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ALBANIAN ECONOMY: RECENT DEVELOPMENTS

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Albania began its transition to the market economy in 1991. Unlike some Former Soviet Union and CEE countries that started the liberalisation of the economy in the 1980s, Albania did not undertake any pre-transition reforms before 1991. During 1991-1992 the economy was characterised by a sharp decline in output and high levels of unemployment and inflation. The political situation at the end of the old regime and the decline in output led to a mass emigration of the work force abroad, especially to Italy and Greece.

In 1992, with the aid of the international community, the Albanian authorities adopted a wide-ranging programme of reforms. From the beginning of the stabilisation programme in 1992 output grew rapidly until 1997 when it was adversely affected by the turmoil that followed the collapse of the pyramid schemes. The initial rapid pace of growth was mainly observed in those sectors of the economy where privatisation proceeded fastest like agriculture and services.

Following the crisis of 1997-1998, the Albanian economy has been growing relatively fast, owing to the policies of economic stabilization and a period of relative political stability. Overall, there are encouraging signs for further strengthening of macroeconomic equilibrium in Albania. Over the past six years, the economy has

experienced a considerable growth in real terms, the domestic currency has been more stable and even appreciating, and inflation have been kept at modest levels.

Table 1: Main economic indicators

	1998	1999	2000	2001	2002	2003
Real GDP growth (%)	12.7	8.9	7.7	6.5	4.7	6.0
GDP per capita	842.1	1052.0	1128.0	1332.6	1521.0	1934.9
Unemployment rate	17.8	18.0	16.9	14.6	15.8	15.0
Inflation rate (end year)	8.7	-1.0	4.2	3.5	2.1	3.3
General govt. balance (% of GDP, excluding grants)	-11.4	-12.1	-9.2	-8.2	-6.9	-5.6
General govt. balance (% of GDP, including grants)	-10.9	-9.3	-8.2	-7.6	-6.3	-4.4
Domestic debt (% of GDP)	36.2	37.4	42.6	39.5	38.8	38.0
Trade balance (% of GDP)	-22.8	-19.3	-22.3	-24.2	-23.9	-22.8
Current account balance (% of GDP excluding grants)	-7.1	-7.9	-7.4	-6.2	-9.0	-6.7
Current account balance (% of GDP including grants)	-3.9	-3.9	-4.4	-3.2	-6.5	-6.3
External debt (% of GDP)	36.9	32.3	31.8	28.2	24.4	23.3
Debt-export ratio (%)	358	187	166	143	129	128
Exchange rate lek/usd (av.)	150.6	137.7	143.7	143.5	140.1	121.9
Exchange rate lek/euro (av.)	-	146.96	132.58	128.47	132.36	137.51
Foreign direct investment (% of GDP)	1.5	1.4	3.7	4.8	2.6	2.7

Source: Ministry of Finance, INSTAT, Bank of Albania

Real GDP growth rate in 2003 recovered to its trend of 6 percent from 4.7 in 2002. Unlike the belief that Albanian economy until recently was heavily reliant on agriculture, the latest data issued by Institute of Statistic show a large structural shift from agriculture to services. Agriculture, now accounts for less than one-fourth of the economy while services have reached 46% of GDP and there are signs that this structural change will deepen in the future. While to some extent this is a sign, but the lack of investment and restructuring in agriculture sector has accelerated this sector fall.

Table 2: Origin of GDP (% of total)

	2001	2002	2003
Agriculture	26.0	25.4	24.7
Industry	10.8	10.5	10.2
Construction	8.3	8.6	9.1
Services	45.7	45.9	46.1
Transport	9.1	9.6	10.0

Source: Ministry of Finance, INSTAT, Bank of Albania

The strong growth performance has had a positive impact on the unemployment rate, which has reduced to 15 percent in 2003 from 18 percent in 1998-1999, although the

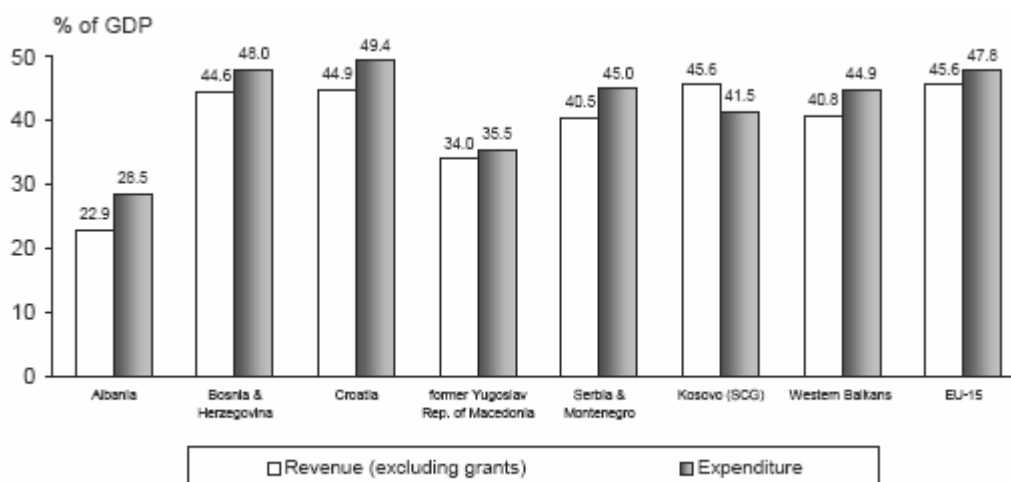
unemployment statistics for Albania should be treated with caution. Economic activity is mostly concentrated in small companies and farms. According to the Albanian Institute of Statistics (INSTAT), around 98 percent of enterprises in Albania have ten or less employees.

The fiscal stance has continuously improved, owing to significant fiscal adjustments in the recent years. In 2003, the size of budget deficit (excluding grants) reduced to 4.4 percent of GDP, which is close to that of the ten EU new member countries with an average deficit of 4.7 percent of GDP in 2002. Yet, there is a strong need for further improvements of fiscal position, given the low level of government revenues compared to GDP, which remain the lowest among the countries in the region. In particular the low level of revenues last year has mostly affected the much needed public investments which were 40% short of the initial target. In addition, the resumption of lending activity by Savings Bank, that holds more than 80 percent of government T-bills, would increase the pressure of improving the alternative sources of financing the budget deficit in the future.

Table 3: General government budgets

% of GDP	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Total revenues	24.1	23.4	16.3	17.0	22.0	22.0	21.9	23.0	22.9	22.4
- Tax revenues	16.0	13.2	10.7	9.8	12.3	12.9	15.6	15.6	15.7	19.6
Expenditure	33.1	33.6	31.3	27.7	30.2	33.3	30.9	31.5	29.1	26.9
- Capital Expenditure	3.4	8.3	4.9	4.2	5.7	5.8	6.6	7.4	5.6	4.1
Budget deficit	-9.0	-10.2	-11.4	-13.2	-11.3	-11.3	-9.1	-8.6	-6.2	-4.4
- Domestically financed	8.6	6.5	9.0	11.3	6.5	5.0	5.4	4.8	3.2	3.2
- Externally financed	0.4	3.7	2.4	1.9	4.8	6.3	3.7	3.8	3.0	1.2

Source: Ministry of Finance, INSTAT, Bank of Albania

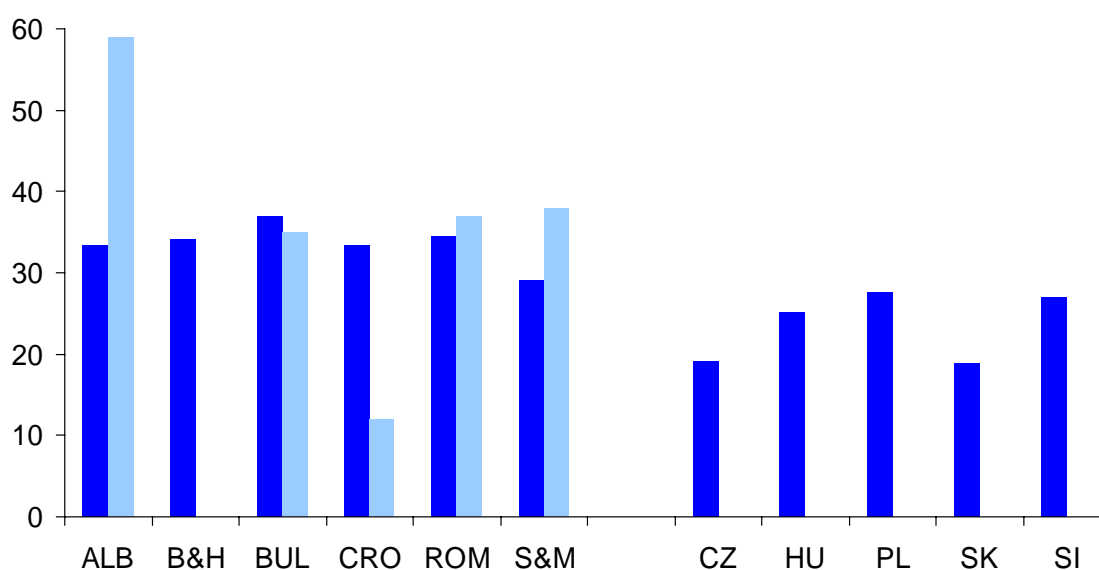


Source: IMF, national statistics, European Commission

P projections

Fig 1. Western Balkans – Revenue (excluding grants) and Expenditure. 2003p

Ongoing reforms to enhance the efficiency of tax administration combined with a concerted effort to reduce the size of the informal economy, which is estimated to be one of the highest in the region, is expected to increase tax revenue as a share of GDP and permit an expansion of priority expenditure within a framework of further fiscal consolidation. As this consolidation takes place and the business sector takes on an increasing role, public and private consumption will decline as share of GDP.



Schneider (2002): shadow economy, % GNP 1999/2000, using currency demand, physical input and DYMIMIC approach; Christie & Holzner (2003): household shadow economy, % GDP 2001, using household income taxation method - HITM)

Fig. 2: Shadow Economy

Albania has shown impressive results in terms of price stability. Inflation has been distinguished generally by lower rates relative to other transition economies. In the last four years, inflation has stabilized at moderate levels as measured both at the end and average period figures, though it sometimes diverges from the target due to unforeseen shocks and speculative factors that are mainly beyond the central bank's control. Monetary policy will continue to aim inflation within 2-4 percent target. However, Albania's reliance on monetary targeting, although so far seem not to have experienced any serious problem may prove to be insufficient to maintain low inflation in the future. In particular, the signalling power of monetary aggregates targeted by BoA may start to deteriorate. Therefore, alternative regimes such as IT that could transmit central bank signals better are being considered. However, several external threats that may prevent the bank from reaching the target independently from the regime in place should be

borne in mind. This might involve changes in the administrative prices and structural reforms in general, lack of fiscal discipline, the impact of dollarisation on the effectiveness of monetary policy, the potential decrease in foreign remittances and its implication on exchange rate volatility, financial system development and stability etc..

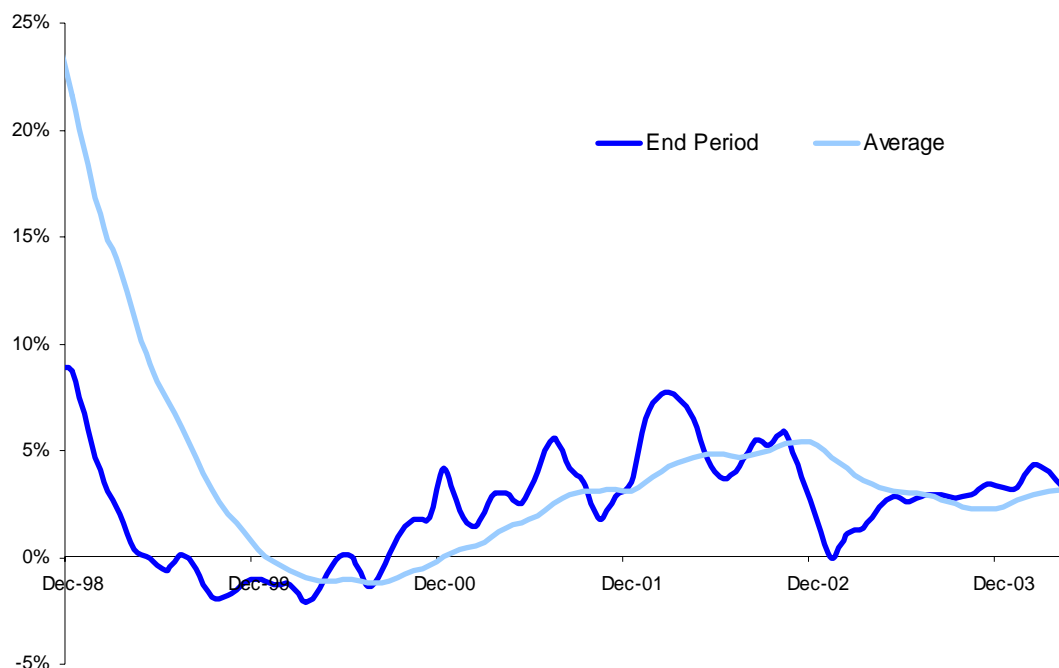


Fig. 3: Consumer Price Inflation

Regarding the financial system development, the recent privatization of largest bank in Albania, the Savings Bank, places the whole banking system under private management. This is expected to boost the competition, improve service quality, and increase the much needed credit to private sector which still remains the lowest among transition countries. There are some concerns though, how Savings Bank will react to monetary policy decisions, considering its dominance in the T-bills' market, deposits' market and potentially in the credit market. Also it puts some extra pressure on further improving the supervisory capacity and regulatory framework.

The Bank of Albania is committed to go ahead with additional structural reforms to enhance banking sector intermediation and financial services provision. In close consultation with commercial banks, governmental institutions, and the private sector, the Bank of Albania developed an action plan for increasing the use of the banking system in the regular conduct of business.

On the external side, large inflows of current transfers and positive service balances in recent years have helped dampen the rising trade deficits with a slight improvement of balance of payments position. Although Albania has been characterised by large current account deficit throughout most of the transition period, only recently its size has become a matter of concern. The current account deficit may still be sustainable in the short run, however its long run sustainability may be questionable if certain measures, such as structural reform that boost the competitiveness of Albanian exports are not undertaken. The volume growth of goods exports is expected to remain strong in 2004, at about 17 percent, while import growth will be around 14 percent. Over the medium term, as business climate improves, growth should be driven by rising foreign and domestic export-oriented investment.

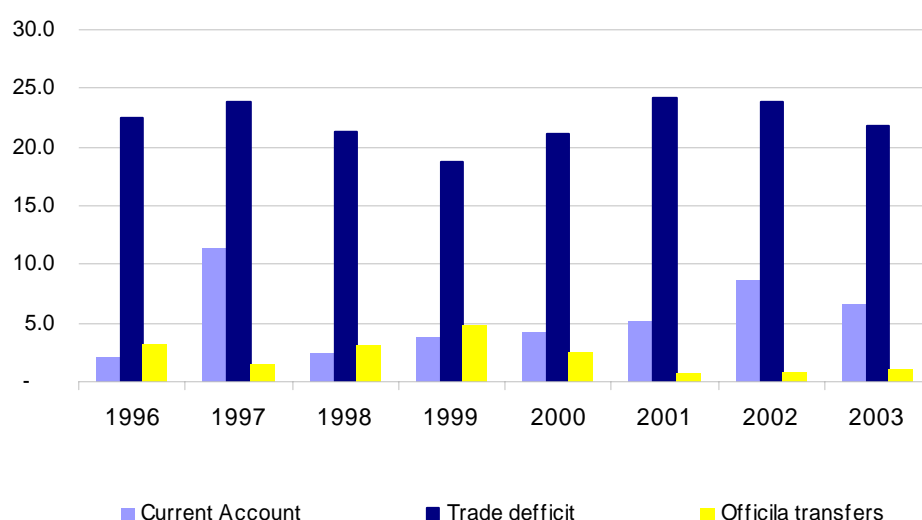


Fig. 4: Albania Current Account Balance (as % of GDP)

Albania remains committed to a liberal trade regime and will continue toward concluding a Stabilisation and Association Agreement with EU and achieving an Albanian-EU free trade area. During 2003 and the first quarter of 2004 six new free Trade Agreements were ratified by Parliament, including a free trade agreement with Kosovo.

The lek appreciated against both USD and Euro in 2003. However, concerns about external competitiveness have pushed BoA to intervene in the market and to reduce the local currency interest rates to prevent the lek from appreciating too strongly in nominal terms against the euro.

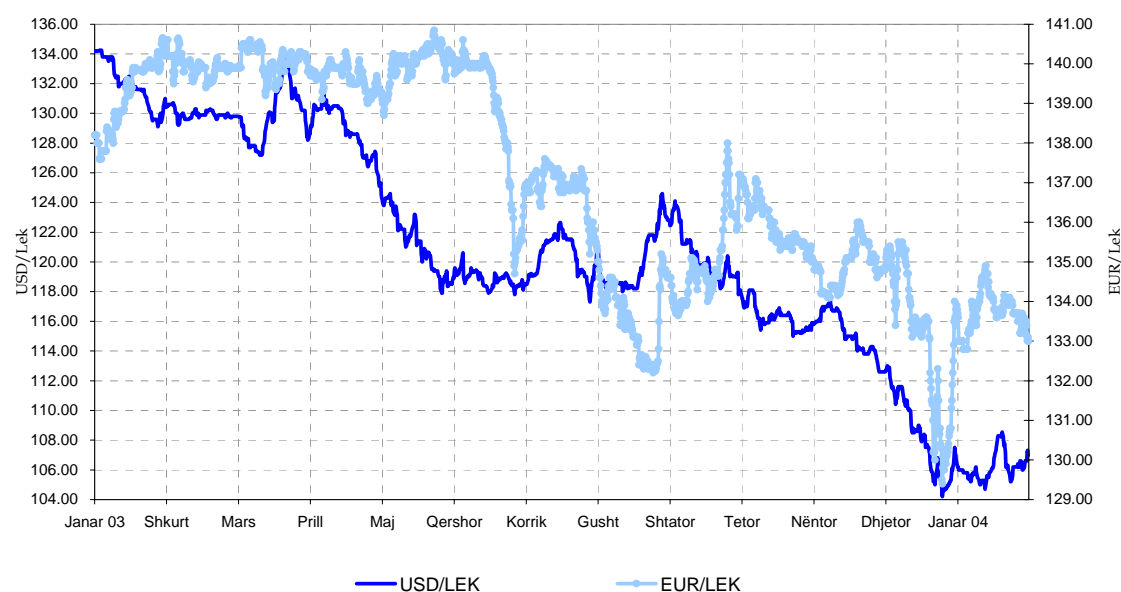


Fig. 5: Exchange rates

Despite the significant macroeconomic achievements, the economy is still fragile and considerable progress is needed to establish an attractive framework favourable to investment and sustainable growth, driven by private sector development. High political tensions, uncertain electricity supply and possible delays in structural reforms, more particularly as regards privatization of large state owned enterprises, are some of the problems to macroeconomic development in the period ahead. The reform of the public administration and the management of public finances also pose important challenges over the medium term.

Although Albania is well positioned to attract foreign direct investments, with its favourable geographical location, competitive salaries, and natural resources, foreign investors have been reluctant to commit their resources in an uncertain business environment (Table 2). Domestic investment seems to suffer too (Fig. x-y) based on surveys of Bank of Albania.

Governance and institution building reforms remain critical for developing a rules-based business climate and attract increasing levels of investment. Although Albania has achieved progress over time, with support from the World Bank, EU, OSCE and UNDP, further progress is needed. Customs procedures, tax administration, land and construction permits, sector licensing, and the judiciary system are the major obstacles

to investment in Albania. We regret seeing Albania ranked as the country with the highest level of corruption among transition countries. The last report from the European Commission criticised Albania for not doing enough to fight corruption and organised crime, and to improve the functioning of the judicial system.

Table 4: Western Balkans – FDI Inflows. 1997 - 2003

	1997	1998	1999	2000	2001	2002	2003 ^p	Average 1997-2003
<i>Per capita - euro</i>								
Albania	14	13	12	50	74	46	42	36
Bosnia and Herzegovina	0	13	36	40	37	61	71	37
Croatia	106	187	310	266	392	234	282	254
former Yugoslav Rep. of Macedonia	7	53	15	96	247	41	20	68
Serbia and Montenegro	81	12	13	3	23	74	144	50
<i>Western Balkans</i> ⁽¹⁾	55	52	78	79	129	98	133	89
<i>% of GDP</i>								
Albania	2.2	1.5	1.1	3.7	4.9	2.8	2.7	2.7
Bosnia and Herzegovina	0.0	1.3	3.3	3.2	2.7	4.4	4.9	2.8
Croatia	2.6	4.3	7.4	5.9	8.0	4.6	6.2	5.6
former Yugoslav Rep. of Macedonia	0.4	3.3	0.9	4.9	12.9	2.1	1.1	3.6
Serbia and Montenegro	4.4	0.8	1.1	0.3	1.4	3.6	6.3	2.6
<i>Western Balkans</i> ⁽¹⁾	2.9	2.7	4.3	4.1	5.7	3.9	5.4	4.1

Source: "The Western Balkans in transition" EC DG for economic and financial affairs occasional paper no. 5.

Also, referring to the Business Confidence Indexes (see Appendix), there is a continuous negative discrepancy between the expected and actual values for all the indicators. On one hand this could be a sign of business unwillingness to accurately reveal its information due to their informality. However, a quick investigation also shows that there have been several events ranging from infrastructure difficulties to security problems that have continuously disrupted normal business activity. Problems surrounding property recognition especially regarding land property poses another serious obstacle to economic development

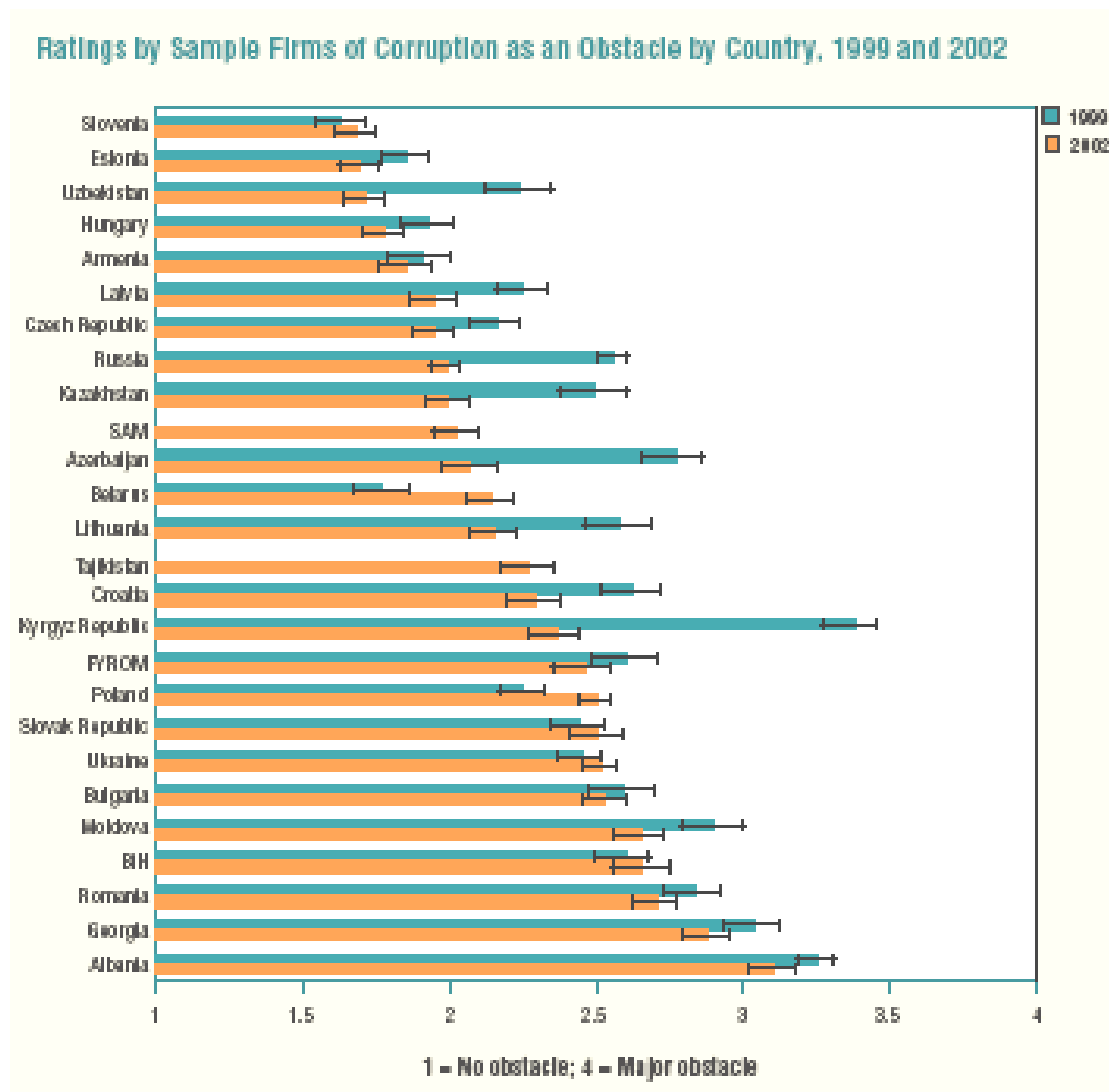


Fig. 6

Source: "Anticorruption in Transition 2" World Bank, 2004.

Despite the rapid output recovery and macroeconomic stability, emigration of the workforce remains still high. According to the Greek Ministry of Foreign Affairs around 700,000 Albanian (about 20 percent of the population) were living abroad in 1998.¹ Leaving aside for the moment the long-run effects of this phenomenon, one immediate drawback is the lack of attachment or responsibility to the place of work. Many employees are not concerned with building up a good reputation in the labour market as they think their future will not be in Albania. This kind of behaviour is also common in many new public institutions and government branches, whose role is crucial in enforcing the new rules and laws of the market economy. Reform in this area

¹ Kule, D., Mancellari, A., Papapanagos, H., Qirici, S., and Sanfey, P., (2000) "The causes and consequences of Albanian emigration during transition: evidence from micro-data," EBRD, Working Paper No. 46.

has moved slowly, particularly with respect to training and the ability to attract and retain highly-skilled staff. It is important to relate more closely public service pay and bonuses with productivity and performance.

To sum up, from the recent macroeconomic developments, Albanian economy seems to be on the right track. However, the pace of structural reforms needs improving to accelerate both the economic development and the process of EU integration.

Appendix: Albanian Business Confidence Index (Source: Bank of Albania. *Preliminary unpublished results. Please do not refer*)

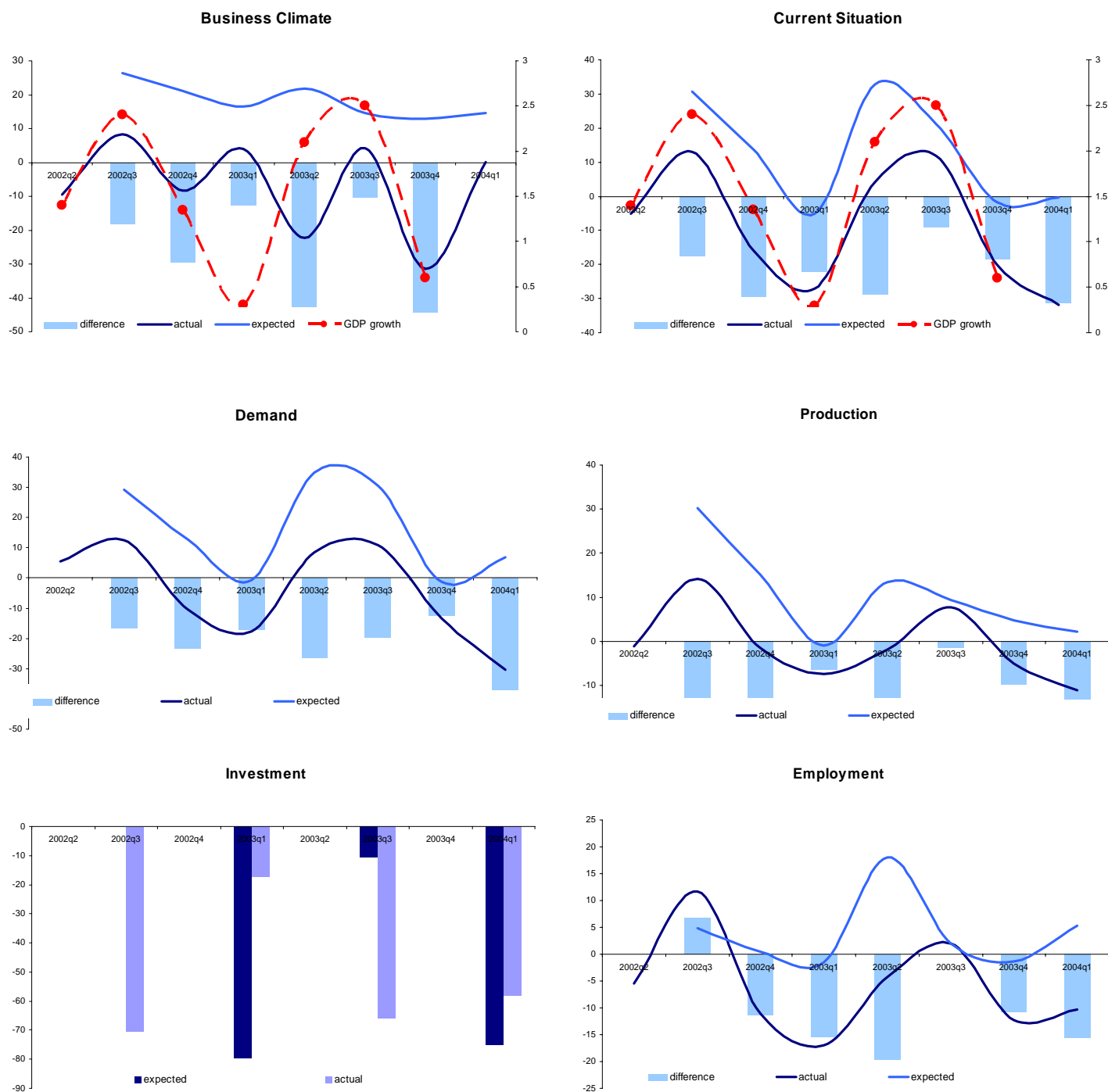


Fig. 7: Economy (% of differences between yes and no answers)