

The importance of sectoral distribution of foreign direct investment - The situation in Albania

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Abstract

Over the last few years there has been an increase in the importance of the share of foreign direct investment in developing countries. This increase, theoretically, is also due to the many positive effects that these investments bring to the host countries. But many empirical studies show that this effect is not always positive. These different effects come as a result of the fact that these studies are based on aggregated data on FDI. Distribution by foreign direct investment sectors would be a more accurate way to understand the importance of foreign direct investment. In the world, the largest share of foreign direct investment is oriented towards the service sector. The purpose of this paper is to explain the importance of the sectoral distribution of foreign direct investment and to explain how foreign direct investments in Albania have been distributed by sectors and the effects brought in the Albanian economy, through a comparative analysis based on secondary data published by various institutions such as the Bank World Bank, Unctad, Bank of Albania, Institute of Statistics, etc

Keywords: foreign direct investments, service sector, employment, priority sectors, added value.

Introduction

Numerous theoretical studies explain the positive effects of foreign direct investment in the host country. However, the effects of FDI on host country economic growth are more confirmed by theories than they find support in empirical studies. Despite the large number of empirical studies on the effect of foreign direct investment on economic growth, the findings are still not always clear (Iamsiraroj and Ulubasoglu, 2015).

These differences in empirical studies on the impact of FDI on economic growth is attributed to the use of data on foreign direct investments totaled, as similarly stated by Alfaro and Charlton (2013). Empirical work mainly uses aggregate FDI data, while the effects of foreign direct investment also depend on the sector where FDI inflows are experienced (Alfaro and Charlton, 2013). This is because the proliferation of many of the expected positive effects of foreign direct investment accepted in theory as the potential for technology transfer, increased competition in the host country, etc., vary from the sector into which foreign investment is entering. The World Investment Report 2001 (UNCTAD), theoretically argues that the impact of FDI is different depending on the economy sector. The effect of FDI varies because the sectors have their characteristics and relate differently to other sectors in different ways.

1. The importance of the sectoral distribution of FDIs

Different authors underline the idea that the economic activities of different countries should be divided into sectors. According to this theory, an economy has three main sectors, the primary sector, the secondary sector and the tertiary sector. The primary sector groups all the economic activities that focus on the extraction of raw materials. The secondary sector is the production sector, and the tertiary sector is the services sector.

Figure 1. The sectors of an economy



Foreign investment by different sectors of the economy presents different opportunities for the overall economic development of the host country.

It is generally assumed that FDI impact on the primary sector is not always positive. There are a number of reasons why this could happen, such as:

- Mainly FDI in this sector are large capital projects. These projects create little connection with the domestic economy as they are usually export-oriented.
- Large resource flows in this sector tend to reduce the country's competitive ability in other sectors, known as the Dutch disease (Sy & Tabarraei, 2009)
- These flows negatively impact the performance of institutions. (Sachs and Werner, 1995).
- Investments in the primary sector can cause wage increases in that sector and this can lead to deindustrialization.

Therefore, FDIs in the primary sector do not always positively contribute to the economy of the host country and the effect of these investment flows on economic growth may be negative. For example, a negative effect of foreign direct investment in this sector is brought by Rutaihva and Simela (2012). They reveal a negative effect of FDI on the growth of the mining sector. This may be particularly problematic for countries very dependent to these sectors.

However, the negative economic impact is not an inevitable result. In the presence of sustainable institutions, there is evidence that FDIs to the primary sector can generate positive impact on a country. Investments in the sector may be particularly important for many countries with a lack of domestic capital (Cipollina et al., 2012).

The secondary sector, unlike the primary sector, may allow more FDI impact on the country's economic development as a consequence of the fact that the FDIs in this sector create more links, backward and forward with the host economy (Havranek and Irsova 2011). The potential for foreign direct investment to assist the country's

technological development in this sector finds more space, as it can transfer technological lines, industrial equipment, and so on.

The tertiary sector has become the main sector of foreign direct investment globally. Foreign investors can increase the efficiency of this sector by bringing new knowledge, technology. The entry of foreign direct investments in this sector has contributed to the reduction of the price of services offered to consumers. However, the literature recognizes some negative elements brought to the economies of the host countries by foreign direct investment mainly oriented only to the service sector.

- The diffusion of technology through foreign direct investment finds less room in this sector. Mainly foreign direct investments in this sector bring with them into the host country knowledge and best practices in management (Doytch and Uctum, 2011).
- Due to the fact that in this industry foreign investors are mostly superior in knowledge, they can damage domestic investment.
- Foreign direct investments in this sector are mainly oriented towards the domestic market. Consequently this creates less backward links, negatively affecting productivity (Chakraborty and Nunnenkamp, 2008).

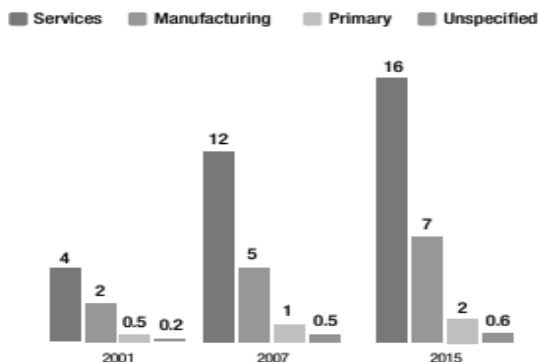
However, we can say that if foreign-oriented investment in the service sector are increasing such qualitatively the services in the host country, then the productivity of other sectors of the economy can also be increased (Chakraborty and Nunnenkamp, 2008). For example, the Western Balkans has experienced positive economic moments, even with foreign direct investments mostly to the service sector (Estrin and Uvalic, 2014). This is because the service sector is just as important as other sectors for a country's economic development.

For example, we can mention FDI oriented to the banking sector. These foreign investments in this sector created a functional banking system. This system contributed to the development of other sectors of the economy, through increased access to financial markets (Bongini, Drozdoeska, Smaga and Winkkocki 2016).

2. Sectorial distribution of FDI in global level

Data on the distribution by global economic activity of foreign direct investment shows a significant increase of FDI in the services sector. Over 60% of foreign direct investments globally belong to the service sector. However, there is an element to be clarified in the calculation of this value, which may have been overestimated the foreign direct investment in the service sector by mistake. In fact, everything can be explained by taking into account that the economic sector classification is based on the sector where the investment occurs in the host economy and not in the industry where the multinational enterprise is part. These multinational companies that may be part of the manufacturing sector in their country, and in host countries, through their branches, they carry out service activities (WIR 2017).

Chart 1 .Stok of FDI by sector worldwide.



Source: Unctad, World investment report 2017

However, this does not mean that the importance of the services sector is reduced in attracting foreign investment. The industry-based classification of the host country where the multinational company operates is based on a correct economic logic. Those investments that do not add to the host country's productive capacity and cannot be part of the primary sector, should be classified as direct foreign investment in the services sector.

3. Analysis of FDI in Albania based on sectors

The sectoral composition of FDI has undergone changes. In 2007-2011, the monetary and financial intermediation sectors were the main sectors. While the main industry in 2012 was the extracting industry, the transport sector in 2013 was the main sector in the share obtained from the total of FDI-s.

Table 1. Sectoral Distribution of Albania's inward FDI stock in 2011-2014.

NACE Rev. 1 classification:	2011	2012	2013	2014	2011	2012	2013	2014
	EUR mn				in % of total			
A Agriculture, hunting and forestry	4	2	1	1	0.1	0.0	0.0	0.0
B Fishing	4	0	-	-	0.1	0.0	-	-
C Mining and quarrying	612	810	742	677	18.0	24.8	18.0	14.9
D Manufacturing	431	388	394	412	12.7	11.9	9.6	9.1
E Electricity, gas and water supply	247	9	-4	399	7.3	0.3	-0.1	8.8
F Construction	11	78	140	107	0.3	2.4	3.4	2.4
G Wholesale, retail trade, repair of motor vehicles etc.	217	153	156	189	6.4	4.7	3.8	4.1
H Hotels and restaurants	70	64	63	60	2.1	2.0	1.5	1.3
I Transport, storage and communication	389	437	1,157	1,219	11.4	13.4	28.1	26.8
J Financial intermediation	715	753	818	768	21.0	23.1	19.9	16.9
K Real estate, renting and business activities	83	85	361	400	2.4	2.6	8.8	8.8
L Public administration, defence, compuls.soc.security	-	-	-	-	-	-	-	-
M Education	6	8	13	17	0.2	0.3	0.3	0.4
N Health and social work	47	37	33	29	1.4	1.1	0.8	0.6
O Other community, social and personal services	9	18	19	26	0.3	0.6	0.5	0.6
P Private households with employed persons	-	-	-	-	-	-	-	-
Q Extra-territorial organizations & bodies	36	46	60	60	1.1	1.4	1.5	1.3
Other not elsewhere classified activities (A-Q)	521	374	160	189	15.3	11.5	3.9	4.2
Total by activities	3,400	3,262	4,113	4,553	100.0	100.0	100.0	100.0

Source: FDI report 2016, <https://wiiv.ac.at/slump-despite-global-upturn-dlp-3899.pdf>

In Albania, foreign direct investments in 2016 are more concentrated in the sectors of "Information and Communication" and "Electricity, gas and water supply", respectively by 21.4% and 19.5%. Industry is the sector that occupies the most small of FDIs, with 10.7%.

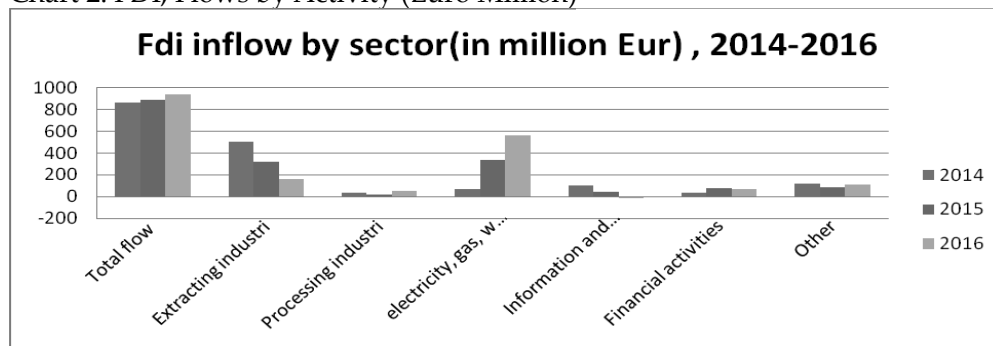
Table 2. FDI, Stock by Activity (Euro Million)

FDI	2014	2015	2016
Total FDI stock	4565.9	4981.7	5677.2
Extractive industry	642.9	635.1	651.8
processing industry	555.2	574.3	607.3
electricity, gas, water	403.8	628.7	1109.1
Information and communication	1108.1	1217.1	1214.5
Financial activities	771.7	857.3	936.5
Other	1012.0	1069.2	1158.0

Source: Bank of Albania.

One thing to notice is the fact that the processing industry and the production and distribution of electricity has marked a negative value. This indicates that there has been a move of foreign investors in this sector (Chart 2). The year 2016 presents a different picture. It was the sector of "Electricity, Gas and Water" and "Extractive Industry" that accounted for most of the FDI flows. A decrease has been recorded in the section "Information and Communication".

Chart 2. FDI, Flows by Activity (Euro Million)



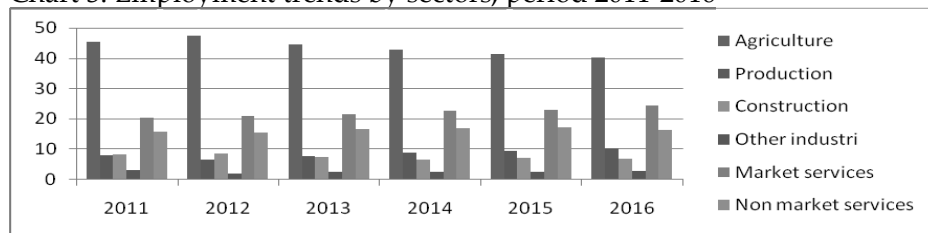
Source: Bank of Albania

Sectoral analysis of the allocation of FDI is important as different sectors contribute differently to the country's economic growth. The services sector and the agricultural sector have the highest percentage of employees, respectively 42.4% and 38.2% of total employees.

In Albania, the sector that contributes more to employment is that of agriculture, with

values over the years more than 40%. However, we see that from 2011 to 2016 there has been a decrease of 0.5%. This can be explained by the tendency of displacement of the population and abandonment of rural areas.

Chart 3. Employment trends by sectors, period 2011-2016



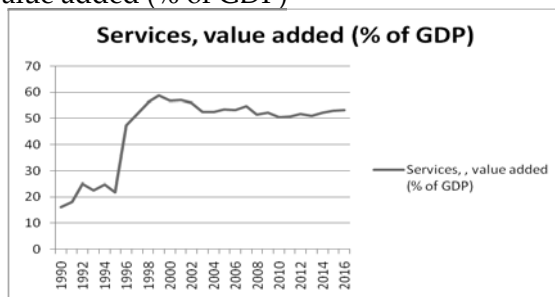
Source: INSTAT

One element of the attention is the fact that while in the employment the agriculture sector holds the main weight, but related to economic growth is the is the sector that contributes less. The second sector for the level of employees in Albania is the service sector. The employment rate in this sector has increased by 2016 to 40.4%. Employment in the manufacturing sector has experienced a slight increase over the years, 2.4% is the increase in the period 2011-2016.

Both foreign and joint ventures in Albania are mainly oriented towards the service sector. These enterprises employed 16% of the total number of employees in 2016, marking a decrease of 1.7%. The largest contribution to the employment of these enterprises is in the manufacturing and service sectors. Net sales realized by foreign and joint ventures have the highest value in the trade sector. While it is the mining sector that has the largest share in the total of investments realized by foreign and joint ventures.¹

As we can see from the data, foreign direct investments are mainly oriented towards the service sector and little to the industry. Service sector performance in Albania over the last 25 years has been positive. The contribution of this sector to GDP has been growing overall.

Graph 1 Services, value added (% of GDP)



Source: World

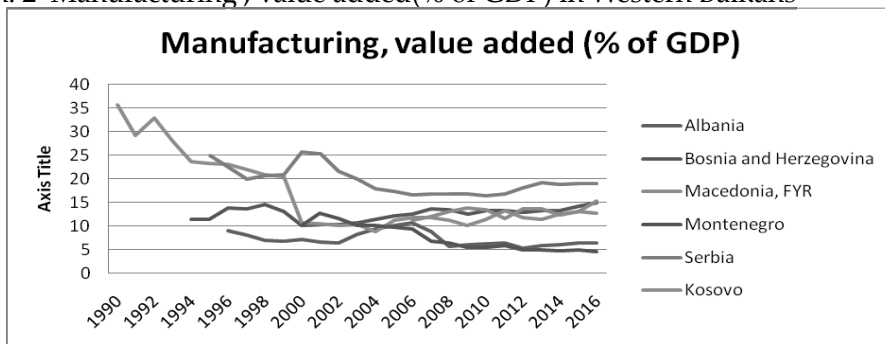
bank, <https://data.worldbank.org/indicator/NV.SRV.TETC.ZS?locations=AL>

¹ <http://www.instat.gov.al/media/3663/foreign-enterprises-in-albania.pdf>.

This distribution mainly in favor of the service sector was dictated also by the fact that after the 1990s the countries of the western Balkans, Albania too, experienced a deeper process of de-industrialization. This trend continues today, with the exception of Serbia, which has seen an increase in the industrial sector. Foreign direct investments have also contributed to the de-industrialization effect (Uvalic, 2016).

Thus, in the Western Balkans countries, value added from the manufacturing sector to total GDP has decreased.

Graph. 2 Manufacturing , value added(% of GDP) in Western Balkans



Source: World

Bank, <https://data.worldbank.org/indicator/NV.IND.MANF.ZS?locations=AL>

What we can conclude is that Albania needs to increase foreign investment in the manufacturing sector. In this way, foreign direct investment flows can affect the industrialization of the country. For this, the policy of absorbing foreign investment must have a more and more sectorial character

Priority Sectors of Albanian Government

The Albanian government has defined the development priorities of the long-term development strategy. These sectors are thought to be the focus of FDI. Priority sectors have been defined taking into account the competitive advantages that Albania presents.

Energy: It is one of the most important sectors for the long-term development of Albania. Albania has in its focus the creation of an operational power system that can produce in order to meet domestic demand and even realize the prospect of exports to the region and beyond. An orientation that goes with the global developments is the empowerment of the renewable energy sector. Albania has rich water resources, which is a good premise for the development of this sector.

Mining Industry: This industry before the 90s listed Albania in the world's top 3 countries for extracting minerals such as chromium, coal, nickel, copper, oil and natural gas. Albania has considerable chromium reserves. This sector represents important potential to help Albania's economic growth. In this sector, over the years, the government has promoted privatization, which has proved successful, as most of this industry has already been privatized. There are several foreign companies

operating in the extraction of its chrome ore and its industrial processing. Kurum Holding operates in copper extraction and processing. Bankers petroleum is the leading company in the oil industry.

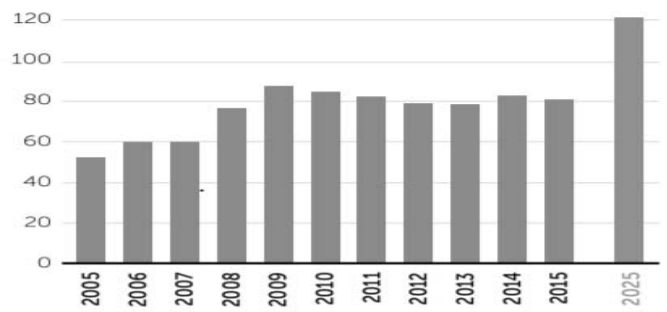
Processing industry: There are many entrepreneurs in this sector which provides good opportunities for foreign investors . Mostly foreign investors from Italy have occupied the main part of this sector. This is also achieved by the increased attention of the Albanian state towards the liberalization of trade through the trade aggrements , mainly with the neighboring countries. This sector contributes to the total gross domestic product at roughly 15%. Foreign direct investments in this sector are mainly in the form of vertical investments to exploit the free labor factor. This has also helped to increase exports from this sector. This sector also has a significant contribution to employment.

The attraction of foreign direct investment in this sector is dictated by several elements such as:

- a relatively young workforce (57% of the Albanian population is under the age of 35);
- Geographic proximity;
- Low wage level compared to the region, the minimum wage in Albania is 24,000 ALL;
- Knowledge of the Italian language by the majority of the population;
- Favorable climate for sustainable investment;
- A consolidated legal framework in line with international standards.

Tourism: The tourism sector is seen as one of the priority sectors for the Albanian economy as this sector presents competitive advantages for the development of this sector. This sector has important effects on economic growth and employment. This sector contributed around 21% to GDP in 2014. This direct contribution of this sector to GDP is expected to grow by 4.1% to ALL 120.4 billion (6.2% of GDP) by 2025.*

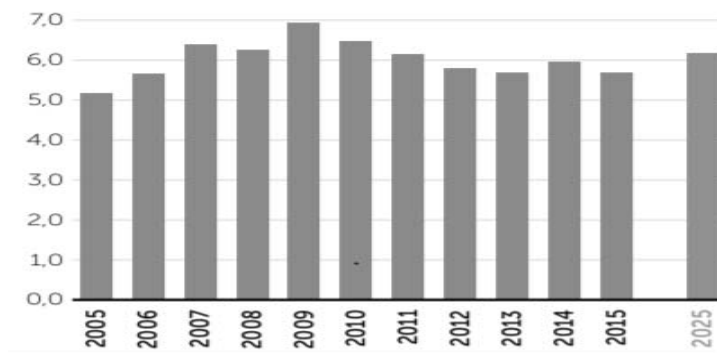
Graph 3. Contribution of the "Travel and Tourism" sector to GDP (Billion ALL).



Source: Aida, Albania calls a country of opportunity 2.

This sector also makes an important contribution to employment.

Graph 4. Contribution of the "Travel and Tourism" sector to GDP (in percentage)



Source: Aida, *Albania calls a country of opportunity 2*

Agriculture and Food Processing: This sector has been the most important sector in the Albanian economy over the years. Also, this sector has the largest share of the employers; where in 2016 about 40.2% of the employees belonged to the agriculture sector. However, this sector has lagged far behind the technology used and displayed many other problems, such as this sector has difficulty in financing, as banks are reluctant to credit (Luzo, Llukani, 2016). There are few foreign investments in this sector due to the factors mentioned above.

ICT: A relatively new sector that is experiencing a rapid growth in the Albanian economy is the information technology. This is due to the fact that the Albanian government has defined it as one of the priority sectors. Numerous improvements have been made to the legislation in this industry in order to address as far as possible the legislation that regulates this industry in European Union countries.

Telecommunications was initially dominated by foreign investment, largely driven by the privatization initiatives undertaken by the Albanian government. The entry of some operators into the market made it possible to increase competition within the sector, thus lowering the service delivery price by reaching levels similar to the countries in the region. This is in fact one of the expected positive effects of foreign investment in the host country.

The infrastructure sector has shown an interest for foreign investors. These foreign investments are realized in various forms, where one form is that of concessions. Infrastructure improvements are a vital element in improving the investment climate in Albania.* Albania still needs significant infrastructure improvements. Thus, the government has identified several potential investments such as:

- Adriatic-Ionian Corridor ";
- Arbr Street ";
- Kukes Airport;
- Vlora Airport;
- The new port of Shengjin;
- Railways.

All these infrastructure projects are thought to have a major impact on the country's economic development, helping to develop all sectors, tourism, transport, trade etc.

The financial services industry is in fact the industry that has attracted the major

part of foreign direct investment. This industry is mainly composed by the banking sector. Successful privatizations have been successfully implemented in this sector over the years, such as the privatization of the Savings Bank, the national commercial bank, and so on. In Albania, 14 banks out of 16 banks are banks with foreign capital.

Conclusions

Foreign direct investment in Albania has followed the same trend as in the world and in the Western Balkans with regard to the distribution by economic activities in the host countries. The service sector has occupied the main share of foreign direct investment over the years. This sector has become important for the Albanian economy. The added value of this sector has been growing, contributing more and more to the total of gross domestic product. Particular importance within this sector for foreign investors has been the financial and telecommunications sector. The number of employees in this sector has also increased. Unfortunately, foreign direct investments in Albania in the manufacturing sector are still at very low levels. This sector has been characterized by decreasing added value over the last 20 years. This has come as a result of the process of de-industrialization that has occurred in Albania. Although Albania has been successful in attracting foreign investors, this growth should have been reflected mainly in this sector, as the production sector is the sector that assists in a long-term and sustainable growth.

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