalization, expropriation, violation of the legislation, and protection against retroactive application of laws.

¹² Defined in the law as: ‘any physical person who is a citizen of the Republic of Kosovo, but has residence abroad’. For more see Law on Foreign Investment, Article 1.3.2.

or international arbitration.¹³ On the other hand, the Law on Strategic Investments in the Republic of Kosovo regulates the procedures for the attraction and selection of foreign investments categorized as 'strategic'.¹⁴ More specifically, the law aims to: (i) regulate the administrative procedures and criteria for the assessment, selection, implementation and supervision of 'strategic projects', whether local or foreign, (ii) regulate the procedures for the utilization of Kosovo's property to implement strategic investments projects, and (iii) reinforce the principles and conditions set out in the legislation relevant to state aid and legislation stemming from the SAA.¹⁵ The adoption of this Law was of utmost importance since it is expected to attract foreign strategic investments, improve the business environment and investment climate in Kosovo, provide a legislative framework to facilitate negotiations with local and foreign investors, and, in turn, support the development of a sustainable economy.

Western Balkan Countries initiatives to improve the Business environment: Where does Kosovo stand?

Over the last 30 years, transition economies have made significant progress in becoming major market players.¹⁶ Given the potential positive impact that FDI can play in accelerating growth and economic transformation, developing countries have increasing interest in attracting FDI (Amerasinghe & Modesto, 2012). Developing economies have made significant progress in attracting FDI during the period 2000-2010, largely as a result of improved political and economic conditions (Hornberger, Battat and Kusek, 2011). However recent figures show that FDI net inflows in SEE countries decreased by 62% between 2008 and 2014. During this period the distribution of FDI among SEE countries has been uneven, with EU member states (Bulgaria, Croatia, and Romania) generally attracting the largest share of FDI.

The countries in South East Europe have, similar to other transition countries, relied on foreign investors to bring the new capital which would induce economic growth and catching-up, but also improve existing business procedures, update frequently outdated technology, open new markets, increase the potential for trade, and bring technology and management know-how (Botrić, 2010).

During the last decade, Kosovo lacked innovative policies, which could have stimulated or boosted the level of exports and attracted a higher level of foreign investment.¹⁷ In recent years, the Government of Kosovo has undertaken several

¹³ Law No. 04/L-220 on Foreign Investment Article 16: Mechanisms for the Resolution of Investment Disputes.

¹⁴ According to the Law on Strategic Investments in the Republic of Kosovo. "Strategic Investment" is the status proposed by the Strategic Investments Committee and approved by the Government of the Republic of Kosovo, which is given to investment projects, qualified as strategic under this Law, throughout the phases of implementation and operation of the strategic project in the territory of the Republic of Kosovo; whereas "Strategic Project" means any private and public-private investment project which meets the criteria determined under this Law.

¹⁵ Law on Strategic Investments in the Republic of Kosovo.

¹⁶ A POLICY REPORT BY GROUP FOR LEGAL AND POLITICAL STUDIES (2017). How 'friendly' is Kosovo for Foreign Direct Investments: A Policy Review of Gaps from a Regional Market Perspective, Pristina, p.15.

¹⁷ FES (2011). Economic Challenges 2011 Plus. Briefing Paper, p. 12; Available at: <http://library.fes>.

reforms aimed at improving the business environment as a means of promoting enterprise development, increasing employment, improving welfare and reducing poverty. According to the latest World Bank Doing Business Report 2016, Kosovo ranked 60 among 190 economies in the ease of doing business¹⁸ and compared to last five year, its significant progress.

However compared to other SEE and developing countries which have shown serious commitment to attracting FDI, this has not been a government priority in Kosovo. The FDI inflows in Kosovo in 2014, 2015 and 2016 have been the lowest in the SEE region. While Kosovo has outperformed BiH and Macedonia in some years during the 2008-2014 period, other countries like Romania, Bulgaria, and Croatia have attracted massive inflows in comparison. In 2014, FDI in Kosovo hit a record low, having decreased by 72% compared to the previous year, similar to Macedonia which also experienced a drastic decline in FDI.

Kosovo's FDI profile

Attracting FDI and improving the climate for investment is a strategic economic priority to all Western Balcan countries not only to finance their budgets, but moreover to improve their economic performance and standard of living.

Foreign Direct Investments (FDIs) received in Kosovo amounted to euro 215.9 million, representing a lower level compared to the amount of euro 308.8 million recorded in 2015. Within FDIs structure, two forms of FDIs were characterized with a decrease in value, including the capital and fund of investments in shares, as well as investments in debt instruments (figure 1). The following Table 2, shows the inflow of FDI through the years:

Table 2. Incoming FDI flows in Kosovo

No		Year						
		2010	2011	2012	2013	2014	2015	2016
1.	Value in EUR million	368,5	384,4	229,1	280,2	151,2	308,8	215,9

Source: CBAK, Annual report 2017

The data of this table shows that FDI had significant shaking, with a significant decline in 2012. On the other hand, the lowest level is reached in year 2014, while the next two years shows a remarkable increase.

FDI in Kosovo during 2010-2016 is predominantly concentrated in the following economic sectors with respective averages: real estate with 56.3%, construction with 12.7% and the financial sector with 12.7%, followed by the trade sector with 4.5% of the total FDI.

[de/pdf-files/bueros/kosovo/08110.pdf](#).

¹⁸ World Bank data (2017). <https://tradingeconomics.com/kosovo/ease-of-doing-business> (accessed Oct. 4, 2017).

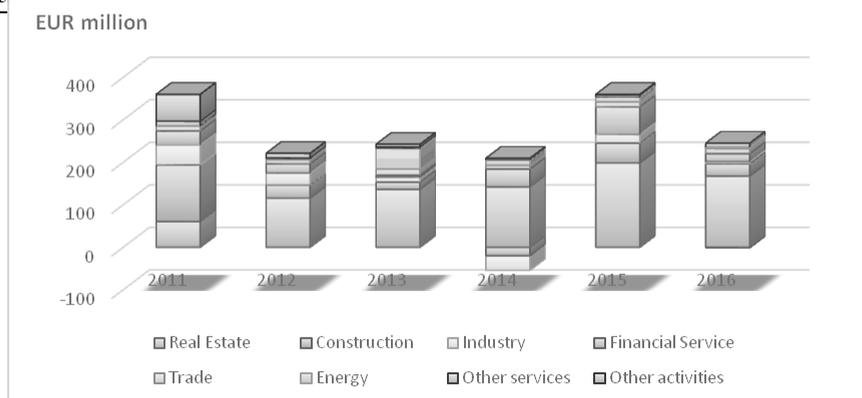


Figure 1. Foreign direct investments by sectors

Source: KAS (2017). *Statistical Yearbook of the Republic of Kosovo, 2016*, p. 224

In terms of the origin of FDI, most FDI in 2016 came from Switzerland (EUR 62 million), followed by Turkey (EUR 35 million), the United Kingdom (EUR 33 million), Germany (EUR 29 million) and Albania (EUR 29 million).

Table 3. Foreign direct investments by country

EUR million	2011	2012	2013	2014	2015	2016
Top five countries						
Switzerland	31	44	42	38	73	62
Turkey	35	66	89	20	55	35
United Kingdom	80	14	11	(40)	27	33
Germany	67	50	22	29	45	29
Albania	11	5	19	20	40	29
Total top five countries	224	178	182	69	240	187
Other countries	161	51	98	83	68	28
Total	384	229	280	151	308	215

Source: CBK monthly statistics bulletin, January 2017, no. 185

As illustrated in Table 3, the FDI in Kosovo originates mainly from industrialist and developed countries; whereas, the most important source of FDI investments originates from Switzerland. Thus, this was followed by investments from Turkey, United Kingdom, and so on.

Another characteristic of FDIs in Kosovo is that the level of reinvesting the earnings and profit, from previously privatized organizations, was very low. Also, funds collected from the sale of companies in the privatization process, have not been activated and directed toward the financing of the economic development of Kosovo. Rather, the fund has been held abroad for several years. In year 2014, the amount of funds deposited in the account in the name of "Kosovo Privatization Agency" reached around € 559 mil. Thus, this amount could have an enormous impact on the overall

economic development of Kosovo, if returned and invested properly.

Top reasons why you should invest in Republic of Kosovo

According to the Investment Promotion Agency several top reasons why you should invest in Kosovo are:

1. Kosovo is ranked 60 among 190 economies in the ease of doing business, according to the latest World Bank annual ratings. The rank of Kosovo improved to 60 in 2016 from 64 in 2015. Ease Of Doing Business in Kosovo averaged 62.67 from 2014 until 2016, reaching an all time high of 64.00 in 2015 and a record low of 60.00 in 2016.
2. Youngest population in Europe - With an average age of 25 years, Kosovo has the youngest population in Europe. Albanian and Serbian are the official languages; English and German are commonly used.
3. Very high availability of skilled and cheap labor - The normal monthly cost of labor in Kosovo is somewhere from €200 to €250. Incomes in Kosovo are unburdened by costly social contributions, different from those in the countries of the region.
4. Very low corporate income tax - Kosovo has very simple and straightforward tax schema. International Accounting Standards apply. The tax burden is very low:
 - Personal Income Tax 0-10 %;
 - VAT 16 %;
 - Corporate Income Tax 10 %;
 - Mandatory contributions for employees only 5 % of gross salaries.
5. EURO as the official currency - Euro is the official currency in Kosovo, by this means eliminating currency and exchange rate risks.
6. Free access to markets of EU, US and CEFTA – Kosovo derives three major benefits from trade liberalization, namely improved export possibilities, a better investment environment and stable relations with its neighbors.
7. Kosovo's independence marks the end to a long period of economic and stabilizing political environment - In addition to increased stability being created in the entire region, it presents a perspective of regional economic development and EU integration. Kosovo has become a member of international institutions such as the International Monetary Fund and the World Bank.
8. Kosovo is well endowed with natural resources and agricultural land so they are great investment opportunities. The sectors of agriculture, food and wood processing, construction, textile, IT, automotive components, energy, and mining offer the most opportunities for foreign investors.
9. Since after the Kosovo war in 1999, Kosovo's legal system has been re-built and is now completely compatible with the EU legislation. Foreign investors are enjoying national treatment, protection against expropriation and nationalization. The deportation of profits and relocation of invested capital is free and unrestricted.
10. Kosovo is Located in the heart of the Balkans, very strategic location and developing infrastructure - Kosovo capital city is Pristina is one hour driving time to any neigh-boring country. Recently some major projects are finished like modern highway connections to Albania, Serbia, and Macedonia.

Conclusions

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 2010 and 2016.

Every modern economy needs investment, especially foreign investment, as are the main generator of economic growth and development. Foreign investments are promoters of economic development, especially in transition countries such as Kosovo, which owns numerous resources, that almost a part of them are still underutilized due to lack of capital and financial resources to introduce. Therefore, the Government of Kosovo should be a priority for attracting investment and creating favorable policies for the business climate

Given the current state of the investment climate in Kosovo, relevant institutions and agencies should dedicate their financial resources and institutional capacity towards creating an enabling business environment and infrastructure in order to successfully attract foreign direct investments.

FDI is the main source of external financing in developing countries and in this framework of Kosovo as well. Foreign investment can lead to increased employment, increased productivity, transferability and new technology, increased exports, and contributes to the country's long-term economic development.

Kosovo's economic development depends on FDI. Kosovo's economy faces some negative trends of economic development, such as: high unemployment, high poverty rate, low GDP per capita and market coverage by imports, corruption, lower economic growth in the country as the level of investments is lower, unstable economic, lack of laws, lack of investment guarantee, bureaucracy, electricity supply and its high price, unfair competition in the market, lack of subsidies.

Despite the many challenges, Kosovo's relatively young population, low labor costs, and abundant natural resources attract foreign investment, with several international firms and franchises already present in the market.

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.

In order to achieve economic development, foreign investment interventions, as well as our country, are indispensable because Kosovo's economy cannot be competitive in a regional economy without growth and development of foreign direct and domestic investments.

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