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Impact of Public Debt on Foreign Direct Investment: The Case of Albania

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Abstract

Public debt is a key macroeconomic indicator that shapes a country's reputation. It remains a significant economic policy challenge for governments in less developed countries due to high debt levels. The aim of this paper is to investigate the relationship between Albania's public debt and foreign direct investments (FDI). For that purpose, first a descriptive research design is employed and second the data are examined through VAR (Vector Autoregression) and Granger causality tests. The VAR autoregression results indicate that in the short term, public debt and FDI are not significantly correlated. In addition, the Granger causality tests reveal no significant causality between FDI and public debt or between exchange rates and public debt. However, there is a bi-directional causality between FDI and exchange rates. Policymakers should focus on debt management, economic openness, and infrastructure development to create a favorable environment for attracting foreign investment. The findings underscore the need for balanced fiscal policies to support long-term economic growth and investment stability.

Keywords: Public debt, Foreign Direct Investment (FDI), VAR (Vector Autoregression), Granger Causality Tests.

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Introduction

According to Abbas and Christensen (2007), public debt shapes a country's image in international markets and is a key determinant of inward foreign direct investment (FDI) flows. The global flow of transnational investments has surged significantly due to increased internationalization and the globalization of firms. Companies are relocating their capital to countries where they see opportunities to maximize their returns (Sharifi-Renania & Mirfatah, 2012). Foreign direct investment (FDI) refers to investments made by one country directly into the assets and resources of another country. FDI is crucial for the future development of all nations, particularly Albania. It generates numerous benefits for the entire economy, which cannot be fully captured as part of the host country's income (Ribeiro, Vaicekauskas, & Lakstutiene, 2012). For developing countries, FDI is essential as it provides resources that can lead to optimal economic development (Imimole & Imoughele, 2010), particularly given their issues with low domestic savings, low tax revenue, low productivity, and limited foreign exchange earnings. Ostadi and Ashja (2014) found that external debt significantly negatively impacts FDI. Rising foreign debt undermines investor confidence and creates negative economic expectations, thereby reducing investment. Their findings also suggest that a larger government size negatively affects the attraction of foreign investment, consistent with the crowding-out effect, where government presence reduces private sector involvement. This paper is organized as follows: The initial section presents the topic; the second section examines relevant existing research; the third section gives an overview of public debt and foreign direct investment (FDI), providing a descriptive analysis; the fourth section outlines the data collection process and methodology; the fifth section explores the empirical results; and the concluding section provides conclusions and recommendations.

Literature Review

The empirical literature on the relationship between public debt and FDI reveals conflicting results. For instance, Ostadi and Ashja (2014) investigated the link between external debt and foreign direct investment (FDI) in D-8 member nations from 1995 to 2011. They used panel data analysis to investigate the effects. The data showed that external debt has a strong negative impact on FDI. Rising levels of foreign debt were found to reduce investor confidence and promote pessimistic expectations about future economic prospects, resulting in a drop in investment

inflows. Furthermore, the study found that government size had a detrimental influence on foreign investment. In contrast, when GDP and population size were utilized as controlled variables, they were found to have a positive influence on FDI attraction.

Ogunjimi (2019) conducted a study to examine the impact of different components of state government debt—namely domestic and external debts—on various types of investment, including domestic investment and foreign direct investment (FDI) in Sri Lanka, both in the short and long terms. The research utilized the ARDL bounds testing approach, covering the period from 1980 to 2020. The study found that, in the short term, domestic debt enhances FDI inflows. However, over the long term, it tends to crowd out FDI. On the other hand, external debt was found to have a significant negative relationship with FDI inflows in the short term, as anticipated. Yet, in the long run, external debt does not appear to have a significant effect on FDI. Oche, Mah, and Mongale (2016) conducted an empirical study of the impact of state debt on foreign direct investment (FDI) in South Africa from 1983 to 2013. They conducted their investigation using the Vector Error Correction Model (VECM). The author's long-run findings demonstrated a positive and statistically significant link between public debt and FDI, implying that higher levels of public debt are associated with greater FDI inflows. Additionally, a positive and significant relationship between interest rates and FDI in South Africa was discovered. However, their study found an insignificant negative link between the exchange rate and FDI, implying that exchange rate swings had little impact on foreign investment. In their study, Jilenga, Xu, and Gondje-Dacka (2016) investigated the impact of external debt and foreign direct investment on Tanzanian economic growth. They analyzed co-integration using time-series data and the ARDL (Autoregressive Distributed Lag) model, as well as the limits test approach. Their findings revealed that, in the long run, external debt boosts economic growth while FDI has a detrimental influence on growth. These findings are consistent with the conclusions reached by Wamboye (2012), who also supported the idea that external debt contributes positively to economic growth despite FDI's negative influence on GDP.

Sánchez-Juárez and García-Almada (2016) investigated the relationship between public debt, public investment, and economic growth in Mexico. They used dynamic panel data models and the generalized method of moments (GMM) in their investigation. Their findings revealed that public debt is favorably connected with public investments, which in turn contribute to increased economic growth. Build-

ing on this, Agyapong and Bedjabeng (2019) conducted additional studies to investigate the effects of public debt and foreign direct investment (FDI) on financial development in African economies. Their research found a substantial positive relationship between external debt and FDI and financial development, implying that greater levels of external debt and FDI are linked to better financial sector development in these economies. Morrissey and Udomkerdmongkol (2012) investigated the impact of governance on foreign direct investment (FDI) in developing countries through a qualitative study. According to the author's findings, countries with great governance had higher total investment, including both private and foreign direct investment. However, they discovered that FDIs can drive out private investment. The evidence consistently suggests that public debt influences FDI levels, although the nature of this impact is complex and varies by circumstance. In light of the COVID-19 epidemic, several economies have increased their debt levels in an attempt to supplement revenue streams, sparking fresh interest in researching the relationship between public debt and FDI.

Overview of Public Debt and Foreign Direct Investments in Albania

Foreign Direct Investments

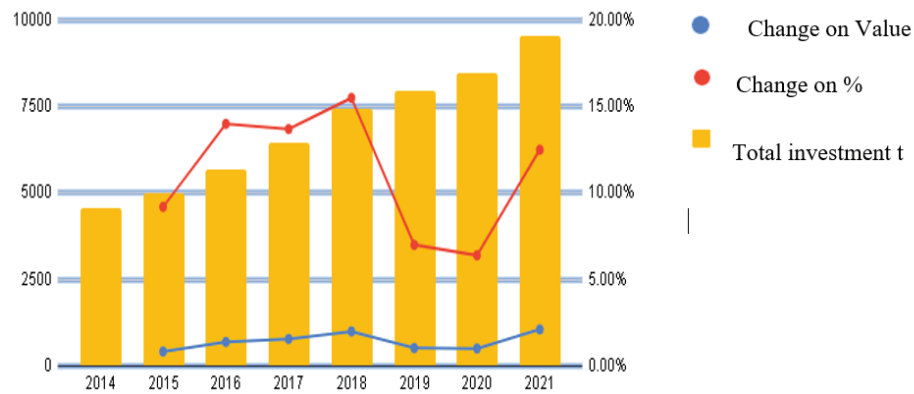
Foreign Direct Investment (FDI) in Albania has shown resilience and growth over recent years, driven by sectors such as energy, infrastructure, and manufacturing. The COVID-19 pandemic initially disrupted FDI flows, but recovery began in 2021 with notable contributions from countries like Switzerland and the Netherlands. Investments have been particularly focused on reconstruction efforts following the 2019 earthquake and pandemic-related economic support. Ongoing reforms and improved business conditions have further boosted investor confidence. Looking ahead, Albania is expected to continue attracting FDI in sectors such as tourism, real estate, and renewable energy. In 2023, FDI continued to grow, driven by ongoing government initiatives to attract foreign capital and improvements in the investment climate. Sectors like renewable energy and real estate particularly benefited from foreign investments. During 2024, expectations are for further growth in FDI, as Albania is working ahead on its regulatory framework, diversifying its economy, and improving infrastructure. Despite the positive trends, challenges persist, such as bureaucratic inefficiencies, corruption, and infrastructural deficits that can inhibit FDI growth. The government has recognized these issues and is working on reforms to address them. Albania has undertaken measures such as tax incentives, easier ac-

cess to permits, and improved transparency in regulatory processes to attract foreign investments and create a more welcoming business environment.

FDI stock in Albania represents the total value of foreign-owned assets in the country, including capital and net loans extended to resident companies. Over recent years, Albania has experienced growth in FDI stock (Chart 1), reflecting increasing interest from international investors.

Chart 1.

Foreign Direct Investment Stock in Albania, change in value and %



Source: National Bank of Albania

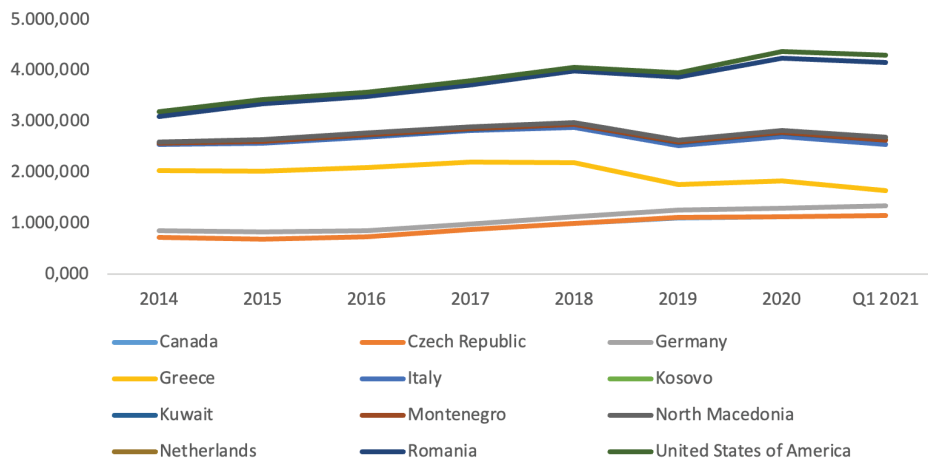
In 2020, foreign business investments in Albania reached 9.5 billion euros, marking a 12% increase. Switzerland and the Netherlands were the leading investors, while Greece reduced its investments by withdrawing some of its companies. In 2021, FDI grew to 9.53 billion euros, a 12.5% rise from the previous year's 8.5 billion euros. Major investors included Switzerland, the Netherlands, Canada, Italy, and Turkey, with Swiss investments totaling 1.76 billion euros (18% of the total) and Dutch investments at 16%. Swiss foreign investment increases are tied to the TAP gas pipeline, while Dutch investments are linked to Statkraft's Devoll Hydropower. Greece, Bosnia, Panama, and Kuwait all cut their investments (Chart 2). Albania now requires enterprises to identify the origin and ultimate owner of foreign investments, which are critical for calculating economic growth and must be reflected in the balance of payments.

In 2021, Albania saw significant FDI activity, with the Netherlands, Canada, and Italy leading in investment, holding over 1 billion euros. Neighboring countries like Greece, Kosovo, North Macedonia, and Montenegro also contributed varying

amounts in investments, respectively, with 257,139, 62, and 2.7 million euros. Greece, Panama, and Kuwait saw notable increases in their investments, while Eastern European nations, including the USA, Hungary, and Germany, showed growing interest in investing in Albania. The rise in reported investment values partly reflects new Albanian legislation requiring clear disclosure of the final beneficial owner of investments. This legislation led to more accurate reporting and reclassification of previously ambiguous investments rather than a true increase in asset values.

Chart 2

The stock of inward FDI in Albania based on origin in million euro (2014-2021)



Source: Ministry of Finance, Institute of Statistics, edited by the author

Public Debt

The public debt comprises both domestic debt (government bonds and Treasury bills) and external debt (loans from international institutions and bilateral agreements). A significant portion of foreign debt has been from concessional sources, which helps reduce the burden on public finances. Throughout the years, the Albanian government implemented various reforms to improve fiscal management, enhance tax collection, and control budget deficits. This included reforms aimed at reducing public expenditures and increasing efficiency in public investments. In 2021, after the COVID-19 pandemic, Albania's public debt rose significantly, reaching approximately 78% of GDP. The increase was attributed to fiscal measures to mitigate the pandemic's economic impact. The debt level remained relatively high in 2022, around 74% of GDP, as the economy began to recover. The

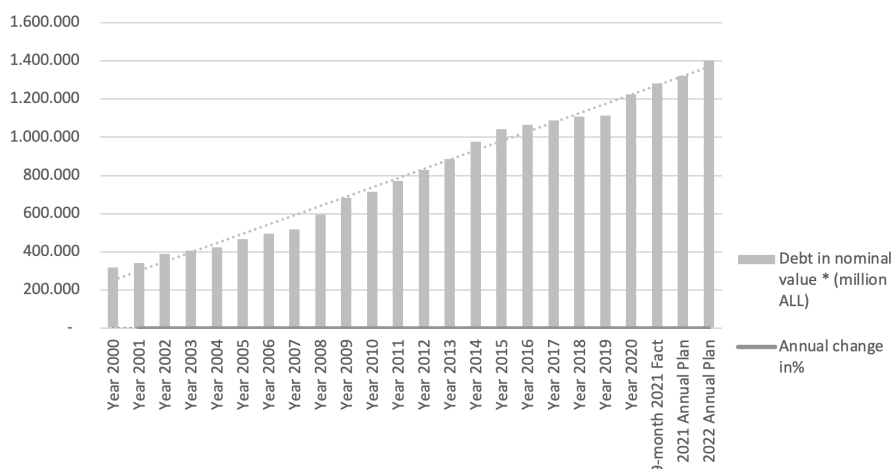
government continued to borrow to finance infrastructure projects and social welfare programs. Public debt was reported at about 70% of GDP in 2023, showing a slight improvement due to efforts aimed at fiscal consolidation and increased revenues from economic growth. Projections indicated that public debt might stabilize around 68%–70% of GDP during 2024, benefiting from improved revenue collection and economic performance.

For 2020, the public debt was estimated at 1.22 billion ALL, or 77.9% of GDP, reflecting an increase of 111.6 billion ALL, or 10%, from 2019.

Since 2019, Albania's public debt has increased primarily due to higher government borrowing. This borrowing was driven by a growing deficit resulting from reduced revenue and increased spending in 2020, influenced by the need for post-earthquake reconstruction and the economic fallout from the COVID-19 pandemic. In 2020, revenue dropped to 425.9 billion ALL, down by 34.4 billion ALL (7.5%) from 2019. Expenditures rose to 536.2 billion ALL, an increase of 44.3 billion ALL (9%) compared to the previous year. The reconstruction fund for 2020 was set at 32 billion ALL, with 29 billion ALL from the State Budget and 3 billion ALL from grants. The issuance of a 650 million euro Eurobond in June 2020, with a 7-year maturity and a 3.5% interest rate, also contributed to the rise in public debt.

Chart 3

Performance of Public Debt (in millions ALL) & annual change in % (2000-2022)

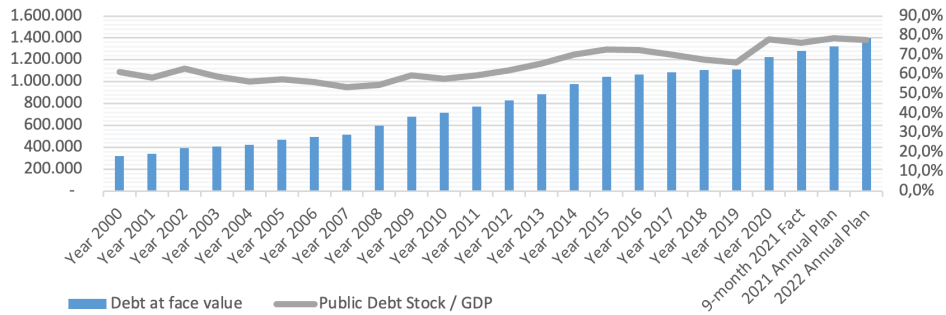


Source: Ministry of Finance, (2021), edited by the author

From 2000 to 2022, the public debt-to-GDP ratio experienced significant fluctuations due to varying economic and fiscal conditions.

Chart 4

Public Debt Stock and as Percentage of GDP (2000-2020)

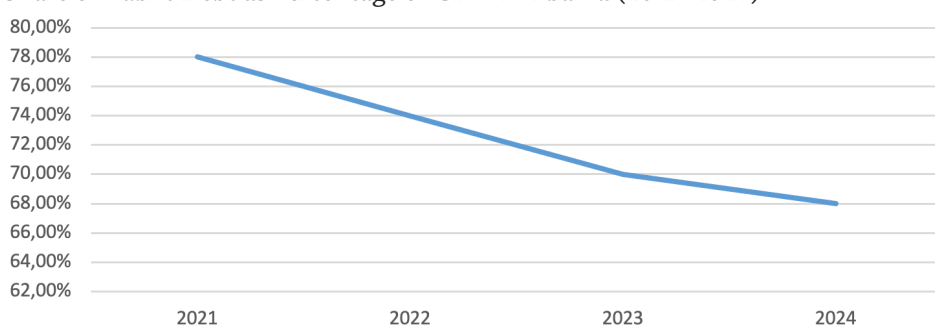


Source: Ministry of Finance (2021), edited by the author,

In 2000, the ratio was low, reflecting economic stability and limited government borrowing. Over the years, it gradually increased as public debt rose with growing expenditures and borrowing needs. The ratio saw substantial spikes during the 2008 global financial crisis and the COVID-19 pandemic, driven by expansive fiscal measures and increased borrowing for economic support. The trend of rising debt continued through the 2010s, peaking in 2020 due to pandemic-related spending. The ratio remained high in 2022 as governments addressed ongoing recovery and reconstruction needs. Projections for 2024 suggest that the ratio will stay elevated due to continued borrowing for recovery and infrastructure investments.

Chart 5

Share of Public Debt as Percentage of GDP in Albania (2021-2024)



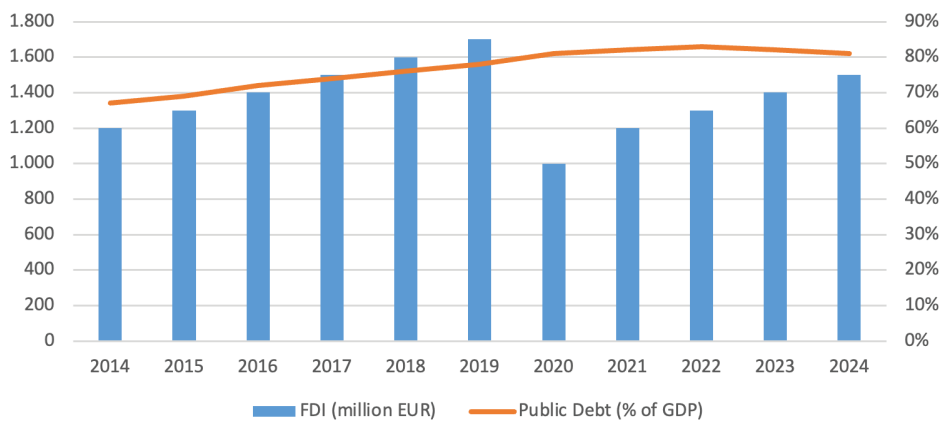
Source: Ministry of Finance, edited by author

From 2021 to 2024, Albania experienced both challenges and opportunities regarding public debt management and foreign direct investment. While public debt has shown signs of stabilization due to fiscal reforms and economic recovery, FDI inflows have spurred growth in key sectors, reflecting a positive trajectory for the Albanian economy. The government's ongoing efforts to create a conducive investment climate are crucial to sustaining this momentum.

The relationship between Foreign Direct Investment (FDI) and public debt in Albania from 2014 to 2024 reveals a dynamic interplay between economic growth, investment flows, and fiscal policies.

Chart 6

Public Debt and FDI in Albania (2014-2024)



Source: Ministry of Finance of Albania (2023), Institute of Statistics, edited by the Author

Albania experienced moderate FDI inflows during 2014 and 2015 with relatively stable public debt. FDI supported economic growth and infrastructure development, contributing to fiscal stability amid fiscal challenges. In 2016 and 2017, FDI increased due to improved business conditions and greater international investment. However, rising public debt occurred due to increased government spending on infrastructure and public services, funded in part by borrowing. Both FDI and public debt grew from 2018 to 2019. FDI continued to support economic expansion and development, while ambitious fiscal policies and infrastructure investments led to higher public debt. The COVID-19 pandemic led to a significant decline in FDI due to global uncertainty, while public debt surged as the government increased borrowing for pandemic relief and economic support. FDI began to re-

cover gradually with economic stabilization and recovery efforts during 2021 and 2022. However, public debt remained high due to continued borrowing for pandemic relief and recovery. In 2023, FDI and public debt remained closely linked. Efforts to attract FDI were aimed at boosting economic growth, but high public debt constrained fiscal flexibility. FDI is expected to be crucial for economic recovery and growth in 2024. Public debt is anticipated to remain high due to ongoing infrastructure investments and recovery efforts. In summary, while FDI has positively impacted Albania's economic development, rising public debt, especially during global crises, has posed challenges. Balancing these factors is crucial for maintaining investment and economic stability.

Data Description and Methodology

This study utilizes secondary data collected from the Ministry of Finance of Albania, the World Development Indicators (WDI), and Trading Economics, covering a period of 22 years from 1999 to 2020. The analysis uses annual data. The variables included in the econometric model are defined as follows:

- **Foreign Direct Investment (FDI)**: Net inflows of FDI as a percentage of Gross Domestic Product (GDP).
- **Public Debt (PDebt)**: Measured as a percentage of GDP.
- **Exchange Rate (EXCH)**: Measured using an index.

The econometric analysis aimed to assess the relationship between public debt, exchange rate, and FDI is done using the following function:

$FDI=f(Pdebt,EXCH)$

The first step is to determine if a time series is stationary or non-stationary. The study applied the Augmented Dickey-Fuller (ADF) test. This step is crucial for confirming the stationarity of each variable before proceeding with further analysis. Once the stationarity of each time series is checked, the next step is to assess the level of cointegration among the variables using the Johansen test. This test checks whether the stochastic trends in the variables, which are expected to contain unit roots, exhibit a long-term relationship. Essentially, the cointegration test helps determine if there is a long-run equilibrium relationship among the variables. If the test indicates that the variables are cointegrated and have a long-run relationship, the study uses the Vector Error Correction Model (VECM) for analysis. If no long-term relationship was found, the VAR model was deemed more appropriate for the analysis.

Empirical Results

Firstly, testing for the presence of unit root was performed, starting with levels and followed by the first difference, using ADF tests. The results showed that the series was non-stationary in levels, and it generated the first difference between them. It was found that variables included in the model were integrated in the same order, that is, I (1), for this reason a cointegration analysis was performed. Cointegration analysis identifies whether two or more non-stationary time series are linked by a long-term equilibrium relationship, even if their individual series are non-stationary.

Table 1

Stationarity test

Variable	Statistic	p-value	Integration
D_FDI	-3.92	0.0019	**I(1)**
D_Pdebt	-4.278	0.0005	**I(1)**
D_Exch	-3.288	0.00154	**I(1)**

Author's calculations

Based on the results of Table 1, the series for the three variables are turned to stationary in their first difference. The test statistic is greater than the critical value, which means they are integrated of order one, I(1). After establishing that the series are stationary at the first order, the next step is to perform the cointegration test (Table 2).

Table 2

Johansen Cointegration Test

Johansen tests for cointegration

Trend: constant — Number of obs = 21
Sample: 2000 - 2020 — Lags = 2

maximum rank	parms	LL	eigenvalue	trace statistic	5% critical value
0	12	-164.78076.	18.8062*	29.68	
1	17	-159.16226	0.41439	7.5692	15.41
2	20	-156.09873	0.25306	1.4421	3.76
3	21	-155.37766	0.06637		

H_0: no cointegration equation
Ha: Cointegration
Author's calculations

The results of the cointegration test in Table 2 show that the rank is 0 in the Johansen cointegration test, which means there are no cointegrating relationships among the non-stationary variables. Therefore, we do not reject the null hypothesis, indicating that there are no cointegrated equations. This implies that the series do not share a long-term equilibrium relationship, but they may still be analyzed for short-term dynamics. Given the absence of cointegration, the VAR mechanism seems to be an appropriate model for analyzing the relationship between the variables, after which was performed a Granger causality test. This test helps identify if past values of Public Debt can cause FDI and vice versa, thus revealing any causal relationships between these two variables.

Table 3

Granger Causality test

Alternative Hypothesis	Chi-square	Probability	Decision	Level of significance
Public debt causes FDI	1.6835	0.431	Reject	--
Exchange rate causes FDI	7.5702	0.023**	Accept	5%
FDI causes public debt	3.0966	0.213	Reject	--
Exchange rate causes public debt	0.07848	0.962	Reject	--
FDI causes exchange rate	3.8971	0.142	Reject	--
Public debt causes exchange rate	5.7749	0.056*	Accept	10%

Author's calculations

The results in Table 3 indicate that Public Debt (Pdebt) does not Granger-cause Foreign Direct Investment (FDI), as the p-value is 0.431, which is greater than the 5% significance level. However, because of the p-value (0.023<0.05), exchange rate causes FDI, based on the same criteria FDI causes exchange rate. Bi-direction causality is shown between variables (FDI and Exchange rate) but at different levels of significance, respectively 10% and 5%.

Conclusion

This study explored the relationship between public debt and the inflow of Foreign Direct Investment (FDI) in Albania over the period from 1999 to 2020. To conduct this investigation, a Johansen Cointegration test and a Vector Autoregression (VAR) model, after which was performed a Granger Causality test.

The VAR model was used to analyze the short-term relationships among the variables; however, there was not a significant relationship between public debt and FDI. The Granger Causality test was utilized to assess the temporal dynamics between the variables, identifying whether past values of one variable could predict future values of another. However, the test's evidence proved the lack of causality between public debt and FDI, as well as the exchange rate and public debt. However, there is evidence of bidirectional causality between Foreign Direct Investment (FDI) and the Exchange rate.

Considering the results of the study, the government policy makers need to push a reform agenda on public debt so as to attract more FDI in the Albanian economy. A higher investor's confidence in the domestic market acts as a stimulus in attracting FDI inflows. To efficiently manage and perhaps reduce public debt, the government should consider implementing a number of strategic measures targeted at boosting economic development and strengthening fiscal stability.

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