

# IS INFLATION TOO LOW IN ALBANIA? MACROECONOMIC FOUNDATIONS AND SOCIO-ECONOMIC DEVELOPMENT

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*Jan-Peter Olters\**

Thus once the inflation genie has been let out of the bottle it is a very tricky policy problem to find the particular calibration and timing that would be appropriate to stem the acceleration in risk premiums created by falling incomes without prematurely aborting the decline in the inflation-generated risk premiums. This is clearly not an easy policy path to traverse but it is the path we must follow.

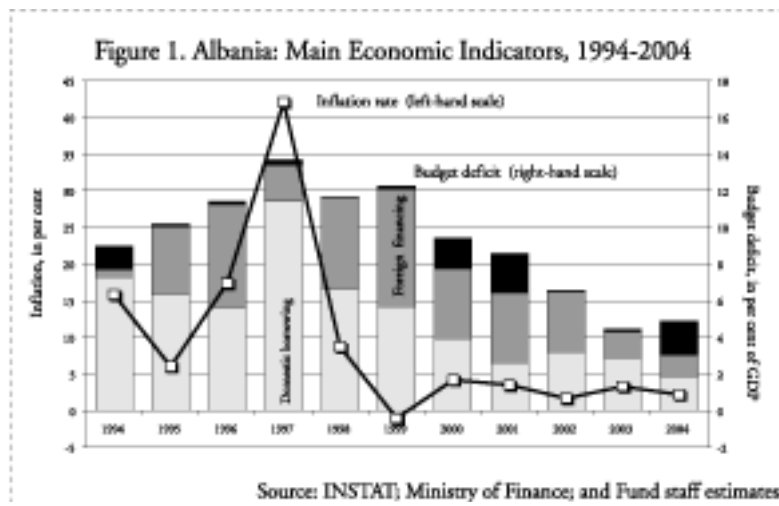
*—Alan Greenspan (1974)*

## 1 INTRODUCTION

In recent staff reports, the International Monetary Fund (IMF) has consistently commended Albania's authorities for achieving and maintaining a low-inflation environment and for safeguarding the external value of the lek. However, rather than "reflecting increased confidence" (IMF 2005:5), a number of observers<sup>1</sup> have regarded the domestic currency's strength to be inconsistent with the country's narrow domestic production base, its high trade deficits, and hesitant foreign direct investments. Instead, they have viewed the lek as being "overvalued", thereby risking either an abrupt correction of the exchange rate or—in case the current trend continues—a gradual decline in international competitiveness. If confirmed, the uncertainty of an "excessively" volatile nominal exchange rate or the

additional costs borne by businesses as a result of an “artificially” overvalued currency will dampen investments<sup>2</sup> and detrimentally affect Albania’s medium-term growth prospects. Subsequently, the superlek’s perceived potential to damage the prospects of, particularly, the export sector (principally textile re-exports and tourism), import-competing industries (e.g., agriculture, agro-processing, and breweries), and banks (given the large percentage of foreign-currency denominated credits) have challenged the recently elected Bank of Albania (BoA) Supervisory Council to convey its view on whether monetary policy has, in fact, become too tight in Albania.

It is important to keep in mind that the BoA targets inflation, not the exchange rate. In the aftermath of the collapse of the pyramid schemes in 1997 (Jarvis 2000, Bezemer 2001), central bank independence was embodied in Law No 8269 (“On the Bank of Albania”) of 23 December 1997, obliging the BoA to pursue monetary policy with the principal objective “to achieve and maintain price stability” (Art. 3). Without undue political interference (and supported by a programme of gradual fiscal consolidation), the BoA was able to take appropriate steps to re-establish an environment of relative price stability (Figure 1). As a result, expectations adjusted, with the public slowly (re)gaining some confidence in the lek. The adequate institutional response to the—rumour-based—bank run in 2002 (Cani



and Hadëri 2003), demonstrating (ex post) the banking sector's new-found resilience to external shocks, as well as the successful privatisation of the market-dominating Savings Bank to a foreign, regionally active commercial bank in 2003/04, helped Albanians to overcome some of their widespread distrust of banks. Deposits grew, accordingly, by an average of almost 6 per cent of GDP in 2003 and 2004, domestic currency outside banks as a share of broad money declined from 32 to 27 per cent during the same two-year period, while the lek increasingly functioned in its role as the country's nominal anchor. The government's decision to pay government employees through the banking sector will be reinforcing these developments.

Throughout 2004, the 12-month inflation rate has been converging towards the floor of the informal 2–4 per cent target range,<sup>3</sup> thereby permitting an interpretation of the lek's strength being a reflection of an "overly tight" overall monetary framework. The adequate policy response, if any, thus hinges on the correct interpretation of the lek's trend appreciation vis-à-vis the two base currencies—the euro and the US dollar—as either a (temporary) misalignment or a (sustainable) equilibrium outcome. There are a number of reasons that could—perceivably—explain an "overvaluation" of the lek. Alternatively, a change in production methods, including in the sectors dominated by small and medium-sized enterprises, could have found its reflection in the lek's exchange rate—if productivity increases in the tradable goods sector did indeed exceed those measured in the economies of Albania's principal trading partners. In that case, consistent with Balassa's (1964) and Samuelson's (1964) model predictions, a further, gradual trend appreciation of Albania's currency would have to be expected. Contrary to widely held perceptions, the "strong" lek would not harm international competitiveness as it reflected a sustainable equilibrium outcome caused by factors endogenous to Albania's economy, such as investment-induced increases in factor productivity—signifying the progress that Albania's private sector is making in developing towards a viable and more mature market economy. In that case, of course, there would not be any need for the BoA to contemplate countermeasures.

Inversely, assuming the current monetary framework—for some reason—reflects exogenous, non-sustainable factors, the question

remains as to what would constitute an “excessively” tight monetary framework that would justify a BoA Board decision to adjust upwards the inflation target range. This would, in principle, be the case if (i) the economy were provided with insufficient—or prohibitively expensive—credits, thereby placing “unnecessary” costs on the private sector and, in turn, impeding the realisation of productivity-enhancing investments or (ii) the market could not adjust its relative prices without resorting to a nominal exchange-rate appreciation, which would increase the prices of goods and services produced by Albanian exporters and import-competing industries. Several economists have argued along those lines. Wachtel and Korhonen (2004), for instance, concluded that “Albania may find itself in the quandary where it can maintain low inflation ... or complete the process of market liberalization but not both simultaneously” (p.22). Against this background, the paper will attempt to contribute to the ongoing discussion of whether or not there is any economic case for raising the current inflation objective.

## 2 INFLATION AND GROWTH

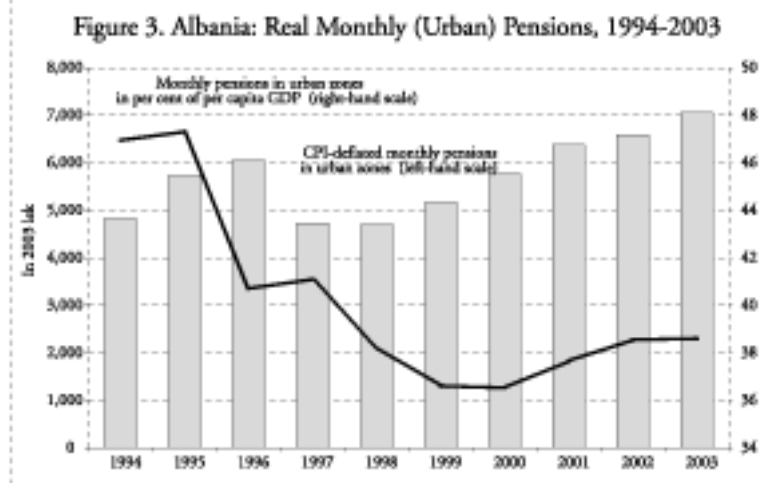
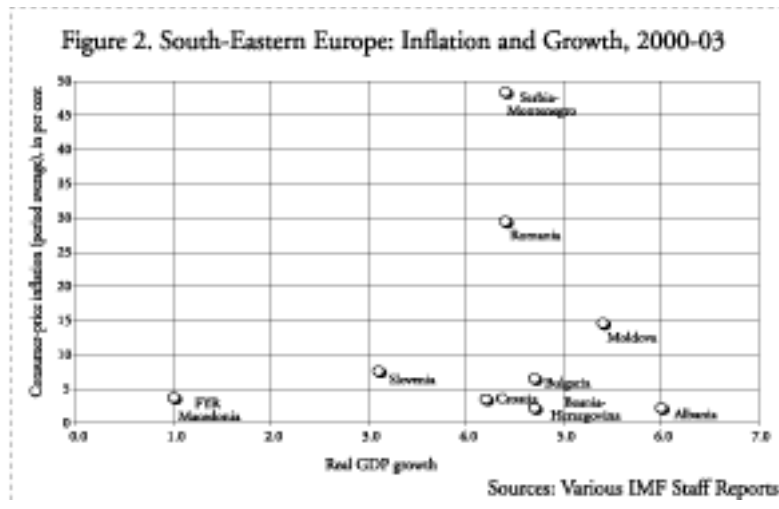
International experiences of central bank independence—and price stability as sole policy objective—have shaped the design of organic central bank laws in many transition economies, including Albania. Cukierman et al. (2002), who empirically confirmed the negative correlation between legal central bank independence and inflation for 26 transition economies (including Albania), concluded that the average level of legal independence of the new central banks of economies in transition was substantially higher than that of developed economies during the 1980s, reflecting the gradual shift in the professional consensus among economists and policy-makers in favour of central bank independence.

Decades of economic research on politicians’ ability to exploit an allegedly stable Phillips-Curve relationship between unemployment and inflation and, more broadly, on the effects of inflation on economic performance eventually culminated in this change of opinion. It has become evident that achieving and maintaining price stability was not an objective in itself but simply a means

to encouraging growth and, ultimately, ensuring higher living standards. From both a theoretic and empirical point of view, the intractable challenge consisted of capturing the “unobservable benefits” of low inflation (Ragan 1998) that would explain the small but permanent effects<sup>4</sup> on growth, typically thought to derive from the improved ability of market participants to utilise price signals to allocate resources efficiently. In addition, low inflation rates were found to (i) reduce the risk of an arbitrary redistribution of income and wealth to the detriment of fixed-income earners and lenders<sup>5</sup>; (ii) help market participants to increase certainty in the expectation of future prices, interest rates, and exchange rates and, consequently, to lengthen their planning horizons; (iii) permit firms to utilise their scarce resources to create rather than protect wealth; (iv) minimise additional distortions to the—nominally based—tax system<sup>6</sup>; and (v) signal to market participants, including (foreign) investors, that public institutions function properly and key macroeconomic variables are in a state of balance.

For these reasons, it is not surprising to see that the low inflation environment in Albania has proven to be consistent with dynamic growth. Compared to other countries in the region, Albania’s average GDP growth rate of about 6 per cent during 2000–03 has exceeded that of any other country, while its average annual price increases of 2.2 per cent were lower than those observed in the other countries (Figure 2). In addition, and contrary to the implications of the Phillips Curve-based political business cycle and their rational expectations-based successor models,<sup>7</sup> the low inflation environment appears to have been beneficial to the most disadvantaged segments of society, particularly those relying on fixed incomes (these, incidentally, are the households with the highest propensity to consume domestically produced goods and services, thereby supporting the development of small- and medium-sized businesses). As a result, the deterioration of pensioners’ relative position within the country’s income distribution was halted (Figure 3): during 1995–98, with an average inflation of 18½ per cent, urban pensions, as a share of per capita GDP, decreased annually by 4.8 per cent—from 47.3 in 1995 to 38.2 per cent in 1998. By contrast, during 2000–03, with an average inflation of 3.2 per cent, urban pensions increased by an average 0.5 per cent—from 36.5 per cent in 2000 to 37.4 per cent in 2003.

In addition, the still very large amount of cash savings—in 2004, average per capita holdings of domestic cash exceeded the equivalent of 300—amplify Albanian households' exposure to unanticipated increases in the inflation rate.



### 2.1 Inflation Expectations

Over the course of the previous quinquennium, having moved towards indirect instruments of monetary policy, the BoA has

demonstrated its ability—and willingness—to take appropriate measures to ensure that inflation rates would stay within, or move back into, the pre-specified band. In addition, rather than feigning monetary stability with the help of a currency peg, Albania’s authorities sought to effect inflation expectations under the constraints of a flexible exchange-rate regime. This instilled confidence into the post-1997/98 disinflation programme and ensured that, as a consequence, Albania’s price level changes gradually approached those prevailing in the pre-accession European Union (EU); see Figure 4.<sup>8</sup> The annual average inflation between 1999 and 2004 averaged 2.2 per cent in Albania, as compared to 1.9 per cent in the EU-15 countries.



The consistency in policy outcomes has enhanced the credibility not only of Albania’s central bank but also of the chosen policy instrument, as informal inflation targeting helped to increase the overall efficiency and transparency in the implementation—and public assessment—of monetary policy. Thus, within the low-inflation environment that—after two short-lived, high-inflation episodes<sup>9</sup> during the initial transition period in the early 1990s and in the aftermath of the collapse of the pyramid scheme in 1997—has prevailed in Albania, researchers managed to establish significant empirical relations between inflation and basic explanatory variables (in particular, money supply and the exchange rate); see Domaç and Elbirt (1998), Kalra (1999), Samiei (2003), and Muço et al. (2004). The

key findings by Muço et al. (2004)—viz., that “the move during 2000 from direct to indirect instruments of monetary control has been associated with greater predictability of the transmission link from money supply to inflation”—is consistent with Samiei’s estimation results,<sup>10</sup> which were thought to be “surprisingly supportive of a Taylor-type reaction function.” Such a result implies that the BoA “has been acting systematically in response to inflation and activity” (p. 63), permitting agents to form price expectations consistent with the BoA’s pre-announced policy objective.

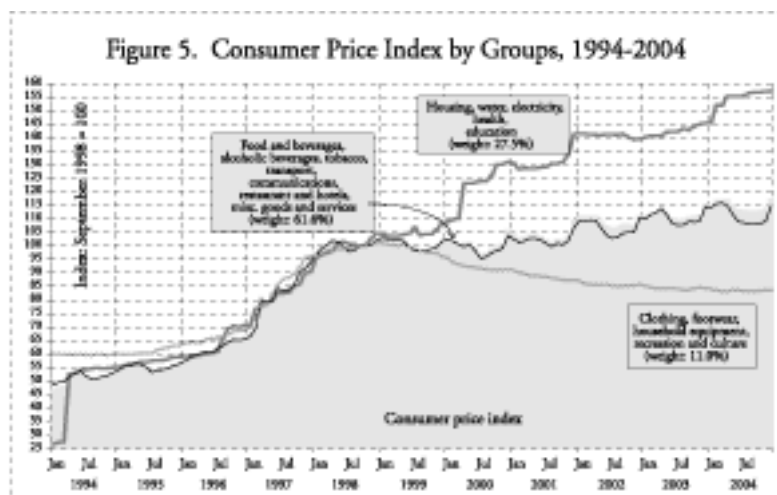
### 2.3 The Effects of Structural Reforms and Remittances on Inflation

In recent years, the two most important factors affecting inflation rates in Albania were (i) structural reforms in regulated industries, in the context of which tariff increases were introduced to bring them broadly in line with cost recovery; and (ii) seasonal changes in supply conditions for, particularly, the agricultural sector.

With the exception of (waste) water, Albania has principally concluded the process of price liberalisations. The latest increase in electricity tariffs has resulted in a price structure that, as of 2005, broadly corresponds to production costs. Contrary to recent years, this should preclude further significant, liberalisation-induced price increases in the foreseeable future. Following the—ultimately reversed—hikes in telephone tariffs in December 2003, prices in the telecommunications sector are, if anything, expected to decrease over the medium term—partly due to the scheduled privatisation of the fixed-line company and the potential competition from a third mobile operator.

In the aftermath of the post-pyramid turmoil in 1998, with overall inflation rates stabilising, price developments in different sectors began to differentiate. As summarised in Figure 5, prices of imported commodities—clothing, footwear, household equipment, home entertainment items, etc.—reflected the appreciating lek and declined by an annual average of 2.5 per cent during 2001–04. Items with a large share of domestically produced items increased by an annual average of 2.9 per cent, broadly in line with overall price-level changes (3.4

per cent). By contrast, prices in the traditionally public sectors—partly because of restructuring programmes (electricity) and the provision of private alternatives (health and education)—increased by an annual average of 6.1 per cent during the same period of time.

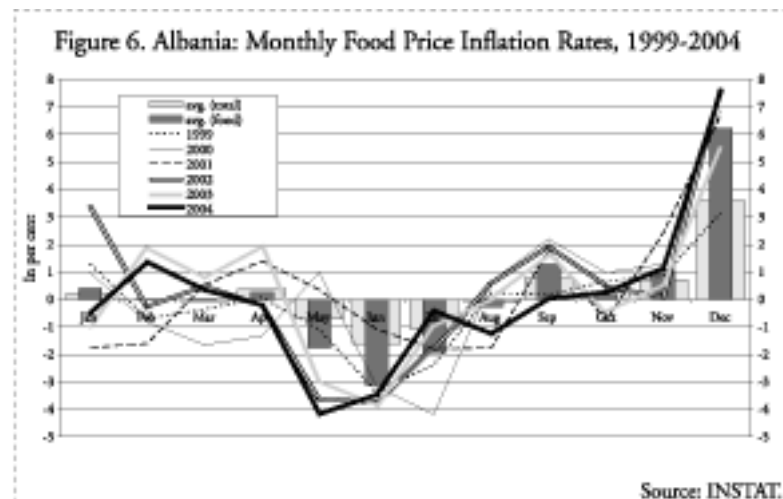


The banking sector, in particular, underwent considerable changes in recent years. The combination of (i) low inflation; (ii) gradual fiscal consolidation; (iii) the deepening of financial intermediation; and (iv) the additional liquidity made available by the privatisation of the publicly-owned Savings Bank (which did not lend) resulted in increased availability of credits and reduced financing costs for investments. As a result, credit to the economy increased by more than 30 per cent during the last three years—and that even prior to the largest bank entering the market in about mid-2004—benefiting from the mixture of a large supply of relatively inexpensive foreign-currency-denominated credits and a strong lek. As a result, several of the import-competing industries managed to expand their market shares, as reflected in the improving trade balance, and helped to dampen price increases in these sectors.

The second important inflation feature has been the traditionally high—and consistent—seasonality in prices; see also Domaç and Elbirt (1998). The monthly inflation rates observed in September and December (averaging, respectively, 0.8 and 3.6 per cent during 1999–

2004) stand in stark contrast to the average 0.2 per cent deflation rate for all the other months (Figure 6). The marked seasonality reflects (i) the importance of agriculture in domestic production (representing an average 27 per cent of GDP in 1999–2004); (ii) infrastructure bottlenecks in transport and storage; and (iii) market imperfections surrounding the import and distribution of vegetables and turkey.

The concentrated inflows of emigrant remittances and tourism receipts—both characterised by bipolar distributions with peaks in summer and December—has reinforced this seasonal pattern, as evidenced by the monthly changes in inflation and nominal exchange rates (Figure 7). Data reflect closely reflect the fact that émigré Albanians tend to visit their families during summer and/or at year’s end, during which time they bring—typically euro-denominated—remittances into the country. Together with highly seasonal tourism demand, the foreign-currency incomes earned during the summer months are exchanged and partly consumed with a one-month delay. By contrast, Albanian families appear to “pre-finance” the purchases for the end-year festivities, thereby causing the consistent December peak in monthly consumer prices and the January depreciation of the exchange rate. This behavioural pattern is clearly reflected in monetary data, certainly for the period immediately preceding the Savings Bank privatisation (2002–03), with deposit withdrawals and an increased circulation of domestic currency visible in December and reversed in January (Table 1).



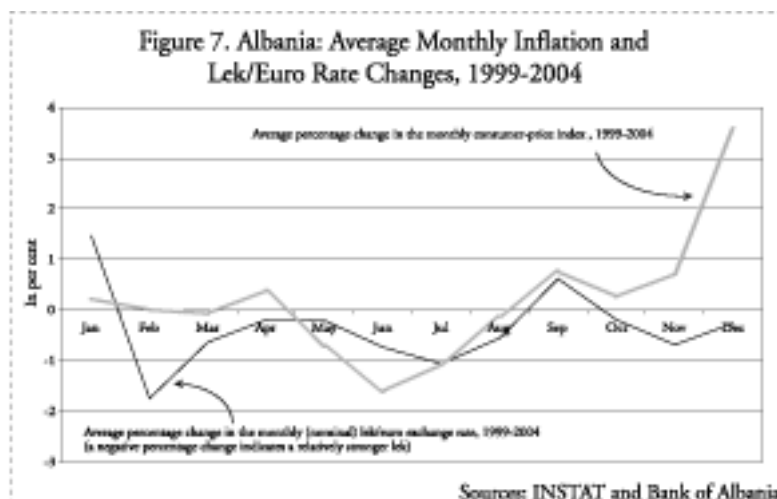


Table 1. Albanian Factors Explaining Year-End Inflation, 2002-04

	2002			2003			2004		
	Jan	Feb-Nov	Dec	Jan	Feb-Nov	Dec	Jan	Feb-Nov	Dec
Average monthly changes in (In percent)									
Consumer price inflation	1.5	-0.3	3.2	-0.2	0.0	3.1	-0.2	-0.1	3.1
Nominal euro exchange rate	-0.4	-1.0	-0.5	-1.5	0.4	0.9	-0.1	0.5	0.6
Nominal dollar exchange rate	-1.4	0.2	1.5	2.5	1.3	6.3	2.3	0.8	3.8
Average monthly changes in (In billions of lek)									
Lek deposits	4.1	0.1	-0.7	5.5	3.0	-0.5	5.3	9.7	14.0
Foreign currency deposits	2.3	0.0	-4.8	0.2	0.8	-2.0	2.5	7.8	6.6
Domestic currency outside banks	-3.6	1.0	5.2	-4.9	-0.5	4.5	-3.4	0.6	15.7

Sources: Albanian authorities and Fund staff estimates.

### 3 WHAT EXPLAINS THE LEK'S APPRECIATION?

In the public debate, the most frequently raised concern relates to the effects of the low-inflation environment on the exchange rate and, subsequently, on Albania's medium-term growth potential. In recent years, with inflation being safely within the target range, the lek appreciated vis-à-vis the US dollar and the euro, both in nominal and real terms. In 2004, the lek's external value increased by an average 3.5 per cent in nominal terms relative to the euro—and by 4.8 per cent if adjusted for the changes in price levels. The comparable figures for the US dollar are 36.5 and 36.9 per cent, respectively (Figures 8 and 9). The lek's appreciation occurred despite repeated BoA interventions in favour of foreign currencies and a 325-basis-

point reduction in the official interest rate between early 2003 and end-2004. That is, from a macroeconomic point of view, there are no indications of an attempt by the monetary authorities to “artificially” raise the lek’s external value beyond a sustainable level—to the contrary, the BoA has consistently eased monetary conditions once price developments and the overall economic environment permitted such a step. Given Albania’s flexible exchange-rate regime, and in the complete absence of foreign exchange rationing, official foreign reserves have continued to cover a comfortable 4 months of imports of goods and services throughout 2000–04.



There appear to be essentially two possible causes that would explain the strength of Albania's currency—viz., (i) a (possibly temporary) surge of remittances and other cash inflows; and (ii) improvements in productivity in the tradable goods sectors that—in line with the predictions of the Balassa-Samuelson model—would have caused a real exchange rate appreciation.

### 3.1 Supply and Demand of Foreign Currency

Especially if expressed in relation to overall economic activities, Albania's balance of payments has shown (i) a consistent improvement in the current account; (ii) a gradual decline in the capital-account surplus; (iii) an increasing net inflow of foreign currency as a result of non-registered economic activities; and (iv) a rise in the overall balance-of-payments "surplus"; see Table 2. With remittances having increased moderately and consistently from about 13 per cent of GDP in 2001 to an estimated 13¾ per cent in 2004, the improvements in the current account therefore largely reflect Albanian enterprises' increased ability to place their products in foreign and domestic markets (see below). As indicated by the trend in "errors and omissions", and given the high prevalence of cash-based transactions even among businesses, there are indications that official data considerably underestimate the speed by which Albanian enterprises have succeeded in gaining market shares and/or the increase in private transfers sent by emigrants to their families. The 2004 Olympic Games in Greece have provided Albanians emigrants with important—but strictly temporary—employment opportunities, particularly in the booming construction sector.<sup>11</sup> The one-off remittances, typically cash-based, from this particular source of income would seem to be reflected in the "net errors and omissions" figure for 2004.

Therefore, in assessing the sustainability of the increasing net capital inflows—as reflected in the lek appreciation—, not only the estimation of the actual size of the Olympics effect but also the longer-term issues of declining levels of foreign aid, including foreign-financed public investments, and low levels of (foreign) direct investments require further attention, which all would suggest a lek depreciation in the months and years to come.<sup>12</sup>

Table 2. Albania: Balance of Payment Trends, 1998-2004

	1998	1999	2000	2001	2002	2003	2004 Est.
	(In millions of euro)						
Current account	-175	-256	-297	-299	-462	-415	-429
Capital account	89	206	346	315	431	399	347
Net error and omissions	100	24	52	121	50	105	266
Net balance	14	-26	101	142	19	87	190
	(In per cent of GDP)						
Current account	-7.1	-7.9	-7.4	-6.4	-9.7	-8.2	-6.9
Capital account	3.6	6.4	8.6	6.9	9.1	7.9	5.7
Net error and omissions	4.1	0.8	1.3	2.7	1.1	2.0	4.4
Residuals	16.08	9.90	11.89	13.90	13.35	13.71	13.80
Net balance	0.6	-0.8	2.5	3.1	0.4	1.7	3.1

Source: Bank of Albania and IMF staff estimates.

### 3.2 Productivity Increases and (Real) Exchange Rate Appreciations

The “catch-up” process of transition countries—reflected in growth rates higher than those in more advanced economies—needs to be based on comparably faster increases in capital/labour ratios and total factor productivity, particularly in the tradable sectors, to remain sustainable. The corresponding increase in labour productivity in the tradable good sectors is reflected in rising wages—however, not only in those: as long as labour is mobile across sectors, wages in the non-tradable sectors will rise as well and result in inflation differentials with more advanced economies and/or a real, CPI-based appreciation of the domestic currency. Available data on the development of average salaries in the various industries are very unreliable, largely because of the high prevalence of cash transactions, the ubiquity of fiscal evasion, and the large size of Albania’s informal sector (Olters

Table 3. Albania: Average Monthly Salary, 1997-2002

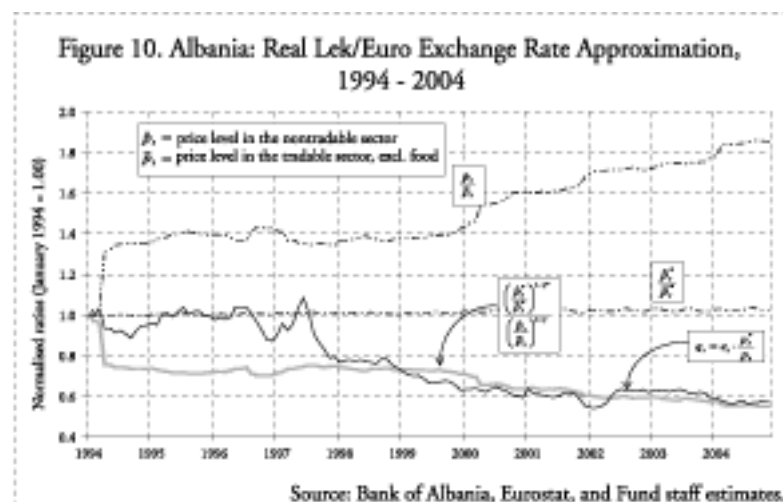
	1997	1998	1999	2000	2001	2002
Industry	9,411	10,792	12,203	13,230	14,839	15,882
Nontradable sectors (average)	8,581	10,568	11,765	13,154	14,384	16,766
Construction	8,340	10,617	10,936	12,489	13,616	15,014
Transport and communication	9,359	11,744	14,589	16,325	18,124	23,434 <sup>1/</sup>
Trade	8,839	9,633	10,901	10,889	12,856	13,934
Services	7,834	11,856	10,718	13,012	13,140	14,453
Industry wages in per cent of NT avg.	109.7	98.4	103.7	100.6	103.2	95.1

Source: INSTAT and Fead staff estimates.

<sup>1/</sup> The large increase in wages paid in communication represents the private, foreign-owned mobile operators.

2003, Muço and Sanfey 2004, Christie and Holzer 2005). Still, the officially published wage data appear to point towards the possibility that this key Balassa-Samuelson assumption would hold (Table 3 and Vladkova-Hollar 2003):

While not conclusive, first indications are that data are not incompatible with a Balassa-Samuelson-type interpretation of the 2003–04 recent lek appreciation. If supported by future research, such a result would indeed reflect productivity improvements in the tradable sector in excess of those in the euro zone—rather than “artificially” induced, short-term phenomena. Data show—as predicted by the Balassa-Samuelson model—a correspondence between the quotient in the relative price ratios and the real exchange rate, implying that the lek’s real appreciation is in line with the increase in the productivity differential transmitted to the CPI through the nontradable inflation pass-through (Appendix). Figure 10 visualises preliminary results for Albania, indicating that (i) productivity increases in the tradable sectors<sup>13</sup>, after about five years of stagnation, appear to have taken hold in about 2000; see equation (A5) and  $\hat{P}_t / \vec{P}_t$ -graph; and (ii) the CPI-deflated lek/euro exchange rate increasingly approximates the quotient in the relative price ratios as stipulated in equation (A9). However, the inclusion of food prices into the basket of tradables loosens the correlation between these two time series considerably.



To support this hypothesis, several critical questions need to be answered, apart from the role that food prices play. Among the critical ones are those related to the interpretation of January 1994 resembling—as closely as possible—an equilibrium in both Albania and the EU-15 countries. Second, further analysis is required to explain the apparent acceleration in productivity increases in 2000 (Figure 11), partly stemming from the rehabilitation and modernisation of the energy sector, which required repeated increases in tariffs to be able to recover costs and, up until end-2004, budgetary subsidies to finance energy imports.

A Balassa-Samuelson-type explanation of the exchange rate seems broadly consistent with available macroeconomic indicators. The reduction of the trade deficit from almost 26 per cent of GDP in 2002 to a projected 23 per cent in 2004 is consistent with the interpretation of the productivity-driven real exchange rate appreciation.

In particular, the fact that the share of Albanian exports of goods and services—while still at a very low base—has increased not only in per cent of GDP but also as a share of world exports (from 0.011 per cent in 2000 to an estimated 0.017 per cent in 2004-S1) would support the indications of the improved international competitiveness of Albanian companies and their ability to “catch up” with those operating in other economies. In addition, several import-competing industries—such as agricultural greenhouse production, vineyards, or breweries—have made considerable inroads in expanding their domestic market share, notwithstanding the exchange rate effects and the reduction in customs duties, including on imported beer.

A large empirical literature has developed testing the degree to which the Balassa-Samuelson effects cause productivity-based exchange-rate movements in transition economies, with most authors having established clear evidence of such a link. According to Halpern and Wyplosz (2001), the adoption of a flexible exchange rate regime strengthens the Balassa-Samuelson effect. According to their “guesstimate,” based on a panel of nine transition countries (excluding Albania) during 1991–99, the implied average annual rate of real appreciation lies at around 3 per cent. De Broek and Sløk (2001) found the clearest evidence of a Balassa-Samuelson effect

in the EU accession countries, with evidence being less strong in other transition countries (including Albania), as most of them had not experienced extended periods of productivity growth. Still, “the analysis tentatively suggests that as these countries embark on a path of sustained growth, they will also experience real exchange rate appreciations” (p. 15). Similar results were also generated for individual countries with fixed exchange rates; cf., e.g., Estonia (Égert 2003) with its currency board, or Slovenia (Žumer 2002), which joined the ERM-2 mechanism in mid-2004. However, contrary to countries with a flexible exchange rate regime (like Albania), the Balassa-Samuelson effect in those instances manifests itself through correspondingly higher inflation rates and not a nominal exchange-rate appreciation. Combined with the temporary depreciation pressure stemming from the factors described in Section 3.1, the relative productivity increases of Albanian companies relative to their international competitors would result in a gradual but more permanent appreciation. These two factors combined would imply—*ceteris paribus* and excluding seasonal factors—that the lek, in the immediate future, will remain relatively constant before starting to appreciate again.

#### 4 IS INFLATION TOO LOW IN ALBANIA?

Even though the analysis is not sufficiently rigorous to permit a formal hypothesis of the existence of a productivity-driven exchange rate appreciation, it provides for a useful reference to be cross-checked with the development of the lek’s exchange rate over the next few months and years. Its course will indicate the degree to which productivity increases in the tradable goods sector explain the strength of Albania’s currency. A Balassa-Samuelson-type interpretation of the recent trend appreciation implies a further, gradual strengthening, whereas short-term factors—if they were indeed the main reasons behind the increase in the lek’s external value—would result in a “correction” of the exchange rate. The modest weakening of the lek vis-à-vis the euro that occurred during the first months of 2005 is consistent with typical seasonal fluctuations in the nominal exchange rate and, as such, not a clear indication (yet) of either hypothesis.

More broadly, however, there are no indications why Albania could—and should—not maintain a low inflation environment while simultaneously completing its structural reform agenda. With the exception of water, Albania has concluded the process of price liberalisations (the new electricity tariffs imply that prices will—as of 2005—broadly correspond to production costs). Contrary to recent years, this will preclude significant, liberalisation-induced inflation spouts in the future. The central bank—together with the affected commercial banks—has skilfully managed the aftermath of the 2002 bank run, further increasing the credibility of its policy commitment to the 2–4 per cent inflation target range, already 2 percentage points higher than the comparable one used by the European Central Bank. As a result, it was possible to induce a sceptical public to entrust its savings to the banking sector. Thus, against the backdrop of consistently low inflation, the BoA could decrease its policy rate, supporting the—now entirely privately owned<sup>14</sup>—commercial banking sector in expanding credit to the economy, stimulating additional private-sector investment and maintaining economic growth at its currently high level. The considerable fluctuations in monthly inflation rates represent a large agricultural sector, important inflows of remittances, infrastructure bottlenecks in transport and storage, and market imperfections surrounding the import and distribution of agricultural products. Property restitution, banking sector reforms, road investments, and improvements in public administration will help to minimise the existence of supply bottlenecks and create sufficient upward buffers to the current inflation target range.

Nonetheless, even in a situation, in which the appreciating lek has been caused by increases in productivity and, as a result, does not forebode an erosion to Albania’s international competitiveness, further progress on structural reforms will need to be made to address supply-side bottlenecks. Against the backdrop of prudent fiscal and monetary policies, the central bank has been able to support businesses by reducing both the real costs of credits (without curtailing their supply) and—through interventions aimed at supporting the foreign reserve cover—the variability in the short-term fluctuations in the exchange rate. From a macroeconomic point of view, there do not appear to be indications of “too tight”

a monetary framework. To further support businesses in their activities, including exporters and import-competing industries, the government needs to more actively engage in what German-speaking economists call *Standortwettbewerb*—i.e., the competition among countries to provide a sufficiently favourable business environment to be able to attract (foreign) direct investments—a precondition for growth, job creation, and poverty reduction. This objective can be realised, but not at the expense of, or by resorting to, higher inflation.

The theoretical and empirical problems in quantifying the permanent effects of low inflation on growth are compounded by data weaknesses in Albania. Sustaining high growth—key to achieving the country’s poverty-reduction objectives—is conditional on attracting high-quality, productivity-fostering investments in key sectors. Against the background of still existent infrastructure deficiencies and governance problems, the maintenance of a macroeconomic equilibrium and, particularly, a low inflation environment with a stable currency has been a key factor in the government’s success in attracting key investors (e.g., in the banking sector). Albania’s authorities have no alternative but to accelerate the implementation of their structural reform agenda in order to overcome as quickly as possible already identified as obstacles to investment and private-sector activities.

#### APPENDIX. THE BALASSA-SAMUELSON MODEL

The simplified Balassa-Samuelson model is based on the assumption that the purchasing-power parity holds for traded goods, seeking to provide a supply-side explanation for (i) the relative price developments of tradables and non-tradables; (ii) the differences in price levels between countries with different levels of development; and (iii) the long-run behaviour of the consumer price-deflated real exchange rate (see Égert et al. 2002).

Each economy is assumed to produce two kinds of goods, with profit-maximising firms producing both tradable and non-tradable goods. Both sectors produce commodities according to a standard, constant-return-to-scale production functions:

$$(A1) \quad \bar{Y}_t = \bar{A}_t \cdot \bar{L}_t^\alpha \cdot \bar{K}_t^{1-\alpha}, \quad 0 < \alpha < 1,$$

$$(A2) \quad \hat{Y}_t = \hat{A}_t \cdot \hat{L}_t^\beta \cdot \hat{K}_t^{1-\beta}, \quad 0 < \beta < 1,$$

with  $Y_t = \bar{Y}_t + \hat{Y}_t$ . The variables  $Y$  (output),  $A$  (total factor productivity),  $L$  (labour), and  $K$  (capital) follow standard denotation, with the embellishments “ $\bar{\phantom{x}}$ ” and “ $\hat{\phantom{x}}$ ” differentiating the production of tradable and non-tradable commodities, respectively. Prices of tradables and interest rates are determined in the world market. Because of domestic labour mobility, wages are set by the higher-productivity sector (typically the tradable goods sector). The assumptions underlying the Balassa-Samuelson effect result in an internal transmission mechanism from productivity growth in the tradable sector towards price increases in the non-tradable sector and inflation. By combining equations (A3) and (A4),

$$(A3) \quad \frac{\partial \bar{Y}_t}{\partial \bar{L}_t} = \alpha \cdot \bar{A}_t \cdot \left( \frac{\bar{K}_t}{\bar{L}_t} \right)^{1-\alpha} = \frac{w}{\bar{p}_t},$$

$$(A4) \quad \frac{\partial \hat{Y}_t}{\partial \hat{L}_t} = \beta \cdot \hat{A}_t \cdot \left( \frac{\hat{K}_t}{\hat{L}_t} \right)^{1-\beta} = \frac{w}{\hat{p}_t},$$

it follows that

$$(A5) \quad \hat{p}_t = \frac{\bar{A}_t}{\hat{A}_t} \cdot \bar{p}_t \cdot \frac{\alpha \cdot \left( \frac{\bar{K}_t}{\bar{L}_t} \right)^{1-\alpha}}{\beta \cdot \left( \frac{\hat{K}_t}{\hat{L}_t} \right)^{1-\beta}}, \quad \text{with } \frac{\partial \hat{p}_t}{\partial \hat{A}_t} > 0,$$

implying that productivity advances in the tradables sector—which, by definition, do not have any impact on tradable price developments—will result in an increase in the relative price of non-tradables and, in turn, the country’s overall price level.

Differences in tradable sector productivities therefore determine differences in inflation rates between countries at different stages of development, given that the purchasing-power parity was assumed to

hold for tradable goods. This implies for countries in the process of catching up with more advanced economies that ceteris paribus their currencies will undergo a concomitant—and unavoidable—process of real, CPI-based appreciation. From (A5) it follows that

$$(A6) \quad \frac{\frac{\hat{p}_t}{\bar{p}_t}}{\frac{\hat{p}_t^*}{\bar{p}_t^*}} = \frac{\frac{\bar{A}_t \cdot \alpha \cdot (\bar{K}_t / \bar{L}_t)^{-\alpha}}{\hat{A}_t \cdot \beta \cdot (\hat{K}_t / \hat{L}_t)^{-\beta}}}{\frac{\bar{A}_t^* \cdot \alpha \cdot (\bar{K}_t^* / \bar{L}_t^*)^{-\alpha}}{\hat{A}_t^* \cdot \beta \cdot (\hat{K}_t^* / \hat{L}_t^*)^{-\beta}}},$$

showing that the difference in the price ratio between two countries is given by the difference in their productivity ratios. Thus, in order to demonstrate the link between changes in productivities, inflation, and exchange rates, the standard definition of the real exchange rate,

$$(A7) \quad q_t = e_t \cdot \frac{p_t^*}{p_t},$$

with  $q_t$  ( $e_t$ ) representing the real (nominal) exchange rate, will be used. With the overall price level equalling

$$(A8) \quad p_t = \bar{p}_t^\gamma \cdot \hat{p}_t^{1-\gamma} \quad \text{and} \quad p_t^* = \bar{p}_t^{*\gamma} \cdot \hat{p}_t^{*1-\gamma},$$

and assuming that, for tradable goods, the purchasing power parity holds, i.e., , the real exchange rate can be expressed as

$$(A9) \quad q_t = e_t \cdot \frac{p_t^*}{p_t} = e_t \cdot \frac{\bar{p}_t^*}{\bar{p}_t} \cdot \frac{\left(\frac{\hat{p}_t^*}{\bar{p}_t^*}\right)^{1-\gamma^*}}{\left(\frac{\hat{p}_t}{\bar{p}_t}\right)^{1-\gamma}} = \frac{\left(\frac{\hat{p}_t^*}{\bar{p}_t^*}\right)^{1-\gamma^*}}{\left(\frac{\hat{p}_t}{\bar{p}_t}\right)^{1-\gamma}} = \left( \frac{\left( \frac{\bar{A}_t \cdot \alpha \cdot (\bar{K}_t / \bar{L}_t)^{-\alpha}}{\hat{A}_t \cdot \beta \cdot (\hat{K}_t / \hat{L}_t)^{-\beta}} \right)^{1-\gamma}}{\left( \frac{\bar{A}_t^* \cdot \alpha \cdot (\bar{K}_t^* / \bar{L}_t^*)^{-\alpha}}{\hat{A}_t^* \cdot \beta \cdot (\hat{K}_t^* / \hat{L}_t^*)^{-\beta}} \right)^{1-\gamma^*}} \right)^{-1}$$

From (A9) it follows that, for the Balassa-Samuelson hypothesis to hold, data should show (i) a negative relationship between the difference in the relative price ratios and the real exchange rate; (ii) a real appreciation in line with the increase in the productivity differential transmitted to the CPI via the non-tradable inflation pass-through.

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## ENDNOTES

\* The author is IMF Resident Representative in Albania (jolders@imf.org). The author is grateful to participants at the 5th Bank of Albania Conference for their helpful comments and to Linda Spahia for her excellent research assistance. Any remaining errors are the author's sole responsibility. This paper should not be reported as representing the views of the IMF; the opinions expressed herein are those of the author and do not necessarily represent those of the IMF or IMF policy.

<sup>1</sup> See, e.g., *Biznesi* of 25/01/05 (Politika monetare dhe ekonomia, Monetary Policies and the Economy); *Biznesi* of 21/01/05 (Rritja ekonomike dhe stabilizimi, Economic Growth and Stabilisation); *Koha Jonë* on 9/01/05 (Forcimi i lekut dekurajon eksportuesit, The Lek's Strength Discourages Exporters; and *Vlerësimi i lekut "zhvlerëson" eksportet,* The Lek's Value "Devalues" exports); *Biznesi* of 25/10/04 (Forcimi i lekut dëmton shqiptaret, The Strengthening Lek Hurts Albanians); *Korrieri* of 26/06/04 (Na duhet inflacion më i lartë, We Need Higher Inflation); or *Biznesi* of 7/03/05 (Banka Botërore kundër superleku, World Bank against superlek).

<sup>2</sup> In its latest staff report, the IMF (2005:7) stressed that, with declining rates of productivity increases, Albania needed to "to attract the strategic domestic and foreign direct investment with the scale, technology and know-how needed to spark a new growth phase based on external competitiveness."

<sup>3</sup> INSTAT reported an annual inflation rate of 2.2 per cent in 2004 (with inflation rates falling to levels below the 2 per cent floor in early 2005). Since 1999, the Bank of Albania has been orienting its monetary policy towards keeping inflation within a band of 2–4 per cent. In the context of the rapidly growing inflation-targeting discussion, Akerlof, Dickens, and Perry (1996) advocated a long-run inflation objective of around 3 per cent in order to ensure that the possible existence of market imperfections did not undermine the central bank in achieving its policy objectives. Rother (2000) argued similarly when, in the Albanian context, he concluded that it appeared "safe to suggest that an inflation target around 3 percent should be sufficient to allow for the necessary price changes" (p. 21).

<sup>4</sup> For OECD countries, Andrés and Hernando (1997), e.g., estimated that, if inflation could be permanently reduced by 1 percentage point, the steady-state level of per capita income would increase between 0.5 and 2 percentage points, depending on a number of factors, including the country's starting position. While small in any given year, the ultimate effects on living standards are considerable. Any policy decision that managed to raise the potential real growth rate, say, from 5 to 6 per cent would ensure that GDP could quadruple (rather than "simply" triple) over a 25-year period.

<sup>5</sup> Thereby limiting the supply and/or increasing the real price of credit to the economy.

<sup>6</sup> Inflation distorts the tax system primarily because it places an additional "inflation tax" on investments, the engine for self-sustained growth in transition economies. As initially discussed by Feldstein (1982), firms' expenses for depreciation and inventory are computed on nominal ("historical cost") rather than on real ("replacement cost") terms. Therefore, in an inflationary environment, tax deductions for investments are "too low" and declared profits "too high". Inflation increases the effective corporate tax rate and thereby lowers investments. In subsequent analyses, Feldstein (1997) estimates that—given the existence of the distortionary inflation tax on investment—a reduction of inflation from 2 to 0 per cent could increase GDP by 0.7 to 1 per cent annually. Using Feldstein's framework, Blaszkiewicz et al. (2002) derive similar results for transition economies (Poland and Ukraine), even though they find them to be smaller than in developed market economies, as taxation on investment is more limited.

<sup>7</sup> For a recent survey on the principal implications of the many strands in positive political economy, see Olters (2004).

<sup>8</sup> Albania is fully surrounded by countries either using the euro or having a euro-based fixed exchange rate regime—with essentially all trading partners and recipient countries of emigrants belonging to the euro zone.

<sup>9</sup> These were caused by temporary supply shocks—viz., the effects of the initial price liberalisations and of the collapse of the pyramid scheme, respectively. With respect to the former episode, the end-of-period inflation rate rose to 237 per cent following the lifting of price controls. However, as noted by McNeilly and Schiesser-Gachnang (1998), the "extremely broad scope of early

price liberalization, including the exchange rate” (p. 34) permitted inflation to fall rapidly to 6 per cent in 1995 and growth to average 9 per cent during 1993–96.

<sup>10</sup> Samiei (2003), however, stresses statistical problems with, and the short length of, data as well as the structural breaks caused by both the BoA’s move to indirect policy instruments in 2000 and the introduction of new weights to the CPI basket in 2002.

<sup>11</sup> Greece is the main country of destination for Albanians. The National Statistical Service of Greece, in its 2001 census, identified more than 438,000 resident Albanians, equivalent to about almost 15 percent of Albania’s resident population. The Government of Albania, in collaboration with the International Organisation for Migration, estimates a total of 600,000 Albanians in Greece, one-fifth of Albania’s resident population.

<sup>12</sup> Largely for this reason, the IMF (2005:3) argued in its staff appraisal that growth prospects in Albania depended crucially on attracting high quality investment and fostering export-oriented activities.

<sup>13</sup> For the purpose of this chapter, “tradables” included alcoholic beverages, tobacco and narcotics, clothing and footwear, furnishings and household equipment, and miscellaneous goods, while “non-tradables” comprised water and electricity, health, transport, communications, recreation and culture, education, as well as restaurants and hotels. The asterisk denotes corresponding variables for the EU-15 countries.

<sup>14</sup> The government still owns minority shares in two banks, which it intends to transfer to the private sector in 2005.

