

Transformative Dynamics of the Economy of Kosovo: A Perspective on History and Development of Foreign Direct Investment

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Abstract

This paper presents an in-depth overview of foreign direct investments (FDI) in Kosovo's economy over more than twenty years. FDI has played a central role, proving indispensable to the development of Kosovo's economy. Thus, FDI is primarily directed towards economic activities like real estate, finance, manufacturing, construction, etc. In terms of the legal framework, Kosovo has approved a range of regulations and laws with the primary goal of protecting, attracting and encouraging foreign investors to invest. However, obstacles such as political instability, energy insecurity, delayed EU integration, and regional political tensions are recognized as the main barriers affecting FDI in Kosovo. Finally, Kosovo should develop suitable policies to boost its investment competitiveness, attract multinational enterprises for investment opportunities, and prioritize less attractive economic sectors for investment of FDI.

Introduction

Over the past few decades, numerous studies have highlighted the key challenges and opportunities that different countries face in attracting Foreign Direct Investment (FDI). In this context, Kosovo has faced a challenging transition and a serious effort to develop and restore its investment environment, largely as a result of the recent war. Thus, this paper provides an overview of FDI in Kosovo's economy over the past few decades. Several key topics related to FDI in Kosovo are explored, with in-depth discussions and comparisons from various perspectives on FDI in Kosovo. The paper is organized as follows: the first section presents the evolution of FDI from the era of the former Yugoslav Federation to the market liberalization in Kosovo and beyond. The second section provides an overview of FDI development in Kosovo, including the investment trends in Kosovo's economy, the role of FDI in key economic sectors, FDI inflows from foreign investors, the impact and benefits of FDI, and the efforts of Kosovo's institutions to enhance

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the business climate and investment environment. The next section highlights the efforts of international and Kosovo institutions to establish and strengthen the legal framework for foreign investments over the past two decades. The final section addresses the main obstacles, barriers, investment risks, and overall business climate affecting FDI in Kosovo.

In terms of methodological approach, a wide range of research papers, documents, and official reports from local and international institutions are used to analyse and evaluate the multidimensional aspects of FDI in Kosovo, including the historical aspects, key challenges of FDI in Kosovo since 1999, major barriers and obstacles, improvements in legal infrastructure and investment environment, dynamics of FDI flows and many other important aspects. Then, the primary research questions to be addressed are as follows: Which are the key sectors that have developed as a result of these investments? How much does the FDI impact well-being, education, the labour force, economic development and growth? What are the main barriers and obstacles to the investment environment in Kosovo? How competitive is Kosovo in attracting FDI compared to other regional countries? Also, the key hypotheses of this paper are as follows: a) Increased FDI in Kosovo leads to economic growth; b) FDI inflows into Kosovo's economy are positively associated with the development of entrepreneurship, business climate and market competition, GDP per capita, etc. Despite various circumstances, difficulties, and challenges, FDI in Kosovo has demonstrated dynamic and relatively consistent growth, with the investment environment evolving from scratch to over 840 million euros in 2023. Also, these investments have facilitated the advancement, modernization, and development of various sectors, including technology, innovation, entrepreneurship, human capital, business climate, market competitiveness, and many others.

The Period From the Former Yugoslav State to the Liberalization of Markets

At the end of the 1960s, the Yugoslav state (including Kosovo) had established key conditions for foreign investors by offering joint venture programs for investments. For many years, it was the only socialist state to permit foreign investments in its economy (Radenkovic-Jocic, 2004). A study by Deichmann *et al.* (2022) argued that the former Yugoslavia's economy was more open to global markets than other countries in the former Soviet bloc. Even though FDI was under strict control by the Yugoslav state, these investments began

to rise gradually, contributing to an average annual GDP growth rate of 6.2% from 1948 to 1979 (Radenković, 2016). During the 1980s, the political situation in Yugoslavia began to deteriorate, and FDI inflows remained low but stable in terms of annual rates (Perez, 2003). However, the Yugoslav state implemented significant changes and economic reforms that increased the role of private property and encouraged FDI inflows, but the breakup of Yugoslavia (1990) led to a significant decline in foreign investments, particularly affecting the service sector (Uvalic & Cvijanović, 2018). Despite progress in economic reforms and efforts to attract foreign investments, FDI was largely neglected in the former Yugoslavia and other post-communist countries until market liberalization in the early 1990s (Deichmann, 2021).

Since the 1990s, FDI has been crucial for the countries that emerged from the breakup of the Yugoslav Federation, which has continuously sought to attract and support these investments, but the potential for FDI varies among these countries due to political tensions, the slow EU membership process, different geopolitical and economic goals, ethnic, cultural and economic circumstances between these countries, etc. (Deichmann *et al.*, 2022; Topalli *et al.*, 2021). In the second half of the 1990s, FDI inflows as a percentage of GDP were relatively low in these countries, although foreign investments exhibited stable average growth between 2001 and 2008 (Kovachev *et al.*, 2020). Consequently, these countries enhanced their macroeconomic performance by attracting significant FDI inflows and implementing new economic reforms between 2001 and 2008 (Uvalic & Cvijanović, 2018). During this period, FDI primarily targeted the privatization of socially-owned enterprises and banks, which have provided the economic perspective of these countries (Estrin & Uvalic, 2016). The process of market liberalization has greatly advanced economic reforms and improved the business environment, leading to a consistent increase in foreign investment, but the global financial crisis (2008) reduced FDI inflows into these countries (Topalli *et al.*, 2021; UNCTAD Report, 2013).

Development of Fdi in Kosovo in the Post-war Period

After the end of the war (1999), foreign investors showed significant interest in Kosovo, but the aftermath of the war created numerous challenges (such as inadequate governmental and local institutions, poor public services, a lack of legal and financial infrastructure, etc.) that made it impossible to establish a stable investment

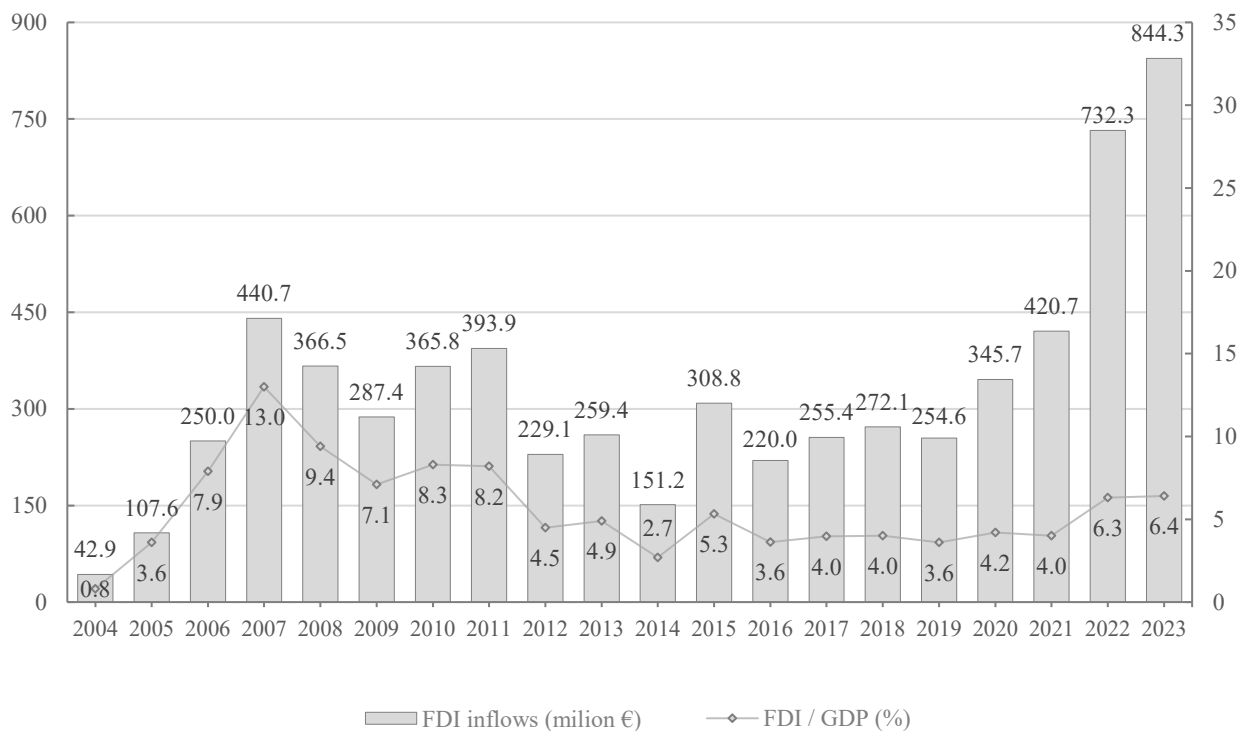
environment and attract foreign investments (Riinvest, 2002). According to IMF Report (2001) the uncertainty surrounding Kosovo's final status has deterred foreign investors from committing to investments in the post-war period. Also, the business environment in Kosovo was not conducive to entrepreneurial growth, resulting in minimal foreign direct investment inflows into the economy between 2000 and 2002 (EU Report, 2004). In 2003, the Ministry of Trade and Industry (MTI) prioritized boosting both foreign and domestic investments in Kosovo, leading to the establishment of the Investment Promotion Agency and the Export and Domestic Production Promotion Agency (ESI Report, 2003). Then, FDI inflows into Kosovo began to improve gradually, but political risks and a shortage of skilled and educated labour force have limited the full impact and benefits of these investments on the economy of Kosovo (Gashi, 2017).

Despite these circumstances, FDI in Kosovo experienced steady growth, with the annual value reaching nearly 43

million euros in 2004 and surpassing 107 million euros in 2005 (CBK Report, 2011). Also, the annual average of FDI inflows as a percentage of GDP increased from 0.8% in 2004 to 3.6% in 2005 (Topalli *et al.*, 2021; CBAK Report, 2008). Furthermore, FDI in Kosovo was estimated at over 266 million euros in 2006. In 2007, FDI inflows experienced a substantial rise, exceeding 440 million euros, representing one of the highest annual rates during that period (CBAK Report, 2008; Riinvest, 2014). During the period 2004 - 2007, FDI inflows grew consistently, marking a brief but significant period of substantial investment increase in Kosovo (World Bank Report, 2021/a). The rise of FDI was closely linked to the privatization of former state- and socially-owned enterprises in Kosovo and this process successfully attracted a significant amount of foreign investment capital from EU countries and Turkey (Gashi, 2017). In addition to foreign investments from privatization, companies with foreign capital in Kosovo reinvested their profits, which amounted to 42.9 million euros only during 2007 (CBAK Report, 2008).

Figure 1

Dynamics of FDI inflows and FDI / GDP in Kosovo (2004 - 2023)



Source: CBK Reports 2007, 2013, 2024 & World Bank (Online Data)

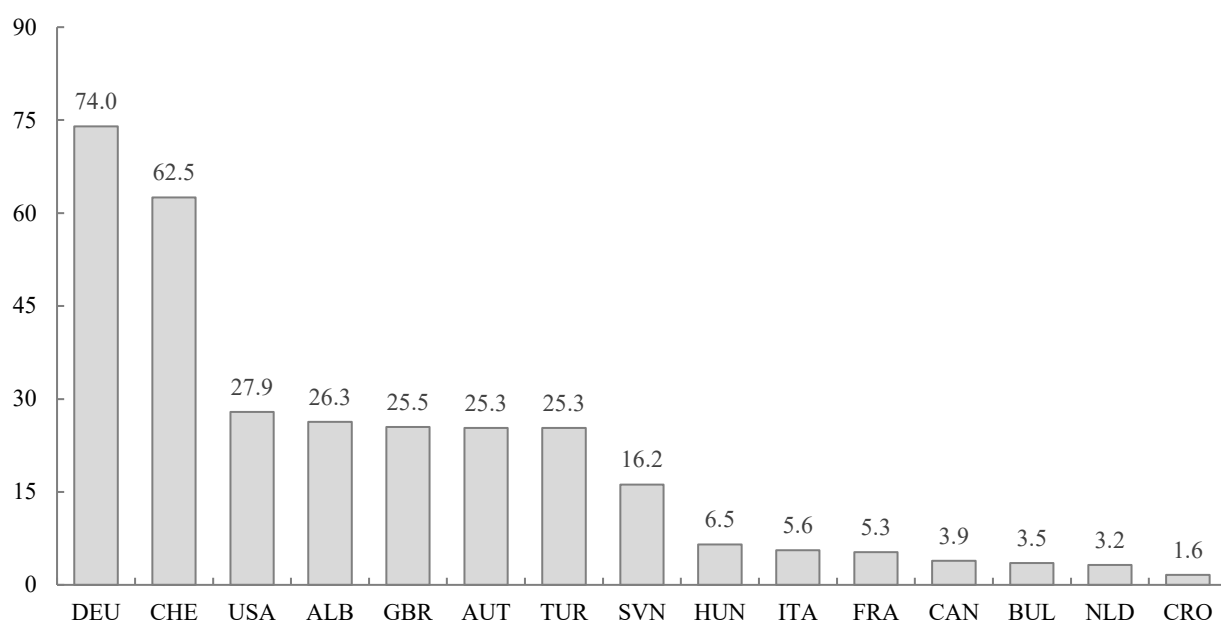
However, the global financial crisis (2008) led to decreased FDI in Kosovo, where these investments experienced annual fluctuations. However, a modest recovery in FDI started to take shape in 2010 and 2011 (OECD Report, 2013). A study by (Hajrizi & Hasani, 2013) has argued that Kosovo's privatization of public enterprises has drawn increased FDI during this recovery phase, though the scale of these investments remains smaller than in neighbouring countries. Despite these circumstances, FDI in financial services, information and communication, agriculture, wholesale and retail trade has notably decreased. However, these investments in the production sector have risen significantly from 6% in 2008 to 22.5% in 2010, primarily driven by new Greenfield projects in Kosovo (CBK Report, 2023/a; OECD Report, 2013).

Between 2012 and 2019, the level of FDI in Kosovo has remained low annually due to various factors, including economic fluctuations in Eurozone countries, political instability, super dividends (where the value of the dividends exceeds company profits), and the sale of securities by foreign firms to local companies (CBK Report, 2013; CBK Report, 2015; CBK Report, 2020; D4D Report, 2017).

During this same period, the ratio of FDI inflows to GDP and GDP per capita has significantly decreased, marking the lowest figures for Kosovo compared to other Western Balkan countries (D4D Report, 2017). Despite the reduction of FDI in Kosovo, most FDI has been directed towards financial services, real estate, retail trade, and construction sectors. However, these investments have primarily boosted domestic consumption rather than fostering growth in Kosovo's production sector between 2012 and 2019 (CBK Report, 2023/a; OECD Report, 2021). In 2020, FDI in Kosovo increased by over 34% from the previous year, with notable growth in economic activities such as financial services, energy, mining, and quarrying sectors (CBK Report, 2021). According to (EBRD Report, 2022) foreign investments in Kosovo showed improved annual growth in 2020, but their contribution remained limited and insufficient to significantly enhance the country's economic competitiveness. However, FDI continued to grow annually, reaching over 420 million euros in 2021 and the real estate, construction, and information and communication sectors saw improved economic activity, while the electricity and mining sectors experienced a notable decline (CBK Report, 2022).

Figure 2

Annual Average of FDI inflows by countries in Kosovo 2007 - 2023 (millions €)



In 2022, FDI experienced a substantial increase, rising by over 730 million euros, or 85% more than the previous year. This growth was largely driven by the Kosovo

diaspora's substantial investments in the real estate sector, which accounted for 67.3% of total FDI. Additionally, the financial, insurance, and construction

sectors also played a key role in this investment surge (CBK Report, 2023/b). Also, FDI in Kosovo advanced significantly in 2023 compared to the previous year, demonstrating that FDI inflows have remained strong and sustained throughout 2023 (see Figure 1) (CBK Report, 2023/c). Thus, Kosovo's institutions have recognized the vital role of FDI in the country's economy. Consequently, Kosovo has implemented a series of reforms to enhance the business climate and has consistently worked to improve its business environment and stimulate economic activity in recent years (Bajrami & Krasniqi, 2019; Knuth *et al.*, 2022; World Bank Report, 2020/a). In the medium term, Kosovo's economy could attract more FDI by establishing closer "*near-shoring*" partnerships with European and global multinational enterprises (IMF Report, 2023/b). In terms of FDI inflows by non-resident countries, most FDI in Kosovo come from Western European countries, followed by investments from Albania, the USA, the UK, Turkey and other countries (see Figure 2).

Undoubtedly, FDI in Kosovo has made a remarkable contribution to economic growth, bringing significant benefits across various areas crucial for the country's development. These investments have enhanced technology and innovation, developed human capital, facilitated knowledge transfer, increased market competition, advanced management practices and other positive contributions (Ziberi & Gashi, 2021). Also, Kosovo has made significant progress in enhancing quality infrastructure and protecting intellectual and industrial property, and recent years have seen increased investments in improving and developing economic zones, business parks, and business incubators (Bajrami & Krasniqi, 2019). As a result of these circumstances, Kosovo has demonstrated potential for FDI outflows, with a total value of 175.5 million euros in 2022, while FDI outflows reached 145.2 million euros between January and September 2023, up from 121.2 million euros in the same period of the previous year (CBK Report, 2023/c). Besides the increase in FDI inflows, Kosovo has also enhanced net FDI inflows as a percentage of GDP in recent years (World Bank, 2020/b). According to the EBRD Report (2022/b) and GAP Institute (2023) the energy sector will be a key investment priority in Kosovo, with the goal of improving the current energy situation and accelerating the transition to green energy.

According to (World Bank Report, 2017/a), Kosovo should focus on policies that attract more FDI flows, boost export promotion, and enhance areas such as property rights, licensing and inspections, trade regulations, etc.

FDI and export promotion are crucial for Kosovo's economic growth and labour market, they enhance employment rates, improve productivity and offer higher wages for employees compared to local companies and the domestic economy (World Bank Report, 2021/b). Then, Kosovo needs to adopt policies that enhance its competitiveness for FDI relative to other regional countries, including strengthening regulatory quality, reducing the infrastructure and human capital gap, improving access to international markets, and maintaining low tax rates and these factors are identified as key strengths for attracting and boosting FDI (World Bank Report, 2021/a). Consequently, developing and strengthening regional supply chains will help reduce economic disparities between Kosovo and Western Balkan countries. These supply chains will also generate useful and positive effects from the FDI of multinational enterprises/companies (Krasniqi *et al.*, 2022). However, Kosovo can enhance FDI by utilizing its natural resources, skilled labour and access to major markets, but it must overcome substantial challenges to become more appealing for higher FDI inflows (Bajrami & Krasniqi, 2019).

The Establishment and Strengthening of the Legal Infrastructure for Foreign Investments

To ensure economic development in the post-war period in Kosovo, international institutions have offered substantial support in crafting development strategies, policies, and reforms as well as strengthening the legal framework to establish a well-functioning market economy and create a favourable environment for investment activities (EU Report, 2009). Thus, the United Nations Mission in Kosovo (UNMIK) approved the regulation (Regulation No. 2001/3), which established legal guarantees to ensure a secure environment for attracting foreign investments to Kosovo (UNMIK Regulation, 2001). In 2005, Kosovo's provisional self-government institutions enacted the Law on Foreign Investments (Law No. 02/L-33), which aims to attract and encourage foreign investors by providing essential legal rights and guarantees that align with both Kosovo's laws and international standards (Assembly of Kosovo, 2005). Then, the Assembly of the Republic of Kosovo approved the Law on Foreign Investments (Law No. 04/L-220), where the primary goal was to enhance the regulation, protection, and promotion of foreign investment in Kosovo, ensuring that such investments receive fair and equitable treatment consistent with contemporary international practices and standards (Assembly of Kosovo, 2013).

In 2017, the Assembly of Kosovo enacted the Law on Strategic Investments (Law No. 05/L-079), which enables foreign investors to utilize the property of Kosovo for their strategic investment activities and grants them strategic investor status and other considerable facilities to attract and encourage international companies and businesses to invest in Kosovo (Assembly of Kosovo, 2017). Subsequently, the Assembly of Kosovo approved the Law on Business Organizations (Law No. 06/L-016), which governs the rights and obligations of shareholders, owners, directors, and other key stakeholders within the management structure of foreign business organizations. This law also addresses the initial registration, requirements, conditions, procedures, and deregistration of foreign business representative offices and branches in Kosovo, where the articles and amendments of this law are in full accordance with the directives of the European Parliament and Council (Assembly of Kosovo, 2018; OECD Report, 2021). Recently, the Government of Kosovo approved the draft Law on Sustainable Investments (Decision No. 02/118), which aims to enhance and strengthen the promotion, support, and protection of investment activities and exports in the Republic of Kosovo (Assembly of Kosovo, 2023).

The Main Obstacles, Barriers, Investment Risk and Business Climate of FDI in Kosovo

Despite efforts by Kosovo's institutions to advance the legal framework and reforms for attracting FDIs, and improve the doing business and its environment, Kosovo has not managed to attract more FDI than other countries (Sahiti *et al.*, 2020). A study by Mehmeti (2011) has argued that export activities and FDI inflow in Kosovo have not improved enough. Kosovo continues to experience energy insecurity, including an unreliable energy supply, an overloaded system, and inefficient distribution, which have imposed substantial costs on households and businesses. This energy issue is also recognized as one of the biggest obstacles to attracting high-quality FDI in Kosovo (World Bank Report, 2017/a). Additionally, insufficient law enforcement, inadequate public infrastructure, Kosovo's lack of EU integration, an unstable business climate, and limited access to financial incentives are identified as other obstacles to attracting more foreign investments in Kosovo (EBRD Report, 2022/a; Kida, 2015). A study by (Conahan *et al.*, 2021) has also identified political instability, corruption and geographical distance as the main challenges for many foreign multinational enterprises to invest in Kosovo. In recent years, the political tensions among Balkan countries have posed another obstacle to increasing the

FDI in these countries (D4D Report, 2017; World Bank Report, 2017/b).

In 2002, the Riinvest Institute conducted a survey of various companies/businesses, including those with foreign investment in their capital structure. The findings indicated that corruption, high tax rates and inadequate investment guarantees were some of the highest barriers to FDI in Kosovo, while high customs duties, limited experience in attracting FDI, and insufficient promotional support were identified as minor barriers. (Riinvest, 2002). Over the past decade, Kosovo has offered economic zones, industrial parks, business parks, and low labour costs. Despite these incentives, FDI inflows into Kosovo's manufacturing sector have remained below 2%, whereas neighbouring countries have managed to increase FDI, resulting in growth in their manufacturing sectors (EBRD Report, 2022/a; Kida, 2015). Then, Kosovo provides a limited market size (approximately 1.8 million inhabitants), which makes it less appealing to foreign investors (Sklias & Roukanas, 2007). According to (IMF Report, 2023/a), the prolonged dialogue process with Serbia for a final agreement may negatively impact foreign investors' perception of investing in Kosovo. Consequently, Kosovo is substantially behind other former Yugoslav countries in attracting FDI, with less than 10% of the total cumulative FDI by 2016 (Deichmann *et al.*, 2022). Also, Kosovo's average annual FDI net inflows (as a percentage of GDP) were lower than those of most Western Balkans countries between 2011 and 2022 (see Figure 3).

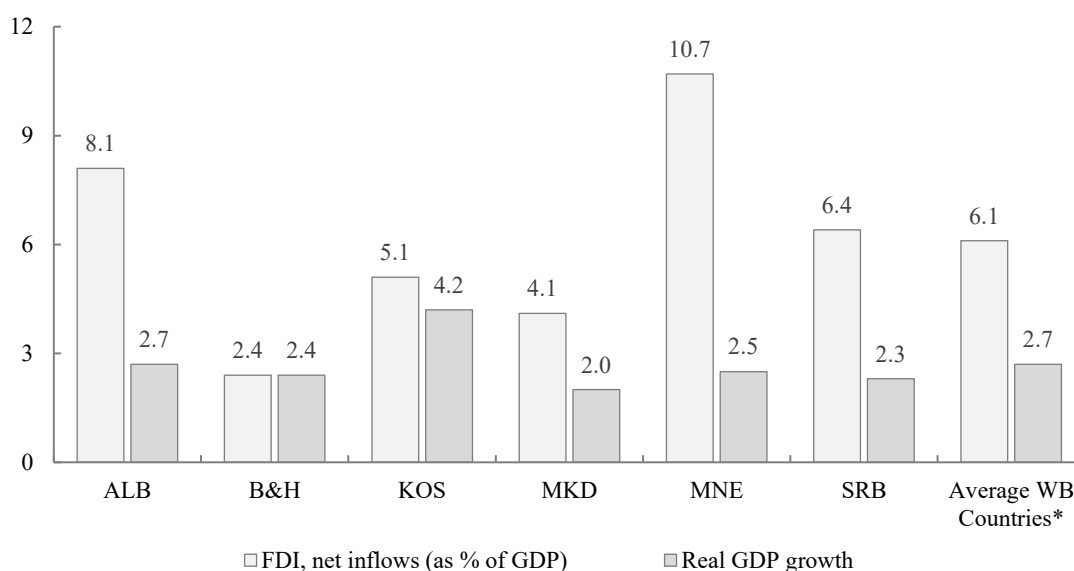
During the last decade, Kosovo's average annual real GDP growth has been strong, but its FDI stock per capita was 50% below the Western Balkan average in 2020 (EBRD Report, 2022/a). Despite having the youngest population in Europe and a population three times larger than Montenegro's, Kosovo has not managed to attract as much FDI as other Balkan countries (Conahan *et al.*, 2021). Despite its low labour costs, Kosovo's status as one of Europe's poorest economies may restrict purchasing power for foreign entrepreneurs and businesses, which could be a risk to their investments (Jensen, 2018). Moreover, FDI in Kosovo has had limited connections with efficiency-seeking sectors, such as foreign investments and export promotion. Investments in these areas could enhance access to export markets, boost labour productivity, increase business competitiveness, and improve integration into regional and global value chains (World Bank Report, 2021/a). A study from (Bajrami & Krasniqi, 2019) has argued that Kosovo faces a "*psychological distance*" due to its history of war and political instability, which has diminished its

attractiveness for FDI. According to (World Bank Report, 2021/b), Kosovo's economy is insufficiently integrated into international markets, and the number of businesses

with foreign capital is notably lower compared to the EU and Balkan countries.

Figure 3

Average annual of FDI inflows and GDP in the Western Balkan countries 2011 – 2022



Source: Eurostat (Online Data), EU Report 2023, World Bank (Online Data) & (*) author calculations

In addition to these circumstances, foreign investors in Kosovo encounter several challenges that significantly hinder their investment activities, including unfair market competition, unreliable energy supply, high-interest loans, inadequate business infrastructure, and imbalanced competition between foreign investments and the informal economy (Hajrizi & Hasani, 2013). Despite the improvement of foreign investments in Kosovo in recent years, these foreign investments experienced instability, primarily due to fluctuations in the mining, transport, and communication sectors, leading to a decline in their quality in Kosovo from 2009 to 2014 (Sahiti *et al.*, 2020). To analyse the impact of the business environment on foreign investment in Kosovo, the Riinvest Institute conducted another survey of various companies and businesses in Kosovo and their results highlighted an unfavourable business environment. Their results also showed that 54% of these businesses experienced declining sales and only 11% of them were engaged in export markets, thus, these issues contribute to a discouraging climate for potential foreign investors, ultimately reducing FDI flows (Riinvest, 2014; Riinvest, 2013).

Conclusions

After a prolonged and difficult transition path in the former Yugoslav Federation and then, under the Serbian state, Kosovo began from scratch to establish its institutions and political and economic systems, but it faced various challenges during the post-war period. Given these circumstances, FDI has been crucial, making a significant contribution to many sectors of Kosovo's economy over the past two decades.

Thus, FDI in Kosovo has enhanced the business environment, market competition, service quality, knowledge, technology, welfare, and employment, and they also reduced the economic disparities between Kosovo and the countries of the region. Between 2007 and 2022, foreign investors primarily concentrated their investments in real estate (49.6%), finance and insurance (14.8%), manufacturing, wholesale, and retail trade (9.2%), construction (7.1%), etc. Then, FDI inflows in Kosovo are primarily led by investors from Germany, Switzerland, the USA, Albania, Austria, Great Britain, and other countries. In terms of the legal framework,

international institutions and then, the institutions of Kosovo have approved a series of regulations and laws that meet international standards, creating favourable conditions for foreign investors to carry out their investment projects. However, energy insecurity, geographical distance, a limited market size (purchasing power), political instability, regional tensions, and the lack of integration into international markets and the EU

are identified as some of the main obstacles and barriers for foreign investors. Finally, Kosovo's institutions should implement proactive policies to boost FDI flows, enhance the investment environment and business climate, promote their opportunities to international companies, attract prominent investors, develop investment opportunities in less appealing sectors, strengthen regional economic stability, etc.

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Transformacijska dinamika kosovskega gospodarstva: Pregled zgodovine in razvoja neposrednih tujih naložb

Izvleček

Ta članek prikazuje poglobljen pregled neposrednih tujih naložb (NTI) kosovskega gospodarstva za obdobje več kot dvajsetih let. NTI so imele ključno vlogo in so se izkazale za nepogrešljive pri razvoju kosovskega gospodarstva. NTI so v glavnem usmerjene h gospodarskim dejavnostim, kot so nepremičnine, finance, proizvodnja, gradbeništvo itd. Kar zadeva pravni okvir, je Kosovo sprejelo vrsto predpisov in zakonov s primarnim ciljem zaščititi, privabiti in spodbujati tuje vlagatelje k naložbam. Vendar pa so ovire, kot so politična nestabilnost, energetska negotovost, zamude pri integraciji v EU in politične napetosti v regiji, prepoznane kot glavne ovire, ki vplivajo na NTI v Kosovu. Kosovo bi moralo razviti ustrezne politike za izboljšanje svoje konkurenčnosti na področju naložb, privabiti multinacionalna podjetja k naložbenim priložnostim in dati prednost manj privlačnim gospodarskim sektorjem za naložbe NTI..

Ključne besede: poslovno okolje, prilivi NTI, tuji vlagatelji, gospodarska rast, Kosovo