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Free Trade and FDI in Kosovo: Prospects for Integration into the EU and Turkish Production Networks

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Abstract. Kosovo has recently signed two major trade agreements, the SAA with the EU, andan FTA with Turkey. However, as the experience from developing countries shows, trade liberalisation is a precondition, but it does not ensure economic growth and prosperity, especially when the supply-side constraints limit country's ability to reap the benefits of free trade. Violencein the nineties; years of underperforming post-war institutions; the neglect of policy reforms, especially poorly managed privatisation process; reduced greatly Kosovo's industrial base and its manufacturing capacities. Moreover, these factors, coupled with problems with the rule of law, produced a high-risk environment that is deterring the inflow of foreign capital. Following the signing of the two agreements, one can expect that Kosovo will become more attractive tothe European and Turkish investors. In addition to other benefits, the flow of foreign capital may enable Kosovo's industries to integrate intothe global value chains. However, as with free trade, the impact of FDI inflow and the integration into global value chains depend largely on domestic market conditions. This paper provides a discussion on the developments regarding trade liberalisation and FDI, and the opportunities the latter create on the integration of Kosovo's industries into global production networks. In terms of policy directions, the paper argues that, although the trade liberalisation will act as a pull factor, the existingstructural impediments in Kosovo will mostlikely limit the flow of foreign capital and the impact of the existing FDI in Kosovo, specifically, integration into global value chains.
Keywords. Trade liberalisation, FDI, GVC, Kosovo.
JEL. F15, F23, F60.

1. Introduction

Financial and economic integration into the world economy proved to be critical to the revival of the former-communist Central European countries (European Bank for Reconstruction and Development [EBRD], 2009). The region recorded high and sustainable growth rates until late 2000 steaming largely from the increased international competitiveness and FDI inflows. However, in the Western Balkans results differ significantly. The same free market policies have been employed, but economic growth in Western Balkans countries has been rather shaky. At least at the initial stage of transition, the failure can be explained by the political turmoil that hit the region following the break-up of Yugoslavia. A series of armed conflicts delayed the start of the transformational reforms by almost a decade. As a result, the meaningful reforms started in early 2000, while the economic integration was high on the regional agenda. The EU, led by its own example, was pressing for a free trade area in the region, with the view that the integration would reduce the animosities between the peoples of Western Balkans created by the conflicts of the previous decade. The EU went even further, by conditioning the process of regional integration in Western Balkans to the process of the EU membership, giving the former a whole new dimension.

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Western Balkan countries, including Kosovo, endorsed fully the process of trade liberalization. After years of negotiations, countries of the Western Balkansbecame members of Central European Free Trade Agreement (CEFTA), which, in its new format, entered into force in 2007. CEFTA resulted in a removal of all tariff barriers in goods between member countries. In addition, during 2000, countries of the Western Balkans embarked on a wider liberalisation, including the liberalisation of trade with the EU and the membership in WTO. In this decade, all Western Balkans countries signed a Stabilisation and Association Agreement (SAA) with the EU. Due to political reasons, Kosovo lagged behind; the SAA between the EU and Kosovo has entered into force on April 1, 2016. With regards to WTO, Albania, Croatia, and Macedonia became members in 2000, followed by Montenegro in 2012. Bosnia and Herzegovina and Serbia are in advanced stages of accession process, while Kosovo, as a latecomer, has not made a formal application yet. On a final note, other liberalisation steps for the most of Western Balkans' countries include EFTA membership, and other bilateral agreements, notably with Turkey. Kosovo has negotiated an FTA with Turkey but the entry into force awaits the ratification by the Kosovo Parliament.

In addition to the integration processes, Kosovo, as other countries in the region, embarked on significant structural reforms. As a result, the business climate is getting better, while the private sector is taking off; a significant number of old socially owned enterprises have been privatised, and a vibrant SME sector hasemerged. Gradually, the flow of foreign investments is increasing, partially due to the opportunities offered, but also the incentives providedby the government.

However, none of these resembles the success observed in the Central Europiancountries. The economic integration of the region did not produce the expected results, especially in the case of Kosovo. Impediments to free flow of goods, especially in a form of NTBs, are widespread. The negotiations within CEFTA on the liberalisation of services have been concluded. The signals received from Brussels regarding the EU membership are not clear. It is not only the limited integration, but these countries have been lagging on the institutional reforms. Against this backdrop, foreign investors still attach a high degree of risk to Western Balkans, and particularly Kosovo. As a result, growth rates remain moderate, unemployment is high, and poverty is still widespread.

In this paper, we concentrate on the developments related to trade liberalisation between Kosovo and the EU through SAA, on the one hand, and, on the other hand, between Kosovo and Turkey. Particularly, the paper brings together a discussion on trade integration and FDI, and how the latter two can support Kosovo industries to integrate in global value chains (GVC), with particular emphasis on the EU and Turkish production networks. In the final part, the discussion concentrates on structural impediments Kosovo faces in order to attract FDI and integrate into GVCs.

2. Kosovo's trade and investment relations with the EU and Turkey

2.1. Trade developments[1]

As pointed out earlier, Kosovo has made significant steps in liberalizing its economy, notably trade. The benefits from trade liberalisation are potentially far reaching, both static and dynamic. In terms of GVC, trade liberalisation is a precondition for local producers to integrate into global production networks, and climb up the value ladder. However, the huge and persisting trade deficit in goods raises serious challenges to policymakers in Kosovo (Table 1 presents the situation in the external sector of Kosovo). Together with high rates of unemployment, the external position of Kosovo remains the single most pressing issue for the country. Despite this situation, the liberal paradigm continues to act as overriding mode of

[1] The analysis in this section relies largely on Ministry of Trade and Industry [MTI] (2015) co-authored by the author of this paper.

thinking within policy-making circles in Kosovo. As a result, Kosovo in the last few years has negotiatiated two trade deals with its major trade partners, namely the EU and Turkey.

Table 1. *Kosovo's external trade indicators*

Indicators	2008	2011	2014
Exports of goods and services (current, m. €)	595.4	944.4	1095.2
Goods exports (current, m €)	198.5	319.2	324.6
Service exports (current, m €)	396.9	625.2	770.6
Exports of goods and services (% of GDP)	15.1	19.8	19.9
Imports of goods and services (current, m €)	2,178.5	2,861.2	2,972.7
Goods imports (current, m €)	1,928.2	2,492.4	2,538.2
Service imports (current, m €)	250.3	368.9	434.5
Imports of goods and services (% of GDP)	55.3	59.9	54.0
Trade balance on goods and services (current, m €)	-1,583.2	-1,916.9	-1,877.6
Trade balance in goods (current, m €)	1,729.8	2,173.2	2,213.7
Trade balance in services (current, m €)	146.6	256.3	336.1

Source: Central Bank of Kosovo (various years)

The geography of Kosovo's trade has remained fairly similar in the post-war years. The EU block is the largest trading partner of Kosovo. Over the last ten years, Kosovo has been exporting, on average, around 40 per cent of its production to the EU countries. The EU market is followed by neighbouring countries, which constitute, on average, 37 per cent of the total exports, over the period 2005 – 2014. Recently, Kosovo businesses have begun moving more towards other and more distant markets, especially Turkey, China and India. Imports, on the other hand, show similar tendencies as exports: the structure of partners is similar. Again, two major trading blocks, the EU and CEFTA countries, dominate import structure. On average, together they constitute over 80 per cent of total goods imports, over 2005 - 2014. Countries such as Turkey, China, Switzerland, USA, etc. cover the rest of total import in goods (see table below).

Table 2. *Kosovo's exports and imports of goods with the EU and Turkey (current, m. €)*

Indicators	2012	2013	2014
Exports with the EU	199.9	204.9	238.3
Imports with the EU	1,050.1	1,083.2	1,081.1
Trade balance with the EU	-850.20	-878.30	-842.80
Exports with Turkey	11.4	7.4	10.4
Imports with Turkey	199.9	204.9	238.3
Trade balance with Turkey	-188.50	-197.50	-227.90

Source: Kosovo Agency of Statistics (various years)

In April 2016 the SAA between Kosovo and the EU entered into force. The deal is of immense importance for Kosovo as it represents the first contractual relationship between the partners, and it is seen as an important milestone in Kosovo's European integration process. Beyond political implications, the largest portion of the SAA concentrates on the liberalisation of goods. According to the Agreement, all Kosovo products are immediately exempted form customs duty, except baby beef, sugar, and wine, which are subject to quantitative restrictions. On the other hand, Kosovo will phase out custom duties according to specific transitional periods (from five to ten years). Kosovo has entered into an agreement with 99.7% of Kosovo products, thus 0.3% of products are not part of the SAA (see discussion comparing the SAA and FTA with Turkey).

On the 27th of September 2013, the Republic of Kosovo signed a Free Trade Agreement with Turkey. This agreement guarantees Kosovo's exporters duty-free access to the Turkish market for 8,336 industrial products. In exchange, Kosovo has agreed to eliminate customs duty for 2,292 industrial products with immediate effect. These are largely the products either not produced in Kosovo or lacking a significant potential for development. With regard to the agricultural products, Kosovo has negotiated the abolishment of customs duties for 2,442 products, except for meat. In return, Kosovo will immediately abolish customs duty on only 493 agricultural imports from Turkey. Kosovo will protect for additional 10 years 52 other agricultural products, considered to be sensitive and within Kosovo's comparative advantages.

However, although Kosovo committed to only reducing customs duties progressively, the fiscal implication, as shown in the next figure, will be significant. The calculations have been based on the assumption that both agreements will enter into force in 2016.

As the figure shows, the FTA with Turkey imposes significantly less tariff reduction commitments upon Kosovo than the SAA. Before the entry into force of the SAA, the average nominal tariff rate was 8.03 per cent for all imports. Once the SAA entered into force the average nominal tariff rate for EU imports dropped sharply by 2.5 per cent, to then taper off to nearly 0 per cent over the next nine years. The initial sharp drop was expected as the tariff on over 70 per cent of the product lines have been abolished immediately (see Table 3). Apart from 14 tariff lines that have been excluded from negotiations, the rest of tariff lines will be abolished progressively over 10 years: around 17 per cent of product lines within five years; less than 13 per cent over seven years; and only 0.13 per cent in ten years.

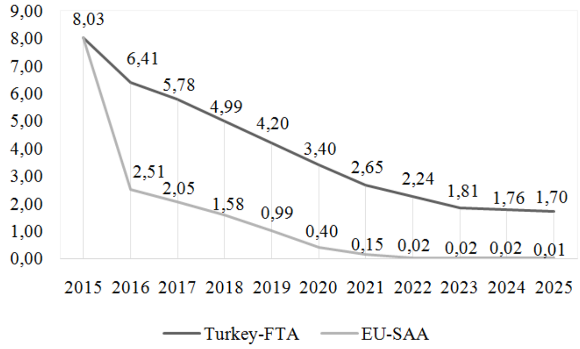

Figure 1. *Average nominal tariff rates for EU and Turkey before and after agreements enter into force*

Source: Author's calculations based on KAS (2015) data.

Note: Averages have been calculated based on the total number of tariff lines in Kosovo

Customs' Tariff Code (TARIK) of 2012. The same has been used to negotiate with the EU and Turkey counterparts.

Table 3. *The schedule of concessions granted in the SAA and the FTA with Turkey*

Sectors	SAA with EU		FTA with Turkey	
	Schedules (years)	Products covered (HS-8 digit)	Schedules (years)	Products covered (HS-8 digit)
Agriculture Sector	Zero	1,204	Zero	433
	Five	353	Six	214
	Seven	180	Eight	39
	Ten	8	Ten	19
	-	-	Ten-A	16
	Excluded	11	Excluded	1,035
Processed Agriculture Products (PAPs)	Zero	135	Zero	69
	Five	98	Six	94
	Seven	76	Eight	32
	Ten	4	Ten	6
	-	-	Ten-A	10
	Excluded	3	Excluded	105
Fish Products	Zero	490	Zero	29
	Five	1	Six	6
	Seven	1	Ten	1
	Excluded	0	Excluded	456
Industrial products	Zero	4,763	Zero	2,254
	Five	1,131	Four	210
	Seven	925	Six	1,234
	-	-	Eight	2,651
	-	-	Ten	470
	Excluded	0	Excluded	0

In the case of Turkey, once the agreements enters into force, the immediate drop in the average tariff rates will not be as sharp as in the case of SAA. This is largely because only 30 per cent of tariff lines will be abolished completely once the FTA enters into force. Also, 17 per cent of tariff lines were excluded altogether from negotiations. According to the agreement, the majority of tariffs will be abolished within eight years, that is, 29 per cent, followed by 16.5 per cent of lines that will be abolished within six years. For 5.5 per cent of products tariffs will be reduced progressively within 10 years; only a fraction of products has been granted a grace period of two years (classified within Ten-A category), whereby the progressive reduction will start in the third year following the entry into force of the FTA.

Table3 shows also that for around 70 per cent of agriculture and industrial products tariff duties will be abolished once the SAA enters into force. The rest will be abolished progressively within five to seven years. For Processed Agriculture Products (PAP)the picture is much the same, while the fishery sector will be almost fully liberalised once the Agreement enters into force. In the latter case, only two product lines will enjoy gradual tariff reductions within five and seven years.

In the case of the FTA with Turkey, the situation is rather different: around 60 per cent of agriculture products have been excluded from negotiations, while only about 25 per cent of all tariff lines will be abolished once the Agreements enters into force. For the rest of products, the reductions will be completed within six and eight years. Again we see a rather similar picture regarding PAPs, while the majority of fish products have not even been included in negotiations because presumably there was no major production from either party. Only 33 per cent of industrial products will have zero tariff rate once the Agreement enters into force, while the tariff for the remaining product lines will be reduced progressively over six to eight years.

2.2. FDI flows

The literature generally points to the positive effects capital flows have on the level of development. The literature argues that FDI contribute substantially to gross fixed capital formation, GDP growth, and enterprise restructuring. In addition, FDI generate employment, promote exports, diversify and upgrade industries. Another benefit from FDI is the option it provides to local industries to integrate into global production networks. The evidence is overwhelming; according to a joint report from the Organization for Economic Cooperation and Development, World Trade Organization and United Nations Conference on Trade and Development [OECD/WTO/UNCTAD] (2013) analyzing the implications of GVC on trade, investment, development and jobs. The study argues that"the expansion of the operations of MNEs through FDI has been a major driver of growth of GVCs, as illustrated by the close correlation between FDI stocks in countries and their GVC participation" (p.9). Specifically, the study argues, the presence of foreign affiliates is clearly an important factor influencing participation in international production networks.

The evidence on the effects of FDI on Kosovo's economy is rather scarce. However, the aggregate data show some interesting tendencies. Although as a whole, the EU has been the biggest foreign investor in Kosovo for the last few years, still, Turkey, individually, is the biggest FDI contributor to Kosovo (see Table 4). The main EU contributor is Germany, with almost €300 million in stock of investments, followed by Slovenia, Austria and Holland.

Table 4. *Kosovo's stock of FDI in the post war years (selected countries; in m. €)*

Country	Amount
European Union	1,101.6
Germany	299.5
Slovenia	222.3
Austria	183.4
Holland	162.6
Great Britain	64.5
Bulgaria	33.2
Other EU	136.0
Turkey	351.4

Source: Central Bank of Kosovo (various years)

The geographical composition of net FDI flows over years is provided in the table below. As the data show, particularly the year 2014 has evidenced a sharp drop in foreign investments. The outflow in countries such as Great Britain, Holland, and Slovenia has been significant. In other years, the level of foreign investments remains largely the same. One should note that the greatest flow of FDI has been registered in 2007 with around €450 million euros. These flows are largely related to the privatisation of the former socially owned enterprises. However, even the privatisation process has been able to attract a substantial amount of the EU and Turkish capital. The EU investors have concluded only 5.5 per cent of the total privatisation deals in Kosovo. One could add to this figure additional 9 per cent of the deals involving Kosovo's Diaspora that is overwhelmingly residing in the EU countries.[2] Otherwise, over the years, Kosovo's Diaspora has been very active in investing in Kosovo.

Table 5. *Net flow of FDI in Kosovo (selected countries; in m. €)*

	2008	2011	2014	2015
Germany	44.0	66.6	29.4	45.3
Slovenia	44.3	16.2	-9.4	5.6
Austria	51.3	19.6	30.3	33.5
Holland	25.9	4.7	-7.8	-24.1
Great Britain	36.6	80.1	-39.5	26.6
Turkey	23.8	34.7	20.0	57.8
Total	369.9	384.4	151.2	324.4

However, the presence of FDI does not demonstrate that foreign capital is actually taking advantage of investment opportunities in export-oriented sectors of Kosovo's economy. Quite the contrary, the overwhelming share of FDI (75.3 per cent) is directed into non-tradable sectors (construction and services), whereas only slightly over 15 per cent of total FDI flows are absorbed by manufacturing activities (Table 6). This explains why existing levels of foreign investment are not closely associated with industrialization and export growth (MTI, 2015). According to MTI (2015) it also shows that foreign capital inflows in Kosovo effectively contribute to establishing economic activities (e.g. services) that maintain and reproduce the overall consumptive character of the economy.

Table 6. *Kosovo: Net foreign investment flows, by sector, 2007-2014*

Sector (% of total net FDI flows)	2007	2011	2014	Average
Agriculture	1.79	0.14	0.11	1.16
Industry	26.95	10.89	-10.85	15.78
Construction	1.17	34.63	-13.13	9.1
Services	66.23	37.89	122.95	66.2
Other	3.83	16.43	0.91	7.75

Source: Central Bank of Kosovo *Times Series* (various years)
Notes: Averages over the whole time period

The same situation is evidenced elsewhere in the region. Estrin & Uvalic (2013, p. 35) explain that "the manufacturing industry, as the key sector for developing export potential, has actually continued to decline in most SEE countries also during the past decade, after the very strong process of deindustrialization in the 1990s which has been more extreme than in CEE". In addition, as International Monetary Fund [IMF] (2015) explains, FDI inflows in the region were directed into non-tradable sectors, such as financial services, real estate, and construction, rather than tradable sectors that can generate stronger export performance.

[2] Kosovo Privatisation Agency (2015) *Annual Report*. [Retrieved from].

3. FDI and integration into GVCs: bottlenecks and policy options

The SAA has been hailed as a major achievement in policy circles in Kosovo. It is argued that, a deal with the world's largest trading bloc is most attractive, as it will provide access to a half of billion consumers in 28 EU member states. Furthermore, businesses will benefit from the SAA through creation of a more stable and predictable trade and investment environment. Moreover, the SAA will commit Kosovo to undertaking major reforms in areas such as intellectual property, public procurements, competition policy, and trade and sustainable development. In the same light, the literature views the impact of FDI in developing world. It is argued that FDI generate jobs, exports, and growth. In addition, spillover effects by FDI affect positively local industries, making them more competitive domestically and internationally.

Jointly, free trade and FDI, respectively, create opportunities for a potential integration of Kosovo's industries into global production networks. On the one hand, free trade – the removal of tariff and non-tariff barriers to upstream or downstream activities – and the ease of conducting international transactions (i.e. trade facilitation) are vital to successful participation in global value chains. European and Turkish capital can either integrate Kosovo industries into global value chains by acquiring specific chains in the upstream or downstream activities, or, as FDI are conventionally viewed, by serving as a channel of technology and knowledge transfer vital to increasing Kosovo's productive capacities and climbing up the value chain ladder.

However, the evidence from developing countries on the benefits of both free trade and FDI, respectively, is rather mixed. Regardless whether we talk about trade liberalisation or capital inflows, the benefits are conditional on domestic conditions. In the case of trade liberalisation, the literature suggests that the benefits of free trade are conditional and that export performance in general depends on many domestic supply-side factors (see the joint report from the Organization for Economic Cooperation and Development, World Trade Organization and World Bank (OECD/WTO/World Bank, 2014). Hence, in order to benefit from free trade, countries have to address supply-side weaknesses if the potential benefits of free trade are to be realized. A recent study analyzing Kosovo – EU trade determinants reaches the same conclusion (see Gashi, Hisarciklilar, & Pugh, 2016).Similarly, a large body of literature argues that potential spillover effects of FDI to domestic firms is dependent on local characteristics, including the level of human capital and the overall institutional level of the country, including the level of development of the financial sector (see Alfaro, Kalemli-Ozcan, Sayek, 2009).

Hence, the policymaking in Kosovo will have to see free trade and FDI in conjunction. Through a careful design of policies Kosovo institutions will have to use free trade to attractand channel FDI from its two major contributors, namely, the EU and Turkey. These policies will later bolster productive capacities of the country by brining knowledge and capital, and integrating domestic industries in wider international production networks. The new approach will require a refocus from the liberal paradigm towards a more non-neutralpolicy approach. This type of thinking is gaining prominence in academic circles, especially in relation to attracting foreign capital. For instance, the prominent scholar Jagdish Bhagwati in *The Defence of Globalisation* (2004) argues that"…growth was not a passive, trickle-down strategy for helping the poor. It was an active, pull-up strategy instead. It required a government that would energetically take steps to accelerate growth, through a variety of policies including building infrastructure such as roads and ports and attracting foreign funds".In what follows, we develop the argument by drawingfirst onthe structural impediments that the EU and Turkish investors may likely face in Kosovo, and possible policy solutions.

In order to identify the structural impediments investors face in Kosovo, the good place to start is the *Growth Diagnostics Framework* developed by Hausmann, Rodrik, & Velasco (2007). According to this approach the government should identify the binding constraints the country faces. In other words, the government has to be selective in resolving the most burdening constraints to growth and investments because the span of economic impediments is wide and of various intensities, while the resources, especially institutional, are limited. In this light, Kosovo Government has to be selective and tackle the most pressing barriers to the economic activity, especially those related to the decisions of firms to invest in Kosovo and the decisions related to expanding economic activity of foreign and localoperating in Kosovo. In the former case, one should analyse the major motifs for foreign investors (i.e. the factors influencing foreign firm decision to enter Kosovo market); while in the latter case, one should look through the FDI externalities on the local firms and industries.

Both the decision to enter Kosovo market and the externalities produced by FDI are closely related to two major factors: the skill level of human resources and the quality of institutions. This does not mean that these are the only factors influencing the two types of foreign investor decisions. In addition, we are also aware that the impediments to the entry and expansion of foreign firms in Kosovo are industry specific. But the overwhelming empirical evidence shows that these two factors have a higher pulling force for foreign investors.

Dunning & Lundan (2008) list the motifs for investing abroad; according to them these are market, resource, efficiency, and strategic-asset seeking. Small size of the Kosovo’s market and generally weak purchasing power eliminates the market size factor. However, Kosovo potentially can be attractive to the EU and Turkey investors seeking relatively cheap human and natural resources, on the one hand, and efficiency on the other hand. But, using efficiently these resources – human or natural – requires meeting specific preconditions. First, Kosovo energy and mineral resources are well documented. However, investors in the extractive or industries related to natural resources are generally averse to country risks. Kosovo is a high-risk country; the political and economic risk largely steams from the poor institutional infrastructure and the risks related to the political developments after 1999. Moreover, the rational utilisation of natural resources requires an institutional infrastructure build on the principles of transparency and accountability. This would reduce the potential impact of interest groups and the poor governance of resources that are the main reasons for the emergence of the “resource course”.Second, Kosovo’s young and vibrant population presents an enormous potential. However, the skill level and composition is questionable. The problems are related largely to the underperforming education system. Moreover, as studies show, the highly educated workforce in Kosovo is comparatively more expensive than their peers in the region (World Bank, 2010).

The discussion on the effects FDI in the local economy concern, first, the expansion of foreign firms’ activities within Kosovo; and, second, creating conditionswhich would generate externalities from FDI to local firms and industries. Regarding the former, various incentive schemes – tax or other – can be devised to support the expansion of activities of the existing FDI. In the second case, the situation is much more complex because, the FDI related externalities depend largely on the local market conditions. For instance, Alfaro (2013) and Alfaro *et al.* (2009) argue that countries give incentives to foreign investors on the belief that they enable domestic industries to absorb technology and knowledge. However, according to the authors this does not happen by default. Authors argue that the absorption of knowledge and technology is much more likely to occur when some specific domestic conditions are met, specifically those related to the quality of human resources and the performance of institutions in the country. Problems in each of them reduce firms’ capabilities to absorb knowledge and technologies from foreign firms, and to react to the challenges and opportunities presented by the entry of foreign firms in the local market. For instance, weak financial sector limits the access to the credit, and as a result the possibility of small businesses and entrepreneurs to finance new technologies and absorb new knowledge (Alfaro, 2013).

4. Conclusion

Kosovo has almost entirely liberalized its trade with the world. It has recently signed two major trade agreements; namely, the SAA with the EU, and the FTA with Turkey. Together with CEFTA, which is in place since 2007, Kosovo has liberalized 80 per cent of its trade. However, as the data show, free trade did not bring much prosperity and development to the country. Structural problems are persisting; unemployment is high while negative trade balance is widening. In line with the experiences of the developing world, the research for Kosovo shows that trade liberalisation does not ensure economic growth and prosperity, especially when the supply-side constraints limit country's ability to reap the benefits of free trade. Violence in the nineties; years of underperforming post-war institutions; the slow pace of reforms, especially poorly managed privatisation process; reduced greatly Kosovo's industrial base and its manufacturing capacities.

Moreover, these factors, accompanied by the problems with the rule of law, produced a high-risk environment that deterred the inflow of foreign capital, a vital ingredient in building a competitive private sector. However, it was assumed that the signing of these two agreements will make Kosovo more attractive to the European and Turkish investors. FDIs are assumed to bring new knowledge and capital, as well as help local firms and industries to increase the level of their competitiveness. In addition, the flow of foreign capital may enable Kosovo's industries to integrate into the global value chains. On the one hand, free trade – the removal of tariff and non-tariff barriers to upstream or downstream activities – and the ease of conducting international transactions (i.e. trade facilitation) are vital to successful participation in global value chains. On the other hand, European and Turkish capital can either integrate Kosovo industries into global value chains by acquiring specific chains in the upstream or downstream activities, or, as FDI are conventionally viewed, by serving as a channel of technology and knowledge transfer vital to increasing Kosovo's productive capacities and climbing up the value chain ladder.

However, even if this best-case scenario works, other structural impediments in Kosovo will likely limit the impact of the foreign capital, and, specifically, integration into global value chains. Resource-seeking and efficiency-seeking EU and Turkish investors will likely be attracted to Kosovo, but the high degree of political risk in Kosovo and the lack of skilled and educated labour force will limit full benefits from FDI. The Government of Kosovo will have to sort its own backyard and create conditions to maximize the impact of free trade and foreign investment flows.

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